European Political Economic and Security Issues

EUROPE

FINANCIAL CRISIS AND SECURITY ISSUES

PATRICK B. WERTHERS

EDITOR

NOVA

EUROPEAN POLITICAL, ECONOMIC, AND SECURITY ISSUES

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PREFACE

This book presents and discusses the financial crisis in Europe, as well as the various security issues these nations face because of this global crisis. In addition, the book also publishes chapters in area studies and comparative politics of Europe. Topics discussed herein include the European Union; a European economic recovery plan; the financial crisis; missile defense; The Lisbon Treaty; the U.S.-U.K. relationship from a historical viewpoint; and the role of the itnernational monetary fund.

Chapter 1 - The real test for European governments and institutions comes when faced with the most difficult of circumstances. At such times, they need to show imagination; they need to show determination; and they need to show flexibility. They need to show that they are in tune with the needs of families and communities across the European Union, that they are equal to the task of finding the right response to the sudden downturn in the prospects for growth and jobs in Europe.

Europe will above all be judged on results. Since this Commission took office, it has put the spotlight on the European Union's ability to deliver results for its citizens. It has targeted action on areas which will have an impact on Europeans in every corner of the EU. It has championed a partnership approach to work with the key players at every level. It has made clear that the job is not done until the impact is felt on the ground.

The current economic crisis gives another opportunity to show that Europe serves its citizens best when it makes concrete action the touchstone. Europe can make the difference.

Chapter 2 - According to the most recent National Threat Assessment, the global financial crisis and its geopolitical implications pose the primary near-term security concern of the United States. Over the short run, both the EU and the United States are attempting to resolve the financial crisis while stimulating domestic demand to stem the economic downturn. These efforts have born little progress so far as the economic recession and the financial crisis have become reinforcing events, causing EU governments to forge policy responses to both crises. In addition, both the United States and the EU likely will confront the prospect of growing economic and political instability in Eastern Europe and elsewhere over the impact of the economic recession on restive populations. In the long run, the United States and the EU likely will search for a regulatory scheme that provides for greater stability while not inadvertently offering advantages to any one country or group. Throughout the crisis, the European Central Bank and other central banks have assumed a critical role as the primary institutions with the necessary political and economic clout to respond effectively. Within Europe, national governments, private firms, and international organizations have varied in their response to the financial crisis, reflecting differing views over the proper policy course to pursue and the unequal effects of the financial crisis and the economic downturn. Initially, some EU members preferred to address the crisis on a case-by-case basis. As the crisis has persisted, however, leaders have begun looking for a systemic approach that ultimately may affect the drive within Europe toward greater economic integration.

Within the United States, Congress has appropriated funds to help recapitalize financial institutions, and adopted several economic stimulus measures. In addition, Congress likely will be involved in efforts to reshape institutions and frameworks for international cooperation and coordination in financial markets. European governments are also adopting fiscal measures to stimulate their economies and wrestling with failing banks. The financial crisis has demonstrated that financial markets are highly interdependent and that extensive networks link financial markets across national borders, which is pressing EU governments to work together to find a mutually reinforcing solution. Unlike the United States, however, where the federal government can legislate policies that are consistent across all 50 States, the EU process gives each EU member a great deal of discretion to decide how they will regulate and supervise financial markets within their borders. The limits of this system may well be tested as the EU and others search for a regulatory framework that spans a broad number of national markets. Governments that have expended considerable resources utilizing fiscal and monetary policy tools to stabilize the financial system and to provided a boost to their economies may be required to be increasingly more inventive in providing yet more stimulus to their economies and face political unrest in domestic populations. Attention likely will also focus on those governments that are viewed as not expending economic resources commensurate with the size of their economies to stimulate economic growth.

Chapter 3 - The United States and the European Union (EU) share a comprehensive, dynamic, and mutually beneficial economic relationship. Transatlantic markets are among the most open in the world and are deeply integrated. The current global economic crisis has begun to have a significant negative impact on the transatlantic economy. Nevertheless, the great stake each side has had in the other’s economy affords both sides the ability to withstand each other’s current economic down-turn. The key measure of the strength of the transatlantic relationship could be the ability of both sides to work with each other to weather the current financial storm.

One issue that has worked against a stronger economic relationship is the existence of regulatory barriers that limit an even more integrated market from materializing. The United States and the EU have engaged in a number of attempts to reduce remaining non-tariff and regulatory barriers to trade. In the most recent effort, then-President Bush and German Chancellor Merkel, serving as President of the EU, at the April 2007 U.S.-EU Summit agreed to establish the Transatlantic Economic Council (TEC). The TEC was directed to “advance the work of reducing or eliminating non-tariff barriers to transatlantic commerce and trade.” The leaders also created an advisory group to “provide guidance and direction” to the TEC and invited the U.S. Congress, along with the European Parliament, to accept a new, more substantive role in transatlantic regulatory cooperation by becoming part of the advisory group. The Transatlantic Legislators’ Dialogue (TLD) was appointed to represent the legislatures in the TEC advisory group.

Since it began nearly two decades ago, transatlantic regulatory cooperation has been mostly limited to the executive branches and regulatory bodies on both sides of the Atlantic. However, the idea of legislators assuming a more pro-active role in transatlantic economic and regulatory cooperation is not a new issue. At the 1995 launch of the New Transatlantic Agenda, the leaders of the U.S. and EU acknowledged that they "attached great importance to enhanced parliamentary links" and agreed to "consult with parliamentary leaders on both sides of the Atlantic regarding consultation mechanisms, including building on existing institutions, to discuss matters related to our transatlantic partnership." Advocates of the effort to achieve a more barrier-free transatlantic marketplace believe that ultimate success cannot be achieved without the strong commitment and active engagement of the U.S. Congress and the European Parliament.

Although the Transatlantic Legislators' Dialogue has been in existence since 1999, there appears to be a lack of familiarity with its structure, membership, and function. With respect to its role in the TEC process, several questions have been raised including the make up of the TLD, the role of the standing committees in both the Congress and the Parliament, the staff, and the role of the U.S. Senate. A number of options for reform have been proposed. This report will provide background and analysis on the TEC process, the role of the Congress, and the TLD.

Chapter 4 - On November 19, 2008, Iceland and the International Monetary Fund (IMF) finalized an agreement on a $6 billion economic stabilization program supported by a $2.1 billion loan from the IMF. Following the IMF decision, Denmark, Finland, Norway, and Sweden agreed to provide an additional $2.5 billion. Iceland's banking system had collapsed as a culmination of a series of decisions the banks made that left them highly exposed to disruptions in financial markets. The collapse of the banks also raises questions for U.S. leaders and others about supervising banks that operate across national borders, especially as it becomes increasingly difficult to distinguish the limits of domestic financial markets. Such supervision is important for banks that are headquartered in small economies, but operate across national borders. If such banks become so overexposed in foreign markets that a financial disruption threatens the solvency of the banks, the collapse of the banks can overwhelm domestic credit markets and outstrip the ability of the central bank to serve as the lender of last resort.

Chapter 5 - This report discusses two potential roles the International Monetary Fund (IMF) may have in helping to resolve the current global financial crisis: (1) immediate crisis control through balance of payments lending to emerging market and less-developed countries and (2) increased surveillance of the global economy through better coordination with the international financial regulatory agencies.

Chapter 6 - The United States, its allies, and local leaders have achieved substantial successes in the Balkans since the mid-1990s. The wars in the region have ended, and all of the countries are undertaking political and economic reforms at home and orienting their foreign policies toward Euro-Atlantic institutions. However, difficult challenges remain, including dealing with the impact of Kosovo's independence; fighting organized crime, corruption, and enforcing the rule of law; bringing war criminals to justice; and reforming the economies of the region.

The goal of the United States and the international community is to stabilize the Balkans in a way that is self-sustaining and does not require direct intervention by NATO-led forces and international civilian officials. The United States has reduced the costs of its commitments to the region, in part due to competing U.S. and international priorities, such as the war on terrorism, and efforts to stabilize Iraq and Afghanistan, which have placed strains on U.S. resources. SFOR and KFOR, the NATO-led peacekeeping forces in Bosnia and

Kosovo, were reduced in size. In December 2004, SFOR's mission was concluded, and European Union troops took over peacekeeping duties in Bosnia. No U.S. combat troops remain in Bosnia. About 15,500 troops remain in Kosovo as part of KFOR, including 1,500 U.S. soldiers.

Since the September 11, 2001 attacks on the United States, the war on terrorism has been the United States' main foreign policy priority, including in the Balkans. Before September 11, Al Qaeda supporters operated from Bosnia and Albania. However, the Bush Administration said that these countries and others in the region "actively supported" the war on terrorism, shutting down terrorist front organizations and seizing their assets. Although their efforts are hampered by the weakness of local government institutions, U.S. anti-terrorism efforts in the Balkans are aided by U.S. military and intelligence assets in the region, as well as a reservoir of good will among local Muslims of all ethnic groups.

Congress has played an important role in shaping U.S. Balkans policy. Some Members supported Clinton Administration efforts to intervene to stop the fighting in the region in the mid and late

1 990s, while others were opposed. Members were leery of an open-ended commitment to the region and sought to contain these costs through adoption of benchmarks and limiting U.S. aid and troop levels to the region. The end of the wars in the Balkans and the shift in U.S. priorities in the wake of the September 11 attacks has moved the Balkans to the periphery of congressional concerns, at least when compared to the situation in the 1 990s. However, Congress has continued to have an impact on such issues as Kosovo's status, conditioning some U.S. aid to Serbia on cooperation with the International Criminal Tribunal for the Former Yugoslavia, and supporting NATO membership for the countries of the region. On May 12, 2009, the House passed H.R. 171, which calls on Bosnia to make constitutional reforms and on the Administration to appoint a special envoy to the Balkans. In late May 2009, Vice President Joe Biden will reportedly visit Kosovo, Bosnia, and Serbia to discuss the situation in the region.

Chapter 7 - Successive U.S. governments have urged the creation of an anti-missile system to protect against long-range ballistic missile threats from adversary states. The Bush Administration believed that North Korea and Iran represent strategic threats, and questioned whether they could be deterred by conventional means. The Bush Administration's position on this issue remained unchanged, even after the intelligence community assessed that the Iranian nuclear weapons program halted in 2003. The Bush Administration built long-range missile defense bases in Alaska and California to protect against missile threats, especially from North Korea. Although the system has been tested, most agree that further testing is necessary. The Bush Administration proposed deploying a ground-based mid-course defense (GMD) element of the larger Ballistic Missile Defense System (BMDS) in Europe to defend against an Iranian missile threat. The system would include 10 interceptors in Poland, a radar in the Czech Republic, and another radar deployed in a country closer to Iran, all to be completed by 2013 at a reported cost of at least $4 billion.

The proposed U.S. system has encountered resistance in some European countries and beyond. Critics in Poland and the Czech Republic assert that neither country faces a notable threat from Iran, but that if American GMD facilities were installed, both countries might be targeted by missiles from rogue states—and possibly from Russia. The Bush Administration signed agreements with both countries permitting GMD facilities to be stationed on their territory; however, the two countries' parliaments decided to wait to ratify the accords until after the Obama Administration clarified its intentions on missile defense policy. NATO has deliberated long-range missile defense, and has taken actions that many interpret as an endorsement of the U.S. GMD system.

The GMD plan has also affected U.S.-Russia relations. Former President Putin and his successor, Vladimir Medvedev, have argued that the proposal would reignite the arms race and upset U.S.- Russian-European security relations. U.S. officials dispute Russia's objections, noting that the interceptors are intended to take out Iranian missiles aimed at Europe or the United States and could not possibly act as a deterrent against Russia. Some argue that Russia has been attempting to foment discord among NATO allies. In mid-2007, Russia offered to cooperate on missile defense, proposing the use of a Russian-leased radar in Azerbaijan, but urging that U.S. facilities not be built in Eastern Europe. President Bush welcomed the idea in principle, but insisted upon the need for the European sites. Despite ongoing discussions over the issue, sharp Russian criticism of the program has continued. Medvedev has said that Russia might deploy Iskander tactical missiles to Kaliningrad, but later stated that Moscow would not do so if the United States reversed its plan to emplace GMD facilities in Poland and the Czech Republic.

For FY2008, Congress examined the European GMD proposal and eliminated proposed funding for initial site construction pending formal agreement with Poland and the Czech Republic, independent studies on missile defense options for Europe, and DOD certification of the proposed interceptor. The FY2009 request for the European site was $712 million, which Congress largely supported with funding for site construction available only after Czech and Polish ratification.

Chapter 8 - The factors that shape French foreign policy have changed since the end of the Cold War. The perspectives of France and the United States have diverged in some cases. More core interests remain similar. Both countries' governments have embraced the opportunity to build stability in Europe through an expanded European Union and NATO. Each has recognized that terrorism and the proliferation of weapons of mass destruction are the most important threats to their security today.

Several factors shape French foreign policy. France has a self-identity that calls for efforts to spread French values and views, many rooted in democracy and human rights. France prefers to engage international issues in a multilateral framework, above all through the European Union. European efforts to form an EU security policy potentially independent of NATO emerged in this context. However, more recently, policymakers in France, Europe and the United States have come to view a stronger European defense arm as a complement to rather than a substitute for NATO.

From the September 11, 2001, attacks on the United States through the Iraq war of 2003 until today, France has pressed the United States to confront emerging crises within a multilateral framework. France normally wishes to "legitimize" actions ranging from economic sanctions to military action in the United Nations.

The election of Nicolas Sarkozy to the French presidency in May 2007 appears to have contributed to improved U.S.-French relations. Sarkozy has taken a more practical approach to issues in U.S.-French relations than his predecessor, Jacques Chirac. Perhaps most notably, in April 2009, Sarkozy announced France's full reintegration into NATO's military command structure, more than 40 years after former President Charles de Gaulle withdrew his country from the integrated command structure and ordered U.S. military personnel to leave the country.

Trade and investment ties between the United States and France are extensive, and provide each government a large stake in the vitality and openness of their respective economies. Through trade in goods and services, and, most importantly, through foreign direct investment, the economies of France and the United States have become increasingly integrated.

Other areas of complementarity include the fight against terrorism, the Middle East Peace process, peace operations in the Balkans, and the stabilization of Afghanistan and Lebanon—all challenges where France has played a central role. A major split occurred over Iraq, however, with many countries either supporting or independently sharing French ideas of greater international involvement.

Developments in the Middle East affect French foreign and domestic policy. France has a long history of involvement in the region, and a population of 5-6 million Muslims. Paris believes that resolution of the Arab-Israeli conflict is key to bringing peace to the region. Surges in violence in the Middle East have led to anti-Semitic acts in France, mostly undertaken by young Muslims.

Chapter 9 - German Chancellor Angela Merkel took office in November 2005 promising a foreign policy anchored in a revitalized transatlantic partnership. Most observers agree that since reaching a low-point in the lead-up to the Iraq war in 2003, relations between the United States and Germany have improved. U.S. officials and many Members of Congress view Germany as a key U.S. ally, have welcomed German leadership in Europe, and voiced expectations for increased U.S.-German cooperation on the international stage.

German unification in 1990 and the end of the Cold War represented monumental shifts in the geopolitical realities that had defined German foreign policy. Germany was once again Europe's largest country, and the Soviet threat, which had served to unite West Germany with its pro- western neighbors and the United States, was no longer. Since the early 1 990s, German leaders have been challenged to exercise a foreign policy grounded in a long-standing commitment to multilateralism and an aversion to military force while simultaneously seeking to assume the more proactive global role many argue is necessary to confront emerging security threats. Until 1994, Germany was constitutionally barred from deploying its armed forces abroad. Today, approximately 7,400 German troops are deployed in peacekeeping, stabilization, and reconstruction missions worldwide. However, as Germany's foreign and security policy continues to evolve, some experts perceive a widening gap between the global ambitions of Germany's political class, and a consistently skeptical German public.

Since the end of the Cold War, Germany's relations with the United States have been shaped by several key factors. These include Germany's growing support for a stronger, more capable European Union, and its continued allegiance to NATO as the primary guarantor of European security; Germany's ability and willingness to undertake the defense reforms many argue are necessary for it to meet its commitments within NATO and a burgeoning European Security and Defense Policy; and German popular opinion, especially the influence of strong public opposition to U.S. foreign policies during the George W. Bush Administration on German leaders.

President Obama's popularity in Germany suggests that many Germans expect the new U.S. Administration to distance itself from the perceived unilateralism of the Bush Administration. However, some observers caution that public expectations of the new President could be unreasonably high and note that policy differences between the two countries remain. For example, in the face of the global economic slowdown, German leaders on both sides of the political spectrum have resisted calls from the Obama Administration to stimulate economic growth through larger domestic spending measures. In the foreign policy domain, while German officials have welcomed the Obama Administration's strategic review of Afghanistan/Pakistan policy, they have essentially ruled out sending more combat troops or relaxing constraints on those troops currently serving in Afghanistan before German federal elections scheduled for September 2009.

Chapter 10 - The European Union (EU) is a unique economic and political partnership in which 27 countries share sovereignty over an extensive range of policy areas. With strong U.S. support and encouragement, a group of European statesmen began this process of integration after World War II with the hope of ensuring peace on the continent. Over the years, additional economic and political rationale have emerged to support further integration.

Although some issues require unanimous consensus among member countries, EU decision- making is supranational on most economic and social issues. The three main institutions of the EU are the European Commission (essentially the EU's executive), the Council of the European Union (representing the national governments), and the European Parliament (representing the citizens of the EU). The yet-to-be-ratified Lisbon Treaty is the EU's latest attempt to reform its institutional arrangements and decision-making procedures. Enlargements in 2004 and 2007 increased the number of member countries in the EU from 15 to 27.

The EU has a strong common trade policy, and a developing Common Foreign and Security Policy (CFSP) for a more united voice in global affairs. It has also been developing a European Security and Defense Policy (ESDP) in order to improve its military capabilities and capacity to act independently. Although some shortcomings exist in EU-NATO relations, the two institutions continue to seek a more cooperative and complementary relationship.

The United States and the EU share a large, mutually beneficial trade and investment relationship. The global financial crisis and recession has challenged both sides to forge a common response. The United States and EU have a number of lingering trade disputes, but have led the push to liberalize world trade, and have sought to reduce non-tariff and regulatory barriers in the transatlantic marketplace. With compatible worldviews on most global issues, the United States and the EU also have a well-developed and cooperative political relationship.

Chapter 11 - Winston Churchill once wrote, "Learn all you can from history, for how else can one even make a guess what is going to happen in the future ... in history lie all the secrets of statecraft." Churchill was right, and his advice is especially appropriate to the study of the special relationship. Properly understood, the lessons of the past not only help us keep the problems of the present in perspective, but also point to one central conclusion: some kind of intimate and unbreakable link does exist between the United States and Britain, and its roots are very deep.

Throughout the deliberations of the two conferences that form the basis of this book, I was struck that so many of my fellow participants knew so little of the history of the Anglo-American relationship. Stereotypes abounded, particularly in the British delegation. Many of these participants appeared eager to deny the existence of a shared heritage so critical in helping us resolve disputes past and present. This chapter attempts to explain what the special relationship is and to provide a more balanced view of its value.

Chapter 12 - What constitutes a "special relationship"? And, particularly, what is "special"? Is it "distinctive"? "Unusual" or "unique"? Does it make a value judgment, connoting a relationship that is more important than other bilateral relationships? If so, how does one define or measure the scale of importance? Is it a relationship between governments, between peoples, or both? Is it a relationship that is distinguished by being privileged or preferential in some sense? If so, how? Or is the United States' relationship with every country "special"—perhaps some simply more "special" than others?

These are questions that underlie the assessment one is asked to make about the nature of a U.S.-UK relationship characterized as being "special." Viewed from the economic/business perspective, the relationship is, in many respects, distinctive and, in some respects, unique. On the other hand, many aspects of the relationship fit the pattern of U.S. relations with other countries of the developed world.

Chapter 13 - Germany is the world's fifth largest economy and the largest in Europe, accounting for about one- fifth of the European Union's (EU) GDP. Germany is also the largest European trade and investment partner of the United States. Mutually profitable and growing U.S.-German commercial ties historically have been facilitated by a strong German economy. The health and functioning of the German economy, as well as its approaches to international economic policy issues, thus, are of considerable importance to the United States as well as to the rest of Europe.

By most standards, post-war West Germany registered impressive economic performance in the first decades of its existence. But beginning in the mid-1990s, the German economy has been on a much lower growth path, averaging about 1.5% of GDP per year. Unemployment has also risen steadily. These trends, which are expected to be exacerbated by a steep decline in German GDP growth in 2009, raise questions about the long-term vitality and strength of the German economy.

A number of factors help explain Germany's declining growth rate. One factor has been the high cost associated with integrating the formerly communist East German economy into the Federal Republic since reunification in 1990. A second has been the growing cost of Germany's generous social security and welfare programs and associated regulations which some believe may undercut incentives for work and entrepreneurship. A third is an economy that is more geared towards exporting than domestic investment and consumption.

With few exceptions, German governments have generally been reluctant to advance what many economists consider necessary but unpopular economic policy reforms, including cut-backs in welfare programs and labor market protections. Some believe that Chancellor Angela Merkel's September 2009 reelection in coalition with the pro-business Free Democratic Party (FDP) could increase the likelihood of market-friendly reforms being enacted, but any radical restructuring of Germany's social market economy is considered unlikely.

With declining economic growth and rising expenditures on social protections, Germany faces significant budgetary and resource constraints. This resource crunch could limit Germany's flexibility in pursuing domestic and international policy goals, arguably making Germany less capable of compromise on matters of potential economic advantage. In this regard, Germany's domestic economic challenges could limit its policymaking flexibility. This has affected not only the economic and trade leadership role Germany has traditionally played in Europe, but also its position on issues that directly affect U.S. interests such as the global economic downturn and economic sanctions.

A prosperous German state remains critical to both the U.S. and European economies. Difficulties Germany may have in regaining a stronger economic position are important concerns, affecting the U.S.-German partnership's ability to mutually address and manage a range of bilateral, regional, and global challenges. This report elaborates on these themes in three parts: the first section examines Germany's economic performance in historical perspective and assesses some of the domestic factors that may be contributing to Germany's less than optimal performance; the second discusses the reform challenges facing Germany's political leaders; and the third section evaluates a few salient U.S.-German economic policy differences and strains that seem to be influenced by Germany's weakened economic situation.

Chapter 14 - The European Parliament (EP) is one of the three key institutions of the 27-member European Union (EU), and the only EU institution whose members are directly elected. The current EP has 736 members. The most recent EP elections were held on June 4-7, 2009. Members of the European Parliament (MEPs) serve five-year terms.

Once limited to being a consultative assembly, the EP has accumulated more power over time. It performs important functions in the EU's legislative and budgeting processes, and exercises a degree of supervision over the two other main EU institutions, the Council of the European Union (Council of Ministers) and the European Commission. Although the EP does not formally initiate EU legislation, it shares "co-decision" power with the Council of Ministers in many policy areas, giving it the right to amend or reject proposed EU legislation. The recently ratified Lisbon Treaty increases the EP 's role further, giving it amendment and veto authority over the vast majority of EU legislation (with some exceptions, such as tax matters and foreign policy). Moreover, supporters argue, as the only directly elected EU institution, the EP increasingly plays an important checks-and-balances role on behalf of Europe's citizens.

Members of the European Parliament caucus according to transnational groups based on political affiliation, rather than by nationality. No single group has ever held an absolute majority in the European Parliament, making compromise and coalition-building important elements of the legislative process. Following the June 2009 election, the center-right Group of the European People's Party (EPP) and the re-named center-left Group of the Progressive Alliance of Socialists and Democrats in Europe (S&D) remain the two largest political groups. Every two-and-a-half years (twice per parliamentary term), MEPs vote to elect a President of the European Parliament to lead and oversee its work and to represent the EP externally. The EP has 20 standing committees that are key actors in the adoption of EU legislation and 36 delegations that maintain international parliament-to-parliament relations.

Although supporters point to the EP's growing institutional significance, the European Parliament faces several challenges of public perception. Some skeptics contend that the EP lacks the legitimacy of national parliaments and exercises little real power. Other analysts observe that the complexity of the EU legislative process contributes to limited public interest and understanding of the EP 's role, leading in turn to a trend of declining turnout in European Parliament elections. Another issue is whether MEPs reflect national or European interests—many MEPs tend to campaign on national rather than European issues and many voters view EP elections as a national mid-term election. Criticism has also been directed at the costs incurred by what many consider duplicate facilities—while much of the work of the EP takes place in Brussels, monthly plenary meetings are held in Strasbourg, France, and administrative sections of the EP Secretariat are based in Luxembourg.

Ties between the EP and the U.S. Congress are long-standing, and the Transatlantic Legislators' Dialogue—the formal mechanism for EP-Congressional exchanges—is expected to continue its activities during the second session of the 111th Congress.

Chapter 15 - In December 2007, leaders of the European Union (EU) signed the Lisbon Treaty. With the completion of ratification by the Czech Republic on November 3, 2009, all 27 EU member countries have ratified the document, and it is expected to come into force on December 1, 2009. The Lisbon Treaty reforms the EU's governing institutions and decision-making process to enable the EU to operate more effectively. The treaty grew out of the proposed "constitutional treaty" that foundered after French and Dutch voters rejected it in referendums in 2005.

The Lisbon Treaty seeks to give the EU a stronger and more coherent voice with the creation of a new position, President of the European Council. This individual will chair the activities of the 27 EU heads of state or government, working to facilitate consensus and ensure policy continuity, guide the strategic direction of policy-making, and give the EU greater visibility on the world stage. Additionally, the Lisbon Treaty creates the new position of High Representative of the Union for Foreign Affairs and Security Policy, a de facto EU foreign minister who would be supported by a new EU diplomatic service.

The Lisbon Treaty makes changes to the EU's internal decision-making mechanisms. These changes have been designed to streamline the process and make it less susceptible to gridlock or blockage by a single member state. The treaty attempts to address concerns about democratic accountability and transparency in EU policy-making by granting a greater role to the directly elected European parliament, national parliaments, and citizens' initiatives.

The Swedish Presidency of the EU is planning to use a special EU Summit, probably taking place in mid-November 2009, to resolve remaining institutional questions about the treaty's implementation. A number of important decisions need to be made, including who to appoint to the new President and "foreign minister" positions, and how the exact role of these positions will be defined.

Experts assert that the Lisbon Treaty would have positive implications for U.S.-EU relations. While the treaty is unlikely to have major effects on U.S.-EU trade and economic relations, some believe that it could allow the EU to move past its recent preoccupation with distracting internal questions and take on a more active and effective role as a U.S. partner in tackling global challenges. There are indications that adoption of the Lisbon Treaty would make the EU more amenable to future enlargement, including to the Balkans and perhaps Turkey, which the United States strongly supports. On the other hand, skeptics maintain that a stronger EU poses a potentially detrimental rival to NATO and the United States.

This report provides information on the Lisbon Treaty and possible U.S.-EU implications that may be of interest to the 111th Congress.

Chapter 16 - Successive U.S. governments have urged the creation of an anti-missile system to protect against long-range ballistic missile threats from adversary states. The Bush Administration believed that North Korea and Iran represented strategic threats, and questioned whether they could be deterred by conventional means. The Bush Administration's position on this issue remained unchanged, even after the intelligence community assessed that the Iranian nuclear weapons program halted in 2003. The Bush Administration built long-range missile defense bases in Alaska and California to protect against missile threats, especially from North Korea. Although the system has been tested, most agree that further testing is necessary. Additionally, the Bush Administration proposed deploying a ground-based mid-course defense (GMD) element of the larger Ballistic Missile Defense System (BMDS) in Europe to defend against an Iranian missile threat. The system would include 10 interceptors in Poland, a radar in the Czech Republic, and another radar deployed in a country closer to Iran, all to be completed by 2013 at a reported cost of at least $4 billion.

The proposed U.S. system has encountered resistance in some European countries and beyond. Critics in Poland and the Czech Republic assert that neither country faces a notable threat from Iran, but that if American GMD facilities were installed, both countries might be targeted by missiles from rogue states—and possibly from Russia. The Bush Administration signed agreements with both countries permitting GMD facilities to be stationed on their territory; however, the two countries' parliaments continue to wait on ratifying the accords, in part, until after the Obama Administration clarifies its intentions on missile defense policy. NATO has deliberated long-range missile defense, and has taken actions that some interpret as an endorsement of the U.S. GMD system.

The GMD plan has also affected U.S.-Russia relations. Former President Putin and his successor, Vladimir Medvedev, have argued that the proposal would reignite the arms race and upset U.S.- Russian-European security relations. U.S. officials dispute Russia's objections, noting that the interceptors are intended to take out Iranian missiles aimed at Europe or the United States and could not possibly act as a deterrent against Russia. Some argue that Russia has been attempting to foment discord among NATO allies. In mid-2007, Russia offered to cooperate on missile defense, proposing the use of a Russian-leased radar in Azerbaijan, but urging that U.S. facilities not be built in Eastern Europe. President Bush welcomed the idea in principle, but insisted upon the need for the European sites. Despite ongoing discussions over the issue, sharp Russian criticism of the program has continued.

For FY2008, Congress examined the European GMD proposal and eliminated proposed funding for initial site construction pending formal agreement with Poland and the Czech Republic, independent studies on missile defense options for Europe, and DOD certification of the proposed interceptor. The FY2009 request for the European site was $712 million, which Congress largely supported with funding for site construction available only after Czech and Polish ratification. The Obama Administration proposed $50.5 million for the European site for FGY2010, which with the $618 million remaining and available from the FY2009 budget pending Polish and Czech ratification, the Administration believes is sufficient for the time being.

Chapter 17 - This study reviews the effects of the last international crisis on the Spanish economy and the medium-term expectation of economic recovery. The current crisis has occurred after a sharp growth in the Spanish economy for over a decade, higher than the European average. During this period, infrastructures and human capital improved, exports increased, the public debt was reduced and a position of leadership in activities such as tourism, renewable energies and bank intermediation was consolidated. However, similarly to the majority of countries in the world economy, in 2008 Spain fell into deep economic recession. The economic situation is worrying, not so much on account of the significance of the decrease in the GDP, but also on account of the accumulated imbalances in the labour market, in construction and in the financial position of households and businesses, and the faint prospects of recovery as a result. Consequently, the beginning of economic recovery will be later rather than sooner and, in the best-case scenario, not before the second half of 2010.

Until then, the unemployment rate, already double that of the EU, will continue to rise and could even reach or exceed 20%, making the possible subsequent recovery even more difficult.

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A EUROPEAN ECONOMIC RECOVERY PLAN*

THE TIME TO ACT IS NOW

The real test for European governments and institutions comes when faced with the most difficult of circumstances. At such times, they need to show imagination; they need to show determination; and they need to show flexibility. They need to show that they are in tune with the needs of families and communities across the European Union, that they are equal to the task of finding the right response to the sudden downturn in the prospects for growth and jobs in Europe.

Europe will above all be judged on results. Since this Commission took office, it has put the spotlight on the European Union's ability to deliver results for its citizens. It has targeted action on areas which will have an impact on Europeans in every corner of the EU. It has championed a partnership approach to work with the key players at every level. It has made clear that the job is not done until the impact is felt on the ground.

The current economic crisis gives another opportunity to show that Europe serves its citizens best when it makes concrete action the touchstone. Europe can make the difference.

In difficult times, the temptation is to feel powerless. But Europe is not powerless. The levers of government, the instruments of the European Union, the influence of intelligent coordination add up to a potent force to arrest the trend towards a deeper recession. A Europe ready to take swift, bold, ambitious and well-targeted action will be a Europe able to put the brakes on the downturn and begin to turn the tide. We sink or swim together.

The particular contribution of the European Union is its ability to help partners work together. Harnessing Member States' and Community action will add up to a powerful lever for change. It will open the door to using the strengths of each part of Europe to best effect. It will allow us to shape the global response to this global crisis.

A month ago, the Commission took the initiative to set out how decisive and coordinated action could respond to the economic crisis. I am pleased to see that as national governments work to address their own situations, they have been inspired by the common principles agreed for European action. Today the Commission strengthens this platform for joint action with a Plan to contain the scale of the downturn and to stimulate demand and confidence, saving hundreds of thousands of jobs and keeping large and small businesses at work while waiting for growth to return.

The European Economic Recovery Plan has two key pillars, and one underlying principle:

* Extracted from Communication from the Commission to the European Council, Brussels, 26.11.2008 COM(2008) 800 final.

- The first pillar is a major injection of purchasing power into the economy, to boost demand and stimulate confidence. The Commission is proposing that, as a matter of urgency, Member States and the EU agree to an immediate budgetary impulse amounting to € 200 billion (1.5% of GDP), to boost demand in full respect of the Stability and Growth Pact.
- The second pillar rests on the need to direct short-term action to reinforce Europe's competitiveness in the long term. The Plan sets out a comprehensive programme to direct action to "smart" investment. Smart investment means investing in the right skills for tomorrow's needs; investing in energy efficiency to create jobs and save energy; investing in clean technologies to boost sectors like construction and automobiles in the low-carbon markets of the future; and investing in infrastructure and inter-connection to promote efficiency and innovation.
- At the same time, the ten Actions for Recovery included in the Plan will help Member States to put the right social and economic levers in place to meet today's challenge: to open up new finance for SMEs, cut administrative burdens and kick-start investment to modernise infrastructure. It will drive a competitive Europe ready for the low-carbon economy.
- The fundamental principle of this Plan is solidarity and social justice. In times of hardship, our action must be geared to help those most in need. To work to protect jobs through action on social charges. To immediately address the long-term job prospects of those losing their jobs, through the European Globalisation Adjustment Fund and an accelerated European Social Fund. To cut energy costs for the vulnerable through targeted energy efficiency. To address the needs of those who cannot yet use the internet as a tool to connect.

I am convinced that at times of crisis, opportunities open up to accelerate change and to introduce structural reforms to make us succeed in the globalised economy of the future. This is a great opportunity for Europe.

A comprehensive and ambitious recovery plan is now on the table. The quicker we make it happen, the sooner we will bring the help needed to Europeans today.

José Manuel Durão Barroso
Brussels,
26th November 2008

1. INTRODUCTION

The global financial crisis has hit the EU hard. A squeeze on credit, falls in house prices and tumbling stock markets are all reinforcing a slump in consumer confidence, consumption and investment. Households are under real pressure. Businesses' order books are down. Sectors dependent on consumer credit – like private construction and the automobile industry – have seen their markets sharply deteriorate in many Member States.

The latest economic forecasts painted a bleak picture of close to zero growth and risks of contraction for the EU economy in 2009, with unemployment rising by some 2.7 million in the next two years, on the assumption that no corrective action is taken. In the weeks since the forecasts came out, economic conditions have deteriorated further:

– Financial market conditions remain fragile, and are likely to be tighter for longer than expected;
– Confidence amongst households and firms has fallen much lower than expected;
– The slowdown has spread to emerging economies with negative effects for European exports.

The euro area and several Member States are already in recession. The risk is that this situation will worsen still further: that investment and consumer purchases will be put off, sparking a vicious cycle of falling demand, downsized business plans, reduced innovation, and job cuts. This could push the EU into a deep and longer-lasting recession: the economy contracting further next year, and unemployment could rise by several million people.

Quick and decisive action is needed to stop this downward spiral. Europe must use all the tools at its disposal. This means Member States and the Union working together, coordinating inside Europe and feeding into a larger global response. In tackling the financial crisis, the Union made sure that the EU level and national action worked together. This was successful in bringing stability at a time of immediate danger. Now Member States should again take advantage of the strengths of the EU – effective coordination, credible frameworks offered by the Stability and Growth Pact and the Lisbon Strategy, as well as the benefits of scale offered by the euro and the largest single market in the world. The interplay of national and EU action can help all Member States weather the worst of the global economic storms and emerge stronger from the crisis. The euro, in particular, has proved to be an invaluable asset for the EU economies and an essential element of stability. Supported by the strong role played by the independent European Central Bank, the euro protects against destabilising exchange rate movements, which would have greatly complicated the national responses to the crisis.

A month ago, the Commission took the initiative to outline its plans for dealing with the financial crisis, addressing the difficulties of the wider economy and making Europe a key player in the global response to the financial crisis [1]. In early November, the EU's Heads of State and Government agreed on the need for a coordinated response and asked the Commission to make proposals for discussion at their December meeting.

A European Economic Recovery Plan

This European Economic Recovery Plan is the Commission's response to the current economic situation. Given the scale of the crisis we are facing, the EU needs a co-ordinated approach, big enough and ambitious enough to restore consumer and business confidence. It needs to bring together all the policy levers available at EU and national level. Most of the economic policy levers, and in particular those which can stimulate consumer demand in the short term, are in the hands of the Member States. Member States have very different starting points in terms of fiscal room for manoeuvre. But that makes effective coordination all the more important.

All Member States will need to take action to deal with the crisis. Properly coordinated, national efforts can target different goals in parallel. They can cushion the blow of recession in the short term. But they can also promote the structural reforms needed to help the EU emerge stronger from the crisis, without undermining longer term fiscal sustainability.

For this reason, this Recovery Plan puts particular emphasis on innovation and greening of EU investment. The EU level can act as a catalyst for such "smart action", combining EU policies and funds to help Member States maintain or pull forward investments which will create jobs, boost demand, and strengthen Europe's capacity to benefit from globalisation.

The strategic aims of the Recovery Plan are to:

– Swiftly stimulate demand and boost consumer confidence;
– Lessen the human cost of the economic downturn and its impact on the most vulnerable. Many workers and their families are or will be hit by the crisis. Action can be taken to help stem the loss of jobs; and then to help people return rapidly to the labour market, rather than face long-term unemployment;
– Help Europe to prepare to take advantage when growth returns so that the European economy is in tune with the demands of competitiveness and the needs of the future, as outlined in the Lisbon Strategy for Growth and Jobs. That means pursuing the necessary structural reforms, supporting innovation, and building a knowledge economy;
– Speed up the shift towards a low carbon economy. This will leave Europe well placed to apply its strategy for limiting climate change and promoting energy security: a strategy which will encourage new technologies, create new 'green-collar' jobs and open up new opportunities in fast growing world markets, will keep energy bills for citizens and businesses in check, and will reduce Europe's dependence on foreign energy.

In pursuing these aims, the European Economic Recovery Plan is designed to:

– Exploit synergies and avoid negative spill-over effects through co-ordinated action;
– Draw on all available policy levers, fiscal policies, structural and financial market reforms and external action;
– Ensure full coherence between immediate actions and the EU's medium- to longer term objectives;
– Take full account of the global nature of the problem and shape the EU's contribution to international responses.

This European Economic Recovery Plan proposes a counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the real economy. The aim is to avoid a deep recession. The Plan is anchored in the Stability and Growth Pact and the Lisbon Strategy for Growth and Jobs. It consists of:

- An immediate budgetary impulse amounting to € 200 bn (1.5% of EU GDP), made up of a budgetary expansion by Member States of € 170 bn (around 1.2% of EU

GDP), and EU funding in support of immediate actions of the order of € 30 bn (around 0.3 % of EU GDP);

- And a number of priority actions, grounded in the Lisbon Strategy, and designed at the same time to adapt our economies to long-term challenges, continuing to implement structural reforms aimed at raising potential growth.

2. SUPPORTING THE REAL ECONOMY AND BOOSTING CONFIDENCE

As the economies of all Member States are highly integrated, sharing one single market and many common policies, any response must combine monetary and credit aspects, budgetary policy, and actions in the Lisbon strategy for growth and jobs.

2.1. Monetary and credit conditions.

2.1.1. The Role of the European Central Bank and Other Central Banks

In the current juncture, monetary policy has a crucial role to play. In the light of reduced inflationary expectation over the medium-term, the European Central Bank (ECB) for the euro area, along with other EU central banks, has already cut interest rates. The ECB has signalled that there is scope for further reductions. The ECB has already demonstrated its importance in stabilising markets by lending to banks and contributing to liquidity.

2.1.2. The Role of Banks

At the root of the problems in the real economy lies the instability in the financial markets. A reliable and efficient financial sector is a pre-requisite for a healthy, growing economy. Stabilising the banking system is therefore the first step towards halting the downturn and promoting a swift and sustainable recovery. The EU must maintain this common drive to rebuild stability and confidence in the still-fragile financial sector and create the conditions for a sustained economic recovery. The crisis has shown risks in the current governance of financial markets which have or could become real and systemic in times of serious turbulence. The pace of reform will be maintained in the coming months to restore stability and protect the interests of European citizens and business.

But it is now crucial that banks resume their normal role of providing liquidity and supporting investment in the real economy. Member States should use the major financial support provided to the banking sector to encourage a return to normal lending activities and to ensure that central interest rate cuts are passed on to borrowers. The Commission will continue to monitor the economic and competition impacts of measures taken to support the banking sector.

2.1.3. The Role of the European Investment Bank and the European Bank for Reconstruction and Development

The current crisis requires reinforced interventions from the European Investment Bank (EIB) group. The EIB will increase its yearly interventions in the EU by some €15 billion for the next two years. As this increased activity will take the form of loans, equity, guarantees and risk-sharing financing, it will also generate a positive leverage of additional investment from private sources. In total, this package proposed by EIB will help mobilise complementary private resources to support additional investments over the next two years. To enable the EIB to increase its financing activities, Member States should decide before the end of the year to incorporate EIB ' s reserves to reinforce its capital base in the order of € 60 bn, which will provide a highly visible political signal to the markets and which will significantly increase the Bank's lending capacity. The European Bank for Reconstruction and Development (EBRD) is also expected to add €500 million per year to its present level of financing in the new Member States.

2.2. Budgetary Policy

Restoring confidence will depend on Europe's ability to boost demand by making use of budgetary policy within the flexibility offered by the revised Stability and Growth Pact. In the current circumstances, budgetary policy has an even more important role to play in stabilising economies and sustaining demand.

Only through a significant stimulus package can Europe counter the expected downward trend in demand, with its negative knock-on effects on investments and employment. Therefore, the Commission proposes that Member States agree a co-ordinated budgetary stimulus package which should be timely, targeted and temporary, to be implemented immediately.

In the context of national budgets for 2009, this co-ordinated budgetary impulse should be € 170 bn, which represents 1.2% of the Union's GDP, in order to produce a substantive positive and rapid impact on the European economy and on employment, in addition to the role of the automatic stabilisers. Expenditures and/or reductions in taxation included in the budgetary impulse should be consistent with the flexibility offered by the Stability and Growth Pact and reinforce the structural reforms of the Lisbon Strategy. This budgetary stimulus should be temporary. Member States should commit to reverse the budgetary deterioration and return to the aims set out in the medium term objectives.

To maximise its impact, the budgetary stimulus should take account of the starting positions of each Member State. It is clear that not all Member States are in the same position. Those that took advantage of the good times to achieve more sustainable public finance positions and improve their competitive positions have more room for manoeuvre now. For those Member States, in particular outside the euro area, which are facing significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances.

This budgetary stimulus must be well designed and be based on the following principles:

(1) It should be timely, temporary, targeted, and co-ordinated

National budgetary stimulus packages should be:

– *timely* so that they quickly support economic activity during the period of low demand, as delays in implementation could mean that the fiscal impulse only comes when the recovery is underway;

- *temporary* so as to avoid a permanent deterioration in budgetary positions which would undermine sustainability and eventually require financing through sustained future tax increases;
- *targeted* towards the source of the economic challenge (increasing unemployment, credit constrained firms/households, etc. and supporting structural reforms) as this maximises the stabilisation impact of limited budgetary resources;
- co-ordinated so that they multiply the positive impact and ensure long term budgetary sustainability.

(2) It should mix revenue and expenditure instruments.

In general, discretionary public spending is considered to have a stronger positive impact on demand in the short-run compared with tax cuts. This is because some consumers may prefer to save rather than spend, unless the tax cuts are limited in time. Taking the different situations of Member States into account the following measures could be considered [2]:

- *Public expenditure has an impact on demand in the short-term*. Measures that can be introduced quickly and targeted at households which are especially hard hit by the slowdown are likely to feed through almost directly to consumption, e.g temporarily increased transfers to the unemployed or low income households, or a temporary lengthening of the duration of unemployment benefit. This can also be done through frontloading public investment in projects which could benefit SMEs and could support long-term public policy goals such as improving infrastructure endowments or tackling climate change;
- *Guarantees and loan subsidies* to compensate for the unusually high current risk premium can be particularly effective in an environment where credit is generally constrained. They can help bridge a lack of short-term of working capital which is currently a problem for many companies;
- *Well designed financial incentives* for speeding up the adaptation of our economies to long-term challenges such as climate change, including for example incentives for energy efficiency;
- *Lower taxes and social contributions*: lower social contributions paid by employers can have a positive impact on job retention and creation while lower taxation of labour income can support purchasing power in particular for low wage earners;
- *Temporary reductions* in the level of the standard rate of VAT can be introduced quickly and might provide a fiscal impulse to support consumption.

(3) It should be conducted within the Stability and Growth Pact

Budgetary policy should be conducted within the Stability and Growth Pact, so as to provide a common and credible framework for policy. The 2005 revision of the Pact allows better account to be taken of cyclical conditions while strengthening medium and long-term fiscal discipline. The resulting framework is more demanding in good times, it affords more flexibility in bad times. Extraordinary circumstances combining a financial crisis and a recession justify a co-ordinated budgetary expansion in the EU. It may lead some Member States to breach the 3% GDP deficit reference value. For Member States considered to be in an excessive deficit, corrective action will have to be taken in time frames consistent with the recovery of the economy. This is fully consistent with the procedures of the Stability and Growth Pact which guarantee that the excessive deficit will be corrected in due time, ensuring long-term sustainability of the budgetary positions.

The Stability and Growth Pact will therefore be applied judiciously ensuring credible medium-term fiscal policy strategies. Member States putting in place counter-cyclical measures should submit an updated Stability or Convergence Programme by the end of December 2008. This update should spell out the measures that will be put in place to reverse the fiscal deterioration and ensure long-term sustainability. The Commission will then assess the budgetary impulse measures and stability and convergence programmes based on updated forecasts and will provide guidance on the appropriate stance, relying on the following objectives:

– ensuring the reversibility of measures increasing deficits in the short term;
– *improving budgetary policy-making* in the medium-term, through a strengthening of the national budgetary rules and frameworks;
– *ensuring long-term* sustainability of public finances, in particular through reforms curbing the rise in age-related expenditure.

(4) It should be accompanied by structural reforms that support demand and promote resilience

While the most immediate impact on growth and jobs in the short run needs to come from a monetary and fiscal stimulus, a comprehensive recovery plan also needs to encompass an ambitious structural reform agenda tailored to the needs of individual Member States, and designed to equip them to emerge stronger from the crisis. In part, this is because some structural reforms can also contribute to bolstering aggregate demand in the short term. Moreover, structural reforms are necessary to address some of the underlying root causes of the present crisis, as well as to strengthen the economy's adjustment capacity needed for a rapid recovery.

A resilient, flexible economy helps mitigate the adverse impact of an economic crisis. The Lisbon Strategy has already strengthened the European economic fundamentals. Appropriately tailored, Lisbon strategy structural reforms could be an appropriate short-term policy response to the crisis as they strengthen economic resilience and flexibility. Member States should consider the following measures:

– *Supporting consumer purchasing power through improved market functioning:* policies that improve the functioning of key markets can help sustain demand by helping bring down prices, thus supporting the purchasing power of households;
– *Addressing immediate competitiveness problems*. In Member States with inflation and competitiveness problems measures need to be taken urgently that reinforce the link between the wage setting mechanism and productivity developments;
– *Supporting employment and facilitating labour market transitions*: today's prime labour market challenge is to avoid wasteful labour shedding by industries temporarily affected by short-term demand disturbances. To that end, more flexibility in working time arrangements or enhanced employment services could help;

– *Reducing regulatory and administrative burdens on businesses*. Such reforms help increase productivity, and strengthen competitiveness. Measures that can be implemented rapidly include continuing efforts to reduce the time to start up a business.

2.3. Actions in the Four Priority Areas of the Lisbon Strategy

In order to produce maximum benefits and achieve the Recovery Plan's aims of protecting people and preventing the crisis from deflecting attention from the EU's longer-term interests and the need to invest in its future, there should be a close connection between the fiscal stimulus and actions in the four priority areas of the Lisbon Strategy (people, business, infrastructure and energy, research and innovation), as outlined in this section. In order to achieve this, as part of its annual Lisbon package, the Commission will issue individual reports for each Member State on 16 December 2008 which will include proposals for recommendations.

A smart combination of EU policies and funds can act as a catalyst for key investments taking the EU in the direction of future sustainable prosperity. It is equally important to provide for stable foreseeable framework conditions to boost confidence, facilitate investment and to work for least cost solutions to common problems. Some of the actions proposed in this section are designed to frontload EU funding directly to contribute to the fiscal stimulus and assist Member States with the implementation of their policies. Others are intended to improve the framework conditions for future investments, reduce administrative burdens and speed up innovation. Overall, the actions form an integrated package: their budgetary implications should take into account the principles set out in the previous section.

2.3.1. Protecting Employment and Promoting Entrepreneurship

The top priority must be to protect Europe's citizens from the worst effects of the financial crisis. They are the first to be hit whether as workers, households, or as entrepreneurs. In addressing the employment and social impact of the financial crisis, Member States should actively involve the social partners.

a) People

The implementation of active inclusion and integrated flexicurity policies, focused on activation measures, re-training and skills upgrading, are essential to promote employability, ensure rapid re-integration into the labour market of workers who have been made redundant and avoid long term unemployment. Within this context, adequate social protection that provides incentives to work whilst preserving purchasing power will also be important.

> *1. Launch a major European employment support initiative*
>
> (a) The Commission is proposing to simplify criteria for European Social Fund (ESF) support and step up advance payments from early 2009, so that Member States have earlier access to up to € 1.8 bn in order to:
>
> – Within flexicurity strategies, rapidly *reinforce activation schemes*, in

particular for the low-skilled, involving personalised counselling, intensive (re-)training and upskilling of workers, apprenticeships, subsidised employment as well as grants for self-employment, business start-up's and

- Refocus their programmes to *concentrate support* on the most vulnerable, and where necessary opt for full Community financing of projects during this period;
- Improve the monitoring and *matching of skills* development and upgrading with existing and anticipated job vacancies; this will be implemented in close cooperation with social partners, public employment services and universities;

Working with Member States, the Commission proposes to re-programme ESF expenditure to ensure that immediate priorities are met.

(b) The Commission will also propose to revise the rules of the *European Globalisation Adjustment Fund* so that it can intervene more rapidly in key sectors, either to co- finance training and job placements for those who are made redundant or to keep in the labour market skilled workers who will be needed once the economy starts to recover. The Commission will review the budgetary means available for the Fund in the light of the implementation of the revised rules.

2. Create demand for labour

- Member States should consider *reducing employers' social charges on lower incomes to promote the employability of lower skilled workers*. Member States should also consider the introduction of innovative solutions (e.g. service cheques for household and child care, temporary hiring subsidies for vulnerable groups), which have already been successfully pioneered in parts of the Union;
- The Council should adopt, before the 2009 Spring European Council, the proposed directive to make permanent *reduced VAT rates for labour-intensive services*

b) Business

Sufficient and affordable access to finance is a pre-condition for investment, growth and job creation by the private sector. Member States need to use the leverage they have through the provision of major financial support to the banking sector to ensure that banks resume their normal lending activities. To support small businesses and entrepreneurship, the EU and Member States must take urgent steps to substantially reduce administrative burdens for SMEs and micro-enterprises, in particular by fast-tracking the corresponding Commission's proposals. To this end, the European Small Business Act should also be implemented as soon as possible.

The EU's state aid rules offer Member States a wide range of possibilities for providing financial support to companies, regions and workers/the unemployed and to stimulate demand. At the same time these rules guarantee a level playing field, ensuring that state aids are used to support EU objectives such as R&D, innovation, ICT, transport and energy efficiency, and not to unduly distort competition by favouring particular companies or sectors. In the current exceptional circumstances, access to finance is a major business concern and the Commission will develop temporary guidelines allowing state support for loans (see below).

3. Enhance access to financing for business

- *The EIB has put together a package of € 30 bn for loans to SME's, an increase by* € 10 billion over its usual lending in this sector;
- The EIB will also reinforce by € 1 bn a year its le*nding to mid-sized* corporations, a key sector of the EU economy. Furthermore, an additional € 1 billion will be conferred by the EIB to the EIF for a mezzanine finance facility;
- The Commission will put in place a *simplification package*, notably to *speed up its State aid decision-making*. Any state aid should be channelled through horizontal schemes designed to promote the Lisbon objectives, notably research, innovation, training, environmental protection and in particular clean technologies, transport and energy efficiency. The Commission will *temporarily authorise Member States to ease access to finance for companies* through subsidised guarantees and loan subsidies for investments in products going beyond EU environmental standards [3]

4. Reduce administrative burdens and promote entrepreneurship

Building on the Small Business Act, and in order significantly reduce administrative burdens on business, promote their cash flow and help more people to become entrepreneurs, the EU and Member States should:

- Ensure that *starting up* a business anywhere in the EU can be done within three days at zero costs and that formalities for the hiring of the first employee can be fulfilled via a single access point;
- Remove the requirement on *micro-enterprises* to prepare annual accounts (the estimated savings for these companies are € 7bn per year) and limit the capital requirements of the European private company to one euro;
- Accelerate the adoption of the *European private* company statute proposal so that from early 2009 it can facilitate cross border business activities of SMEs and to allow them to work under a single set of corporate rules across the EU;
- Ensure that public authorities *pay invoices*, including to SMEs, for supplies and services within one month to ease liquidity constraints and accept e-invoicing as equivalent to paper invoicing (this could deliver cost reductions of up to 18 € Bn); any arrears owed by public

bodies should also be settled;

- Reduce by up to 75% the fees for *patent applications* and maintenance and halve the costs for an EU trademark.

2.3.2. Continuing to Invest in the Future

We are witnessing the beginning of a major structural shift towards a low carbon economy. This provides the EU with an opportunity that will create new businesses, new industries and millions of new well-paying jobs. All sectors must participate: for example, the recent decision on the CAP health check commits €3 Bn for climate-friendly investments in rural development. This is where short-term action can bring immediate as well as lasting benefits to the Union.

To accelerate investments, the Commission will clarify the legal framework for partnerships between the public and private sector aiming at carrying out major infrastructure and research investments, in order to facilitate this mixed mode of financing.

c) Infrastructure and Energy

The key to maximising benefits and minimising costs is to target opportunities to boost energy efficiency, for example, of buildings, lighting, cooling and heating systems, and of other technologies like vehicles and machinery. Major positive effects for households and businesses can be harvested in the short term.

At the same time, Europe needs to accelerate its investments in infrastructure, particularly in the environmentally-friendly transport-modes which are part of the Trans-European Networks (TENs), high-speed ICT networks, energy interconnections, and pan-European research infrastructures. Speeding up infrastructure investments will not only cushion the blow to the construction sector, which is slowing down sharply in most Member States, it will also enhance Europe's longer-term sustainable growth-potential. Particularly in the energy sector a number of high profile trans-European projects would help to increase the EU's energy security and integrate more Member States into the European electricity grid.

5. Step up investments to modernise Europe's infrastructure

- For at least the next two years, the *EU budget* is unlikely to spend the full amount set out in the financial framework. Therefore, for 2009 and 2010, the Commission proposes to mobilise an additional *€ 5 bn for trans-European energy interconnectionsand broadband infrastructure projects*. To make this happen, Council and Parliament will need to agree to revise the financial framework, while remaining within the limits of the current budget;
- With a financial envelope of over € 347 bn for 2007-20 13, cohesion policy provides considerable support to public investment by Member States and regions. However there is a risk that pressure on national budgets will slow down the rate of planned investment. To give an immediate boost to the economy,

the implementation of the structural funds should be accelerated.
To this end:

- The Commission will propose to increase its pre-financing of programmes to make up to € 4.5 bn available earlier in 2009;
- Member States should use the available flexibility to frontload the financing of projects by enhancing the part financed by the Community;
- The Commission will propose a number of other measures designed to bring forward the implementation of major investment projects, to facilitate the use of financial engineering funds, to simplify the treatment of advances paid to the beneficiaries and to widen the possibilities for eligible expenditure on a flat rate basis for all the funds.

The Commission underlines the need for early adoption of these proposals.

- By the end of March 2009 the Commission will launch a €500 million call for proposals for *trans-European transport (TEN-T)* projects where this money would lead to construction beginning before the end of 2009. This will bring forward existing funds that would have been reallocated by the mid-term review of the multiannual TEN-T programme in 2010;
- In parallel, the *EIB will significantly increase its financing* of climate change, energy security and infrastructure investments by up to € 6 bn per year, while also accelerating the implementation of the two innovative financial instruments jointly developed with the Commission, i.e. the Risk Sharing Finance Facility to support R&D and the Loan Guarantee Instrument for TEN-T projects to stimulate greater participation of the private sector;
- *The EBRD will more than double its efforts for energy efficiency, climate change mitigation and financing for municipalities and other infrastructure services.* This could lead through the mobilisation of private sector financing to € 5 bn investments.

6. Improve energy efficiency in buildings

Acting together, Member States and EU Institutions should take urgent measures to improve the energy efficiency of the housing stock and public buildings and promote rapid take up of 'green' products:

- Member States should set demanding targets for ensuring that public buildings and both private and social housing meet the highest European *energy-effici*ency standards and make them subject to energy certification on a regular basis. To facilitate reaching their national targets, Member States should consider introducing a reduction of property tax for energy-performing buildings. The Commission has just tabled proposals [4] for a major upgrading in the energy efficiency of buildings and calls on the Council and Parliament to give priority to their adoption;

– In addition, Member States should re-programme their structural funds operational programmes' to devote a greater share to energy-efficiency investments, including where they fund social housing. To widen possibilities, the Commission is proposing an amendment to the Structural Funds Regulations to support this move and stresses the need for early adoption of the amendments;
– The Commission will work with the EIB and a number of national development banks to launch a *2020 fund for energy, climate change and infrastructure* to fund equity and quasi-equity projects;
– The Commission calls on Member States and industry urgently to develop *innovative financing models,* for example, where refurbishments are financed through repayments, based on savings made on energy bills, over several years.

7. Promote the rapid take-up of "green products"

– The Commission will propose *reduced VAT rates for green products and services, aimed at improving in particular energy efficiency of buildings*. It encourages Member States to provide further incentives to consumers to stimulate demand for environmentally-friendly products;
– In addition, Member States should rapidly *implement environmental performance requirements* for external power supplies, stand-by and off mode electric power consumption, set top boxes and fluorescent lamps;
– The Commission will urgently draw up measures for *other products which offer very high potential for energy sa*vings such as televisions, domestic lighting , refrigerators and freezers, washing machines, boilers and air-conditioners

d) Research and Innovation

The financial crisis and the subsequent squeeze on financial resources, both public and private, may tempt some to delay, or substantially cut, planned R&D and education investments, as has happened in the past when Europe was hit by a downturn. With hindsight, such decisions amounted to a major capital and knowledge destruction with very negative effects for Europe's growth and employment prospects in the medium to longer-term. However, there have also been examples of countries, both inside and outside Europe, which had the foresight to increase R&D and education expenditure in difficult economic times by which they laid the basis for their strong position in innovation.

8. Increase investment in R&D , Innovation and Education

Member States and the private sector should increase planned investments in education and R&D (consistent with *their national R&D targets*) to stimulate growth and productivity. They should also consider ways to increase private sector R&D investments, for example, by providing fiscal incentives, grants and/or subsidies. Member States should maintain investments to increase the quality of education.

9. Developing clean technologies for cars and construction.

To *support innovation in manufacturing, in particular in the construction industry and the automobile sector* which have recently seen demand plummet as a result of the crisis and which also face significant challenges in the transition to the green economy the Commission proposes to launch *3 major partnerships between the public and private sectors:*

- *In the automobile sector, a 'European green cars initiative'*, involving research on a broad range of technologies and smart energy infrastructures essential to achieve a breakthrough in the use of renewable and non-polluting energy sources, safety and traffic fluidity. The partnership would be funded by the Community, the EIB, industry and Member States' contributions with a combined envelope of at least € 5 bn. In this context, the EIB would provide cost-based loans to car producers and suppliers to finance innovation, in particular in technologies improving the safety and the environmental performance of cars, e.g. electric vehicles. Demand side measures such as a reduction by Member States of their registration and circulation taxes for lower emission cars, as well as efforts to scrap old cars, should be integrated into the initiative. In addition, the Commission will support the development of a procurement network of regional and local authorities to pool demand for clean buses and other vehicles and speed up the implementation of the CARS21 initiative;
- *In the construction sector*, a 'European energy-efficient buildings' initiative, to promote green technologies and the development of energy-efficient systems and materials in new and renovated buildings with a view to reducing radically their energy consumption and CO_2 emissions [5]. The initiative should have an important regulatory and standardisation component and would involve a procurement network of regional and local authorities. The estimated envelope for this partnership is € 1bn. The initiative would be backed by specific actions proposed under actions 5 and 6 on infrastructure and energy-efficiency;

– *To increase the use of technology in manufacturing*, "a factories of the future initiative": The objective is to help EU manufacturers across sectors, in particular SMEs, to adapt to global competitive pressures by increasing the technological base of EU manufacturing through the development and integration the enabling technologies of the future, such as engineering technologies for adaptable machines and industrial processes, ICT, and advanced materials. The estimated envelope for this action is € 1.2bn.

10. High-speed Internet for all

High-speed Internet connections promote rapid technology diffusion, which in turn creates demand for innovative products and services. Equipping Europe with this modern infrastructure is as important as building the railways in the nineteenth century. To boost Europe's lead in fixed and wireless communications and accelerate the development of high value-added services, the Commission and Member States should work with stakeholders to develop a *broadband strategy* to accelerate the up-grading and extension of networks. The strategy will be supported by public funds in order to provide broadband access to under-served and high cost areas where the market cannot deliver. The aim should be to reach 100% coverage of high speed internet by 2010. In addition, and also with a view to upgrading the performance of existing networks, Member States should promote competitive investments in fibre networks and endorse the Commission's proposals to free up spectrum for wireless broadband. Using the funding mentioned in action 5 above, the Commission will channel an additional € 1 bn to these network investments in 2009/10.

3. Working towards Global Solutions

The challenges the EU is now facing are part of the global macro economic challenges highlighted by the recent Summit on Financial Markets and the World Economy in Washington. This European Economic Recovery Plan will form part of the EU's contribution to closer international macro economic co-operation, including with emerging countries, designed to restore growth, avoid negative spillovers and support developing countries.

The EU has benefited greatly in recent decades from increased cross-border capital and trade flows with developed countries and increasingly also with emerging economies. The financial crisis has shown just how interdependent the world has become. The scale and speed at which a loss of confidence in one part of the world soon affected financial markets and spilt over to real economies worldwide is rightly a matter of concern.

In today's world, a shock to one systemically important financial market is a global problem and has to be treated accordingly. So a key part of any co-ordinated EU response to the economic downturn will have to come through greater engagement with our international partners, and with international organisations, working together to tackle challenges at home and abroad, including in developing countries which will be among those hardest hit.

Keeping World Trade Moving

Europe's recovery depends on our companies' ability to make best use of the possibilities that global markets offer. Europe's return to solid growth will also depend on its capacity to export. Keeping trade links and investment opportunities open is also the best means to limit the global impact of the crisis, since global recovery will depend crucially on the sustainable economic performance of emerging and developing economies.

We must therefore maintain our commitment to open markets across the globe, keeping our own market as open as possible and insisting that third countries do the same, in particular by ensuring compliance with WTO rules. To reach this objective Europe should take renewed action to:

- Reach early agreement on a *global trade deal* in the WTO Doha Round. Following the renewed commitment made at the 15 November Washington Summit, the Commission has immediately stepped up efforts with key WTO partners to reach an agreement on modalities by the end of the year. A successful Round will send a strong short-term signal of confidence in the new global economic order. Over time it will bring consumers and businesses all over the world benefits in terms of lower prices, by cutting remaining high tariffs in key partner markets;
- Continue to support the economic and social consolidation of the candidate countries and the *Western Balkans* in the mutual interest of the EU and the region. To this end the Commission will put in place a € 120 million "Crisis Response Package" leveraging an amount of € 500 million in loans from International Financial Institutions;
- *Create a network of deep and comprehensive free trade agreements* in its neighbourhood as a step towards a more integrated regional market. Working through its neighbourhood policy, the EU can build on the Union for the Mediterranean and its plans for a new Eastern Partnership;
- Step up efforts to secure new and ambitious *Free Trade Agreements* with other trade partners;
- Build a close working relationship with the new US administration, including through the *Transatlantic Economic Council*. More effective regulatory cooperation could also be pursued with other key industrialised countries, such as Canada and Japan;
- Continue *dialogues with key bilateral partners* such as China, India, Brazil and Russia and use them to address public procurement, competition and intellectual property issues.

Tackling Climate Change

The crisis is occurring on the eve of a major structural shift towards the low carbon economy. The goal of fighting climate change can be combined with major new economic opportunities to develop new technologies and create jobs and enhance energy security.

Agreement in the December European Council and with the European Parliament on the EU's internal climate change strategy will strengthen the leading role the EU must seek to play in securing an ambitious international agreement on climate change at the UNFCCC conference in Copenhagen at the end of 2009.

Supporting Developing Countries

The current crisis will further add to existing pressures on developing countries, which are often least well positioned to cope. So it is all the more important that the EU, and others, maintain their commitments to achieving the Millennium Development Goals (MDG). It may also be necessary for developed countries and regions, like the EU, to come up with new, flexible and innovative instruments to help developing countries face the rapid impact of the crisis such as the EU's recent food aid facility.

Continuing to help emerging and developing countries on the path to sustainable growth is particularly relevant in the run up to the International Conference on Financing for Development, which will take place in Doha from 29 November – 2 December. At this meeting, the EU – which in 2007 continued to be the largest donor of Overseas Development Assistance (ODA) - will reaffirm its commitment to arriving at ODA target levels of 0.5 6% of GNP by 2010 and 0.7% by 2015. It will also invite other donors to continue to work towards these goals.

Supporting sustainable development, inter alia through delivering on ODA targets and MDG goals, but also through addressing overall governance challenges, is all the more important in times of economic crisis. Sharing the benefits of sustainable growth, tackling climate change, energy and food security and good governance, are interlinked challenges, where international financial institutions, like other international bodies, also have an important role to play.

4. Conclusions

It is clear that the EU faces a difficult time in the coming months as the effects of the world and European economic slow down puts pressure on jobs and demand. But, acting together, Member States and European Institutions can take action to restore consumer and business confidence, to restart lending and stimulate investment in our economies, creating jobs and helping the unemployed to find new jobs. *The European Economic Recovery Plan* set out in this Communication is designed to create a basis for rapid agreement between Member States to get Europe's economy moving again.

The European Commission calls on the European Parliament to lend its full support to this European Economic Recovery Plan.

It calls on Heads of State and Government, at their meeting on 11 and 12 December 2008, to:

1. Endorse this European Economic Recovery Plan;
2. Request the European Commission and the Council to work together to ensure that combined national and EU level measures amount to at least 1.5% of GDP;
3. Ensure that updated Stability and Convergence Programmes including the national impulse measures, are assessed in accordance with the procedures laid down in the Stability and Growth Pact, while making use of the flexibility it offers;
4. Endorse the 10 actions outlined in the European Economic Recovery Plan; urge the Council and Parliament to accelerate any legislative activity needed to implement these measures;
5. Agree, on the basis of a Commission contribution before the 2009 Spring European Council assessing progress made with the implementation of the Plan, to identify any further measures necessary at EU and Member State level to stimulate the recovery;
6. Continue to work closely with international partners to implement global solutions to strengthen global governance and promote the economic recovery.

REFERENCES

[1] Communication of 29 October - COM(2008) 706.

[2] The general recommendations and the specific actions related to the priority areas set out in this document are subject to compliance with internal market and competition rules, notably for State aid.

[3] This will be done by raising the current €1.5 M safe harbour threshold for risk capital to € 2.5M, and by allowing, subject to certain conditions and maximum amounts, (a) to grant aid for guarantees for loans for certain companies having difficulties to obtain loans ; and (b) to grant aid of up to 50% (for SMEs and 25% (for large companies) of the Reference Rate, for loans for investments in the manufacture of products complying earlier with, or going beyond, new Community standards which increase the level of environmental protection and are not yet in force.

[4] COM(2008) 755, 13.11.2008.

[5] Buildings currently account for 40% of energy consumption.

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THE FINANCIAL CRISIS: IMPACT ON AND RESPONSE BY THE EUROPEAN UNION*

James K. Jackson

ABSTRACT

According to the most recent National Threat Assessment, the global financial crisis and its geopolitical implications pose the primary near-term security concern of the United States. Over the short run, both the EU and the United States are attempting to resolve the financial crisis while stimulating domestic demand to stem the economic downturn. These efforts have born little progress so far as the economic recession and the financial crisis have become reinforcing events, causing EU governments to forge policy responses to both crises. In addition, both the United States and the EU likely will confront the prospect of growing economic and political instability in Eastern Europe and elsewhere over the impact of the economic recession on restive populations. In the long run, the United States and the EU likely will search for a regulatory scheme that provides for greater stability while not inadvertently offering advantages to any one country or group. Throughout the crisis, the European Central Bank and other central banks have assumed a critical role as the primary institutions with the necessary political and economic clout to respond effectively. Within Europe, national governments, private firms, and international organizations have varied in their response to the financial crisis, reflecting differing views over the proper policy course to pursue and the unequal effects of the financial crisis and the economic downturn. Initially, some EU members preferred to address the crisis on a case-by-case basis. As the crisis has persisted, however, leaders have begun looking for a systemic approach that ultimately may affect the drive within Europe toward greater economic integration.

Within the United States, Congress has appropriated funds to help recapitalize financial institutions, and adopted several economic stimulus measures. In addition, Congress likely will be involved in efforts to reshape institutions and frameworks for international cooperation and coordination in financial markets. European governments are also adopting fiscal measures to stimulate their economies and wrestling with failing banks. The financial crisis has demonstrated that financial markets are highly interdependent and that extensive networks link financial markets across national borders, which is pressing EU governments to work together to find a mutually reinforcing solution. Unlike the United States, however, where the federal government can legislate policies that are consistent across all 50 States, the EU process gives each EU member a great deal of discretion to decide how they will regulate and supervise

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financial markets within their borders. The limits of this system may well be tested as the EU and others search for a regulatory framework that spans a broad number of national markets. Governments that have expended considerable resources utilizing fiscal and monetary policy tools to stabilize the financial system and to provided a boost to their economies may be required to be increasingly more inventive in providing yet more stimulus to their economies and face political unrest in domestic populations. Attention likely will also focus on those governments that are viewed as not expending economic resources commensurate with the size of their economies to stimulate economic growth.

This report will be updated as events warrant.

OVERVIEW

Some members of the European Union [1] (EU) initially viewed the financial crisis as a purely American phenomenon. That view has changed as economic activity in the EU has declined at a fast pace over a short period of time. Making matters worse, global trade has declined sharply, eroding prospects for European exports providing a safety valve for domestic industries that are cutting output. In addition, public protests, sparked by rising rates of unemployment and concerns over the growing financial and economic turmoil, are increasing the political stakes for EU governments and their leaders. The global economic crisis is straining the ties that bind together the members of the EU and could present a significant challenge to the ideals of solidarity and common interests. In addition, the longer the economic downturn persists, the greater the prospects are that international pressure will mount against those governments that are perceived as not carrying their share of the responsibility for stimulating their economies to an extent that is commensurate with the size of their economy. According to Dennis Blair, Director of U.S. National Intelligence, the global financial crisis and its geopolitical implications pose, “the primary near-term security concern of the United States.” In addition, he said, “The longer it takes for the [economic] recovery to begin, the greater the likelihood of serious damage to U.S. strategic interests. Roughly a quarter of the countries in the world have already experienced low- level instability such as government changes because of the current slowdown” [2].

Various EU governments have had to expend public resources to rescue failing banks, in addition to protecting depositors and utilizing monetary and fiscal tools to support banks, to unfreeze credit markets, and to stimulate economic growth. These efforts have born modest progress so far as the economic recession and the financial crisis have become reinforcing events, which are forcing EU governments to forge policy responses to both crises. As the loss of real and financial wealth worsens, EU governments have worked both independently and in concert to address the immediate requirements of protecting financial institutions and improving access to credit by households and businesses. The differential effects of the economic downturn, however, are dividing the wealthier countries of the Eurozone [3] from the poorer countries within the EU and in East Europe and are compounding efforts to respond to the financial crisis and the economic recession. Once the immediate issues are resolved, EU governments likely will address long-term solutions to regulating and supervising financial markets. EU governments have found some common ground for solutions to the financial crisis, but the financial crisis has demonstrated that the international scope of financial activities often cause firms operating in their respective jurisdictions to compete over the highly lucrative financial services sector. In the long run, they likely will search for a regulatory scheme that provides for greater stability while not inadvertently offering advantages to any one group.

For the United States and the members of the European Union the stakes are high. Over the short run, both the EU and the United States are attempting to stop the downward spiral in the financial system, improve the financial architecture, and restore balanced economic growth. Over the long run, they likely will search for a regulatory scheme that provides for greater stability while not inadvertently offering advantages to any one country. The financial crisis and the economic downturn have become global events and likely will dominate the attention of policymakers for some time to come. Governments that have expended considerable resources utilizing fiscal and monetary policy tools to stabilize the financial system and to provide a boost to their economies may be required to be increasingly more inventive in providing yet more stimulus to their economies and face political unrest in domestic populations.

EU members are also concerned over the impact the financial crisis and the economic recession are having on the economies of East Europe and prospects for political instability [4] as well as future prospects for market reforms. Worsening economic conditions in East European countries could compound the current problems facing financial institutions in EU members. While mutual necessity may eventually dictate a more unified position among EU members and increased efforts to aid East European economies, some observers are concerned these actions may come too late to forestall another blow to the EU economies and to the United States. Governments elsewhere in Europe, such as Iceland and Latvia, have collapsed as a result of public protests over the way their governments have handled their economies during the crisis, and the International Monetary Fund has issued emergency loans to Hungary and Ukraine. The World Bank in a joint effort with the European Bank for Reconstruction and Development and the European Investment Bank announced on February 27, 2009 that they were providing $31 billion over two years to assist ailing banks and businesses in Eastern and Central Europe [5].

East European countries are experiencing a sharp depreciation in their currencies relative to the Euro and the economic crisis likely will cause their government deficits to rise, undermining the efforts of some of the countries to join the Eurozone [6]. Banks in the EU have nearly $1.5 trillion in assets potentially at risk in Central and Eastern Europe. The data in Table 1 include the exposure of the major Western European banks for East European countries and the Russian Federation. Despite this exposure to banks in Eastern Europe, EU leaders, at a meeting on March 1, 2009 reportedly could not agree on a common approach to the financial crisis and rejected a call by Hungary for financial support for Eastern Europe. Even the East European participants could not bridge their differences and present a unified approach to the EU. Some East European countries pushed for substantial financial assistance from the EU, while other countries expressed little interest in receiving financial assistance [7]

The crisis has underscored the growing interdependence between financial markets and between the U.S. and European economies. As such, the synchronized nature of the current economic downturn probably means that neither the United States nor the EU is likely to emerge from the financial crisis or the economic downturn alone. The United States and the EU share a mutual interest in developing a sound financial architecture to improve supervision and regulation of individual institutions and of international markets. This issue includes developing the organization and structures within national economies that can provide oversight of the different segments of the highly complex financial system. This oversight is viewed by many as critical to the future of the financial system because financial markets generally are considered to play an indispensible role in allocating capital and facilitating economic activity.

Table 1. Major Western European Banks' Claims on Central and Eastern Europe (in billions of U.S. dollars)

	Austria	Belgium	France	Germany	Italy	Nether lands	Sweden	Total
Belarus	$2.1	$0.1	$0.2	$0.9	$0.2	$0.1	$0.0	$3.6
Bulgaria	5.7	2.0	3.6	2.8	8.1	0.7	0.0	22.9
Czech. Rep.	65.1	56.7	38.6	12.7	19.0	6.2	0.2	198.5
Estonia	0.3	0.1	0.1	1.1	0.4	0.0	32.7	34.7
Hungary	38.3	18.7	11.9	37.9	29.3	5.6	0.3	142.0
Latvia	0.8	0.0	0.4	4.8	1.4	0.0	25.0	32.4
Lithuania	0.3	0.1	0.4	3.8	0.7	0.0	28.9	34.2
Poland	17.2	25.2	22.9	55.4	54.4	41.2	8.1	224.4
Romania	46.5	1.2	17.6	3.8	12.9	11.0	0.2	93.2
Russian Fed.	23.9	10.3	34.7	49.5	25.7	25.5	9.9	179.5
Slovakia	33.2	10.9	6.4	4.1	23.6	6.7	0.2	85.1
Ukraine	12.9	0.8	10.6	5.0	4.9	3.7	5.4	43.3
Total	246.3	126.1	147.4	181.8	180.6	100.7	110.9	1,093.8

Source: Lemer, Jeremy, Steven Bernard, and Helen Warrell, Eastern Exposure, Financial Times, February 25, 2009.

In the months ahead, Congress and the Obama Administration likely will consider a number of proposals to restructure the supervisory and regulatory responsibilities over the broad-based financial sector within the United States. At the same time, such international organizations, as the G-20, the Financial Stability Forum, the International Monetary Fund, the Organization for Economic Cooperation and Development, and the Bank for International Settlements likely will offer their own prescriptions for the international financial markets.

Financial Architecture

As policymakers address this issue, they likely will weigh the costs and benefits of centralizing supervisory responsibilities into a few key entities, such as the Federal Reserve, or dispersing them more widely across a number of different entities. A centralized approach may avoid the haphazard way in which certain complex financial markets and transactions went largely unregulated. On the other hand, a broader dispersion of supervisory responsibilities may yield a more specialized approach to market supervision. In the United States, the Federal Reserve holds a monopoly over the conduct of monetary policy, mainly as a means of keeping such policy- making independent of political interests. The Federal Reserve also shares regulatory and supervisory responsibilities with a number of different agencies that are more directly accountable to elected officials and are subject to change. The EU system, however, is different from the U.S. system in ways that may complicate efforts at coordination. For instance, the European Central Bank is not strictly comparable to the Federal Reserve in both scope of its regulatory role and its role in supervising banks. In the EU system each EU member has its own institutional and legal framework for regulating its banking market, and national supervisory authorities are organized differently by each EU country with different powers and accountability.

On various occasions over the past several months, EU leaders have discussed the need to develop a common set of rules that could help regulate financial markets and prevent another financial crisis. What has emerged, however, is a lack of consensus over the details of such a regulatory scheme. On February 22, 2009, leaders and Finance Ministers from Germany, the United Kingdom, France, Italy, Spain, the Netherlands, Czech Republic, and Luxembourg met in Berlin to map out a common approach to overhauling financial rules in preparation for the G20 meeting in London on April 2, 2009. A position paper prepared by German Finance Minister Peer Steinbruck set out five areas of discussion for the European leaders: 1) transparency and accountability; 2) enhancing "sound regulation; 3) promoting integrity in financial markets; 4) strengthening international cooperation; and 5) reforming international financial institutions. Beyond these vague goals, the group has not been able to provide a detailed roadmap of how to achieve a new financial architecture, or to gain a unified approach within the broader membership of the EU.

The European leaders also considered proposals for the G20 meeting that would require banks to increase their capital resources in periods of faster economic growth. Reportedly, the Ministers also discussed the growing economic problems in Eastern European countries, tax havens, trade protectionism, and a $500 billion fund for the International Monetary Fund to deal with economic crises. Following the formal talks, German Chancellor Merkel spoke in favor of adopting global regulations for financial markets and hedge funds. In a statement released on behalf of all of the leaders, Chancellor Merkel said, "All financial markets, products, and participants, including hedge funds and other private pools of capital which may pose a systemic risk must be subjected to appropriate oversight or regulation" [8].

The current financial and economic crises have exposed deep philosophical differences among EU members over the most effective policy course to pursue to address these two crises. EU members have addressed the financial crisis independently and in concert through the EU organization, reflecting the dual nature of the EU system. Unlike the United States, where the Federal government can implement policies that are applied systematically across all 50 States, EU-wide actions reflect compromise among national authorities. As a result, the national authorities exercise considerable freedom in implementing EU Directives and in charting their own response to the crisis. For instance, EU members agreed to support an EU-wide fiscal stimulus to counter the economic downturn. The worsening economic conditions in Europe, however, have not been felt evenly across all EU members, and their response has exposed differences in economic philosophies that have blunted a coordinated approach. EU members also have responded differently to helping banks reduce their exposure to so-called toxic loans, because in the current environment their market value cannot be determined. The efforts by some EU members to address this issue has pushed the EU to consider an EU-wide approach.

Within the EU, however, integration of the financial services sector across borders has been uneven, with integration progressing faster in the money, bond, and equity markets, and slowest in the banking sector where many of the policy changes likely will be focused. According to the European Central Bank, [9] retail banking services remain segmented along national lines as a result of differences in national tax laws, costs of national registration and compliance, and cultural preferences. Nevertheless, cross-border mergers and acquisitions within Europe have played an important role in internationalizing banking groups, which has led to significant cross-border banking activity. Integration within the banking sector in Europe also has increased since the European Community adopted the euro as the EU’s single currency.

The EU response to the two crises has been complicated further by a number of factors, including the need to mesh new proposals with such existing EU Directives as the Stability and Growth Pact [10], the Lisbon Principles [11], and the Financial Services Action Plan [12]. The EU structure gives the individual members considerable latitude to formulate their own policies in response to crises. In some cases, this has meant that the EU has had to adopt policies that have been implemented by some of its members to prevent a sort of EU-wide competition. For instance, EU members were pressed to support a broad set of measures to increase the guarantees on bank accounts for depositors in response to actions by Ireland, Greece, and Germany. Some EU members are also considering procedures to deal with the bad loans of banks within their jurisdictions, which has pushed the EU as a whole to follow suit and consider the best approach to deal with the toxic loans of EU banks. This and other issues have exposed sharp differences among the EU members over the best approach to deal with financial market reforms and economic stimulus measures. These differences may well become more pronounced as multilateral discussions shift from addressing the general goal of containing the financial crisis to the more contentious issues of specific market reforms, regulations, and supervision.

Economic Performance

Estimates developed by the International Monetary Fund in January 2009 provide a rough indicator of the impact the financial crisis and an economic recession are having on the performance of major advanced countries. Economic growth in Europe is expected to slow by nearly 2% in 2009 to post a 0.2% drop in the rate of economic growth, while the threat of inflation is expected to lessen, as indicated in Table 2. Economic growth, as represented by gross domestic product (GDP), is expected to register a negative 1.6% rate for the United States in 2009, while the euro area countries could experience a combined negative rate of 2.0%, down from a projected rate of growth of 1.2% in 2008. The sharp drop in the prices of oil and other commodities in the later part of 2008 may have helped improve the rate of economic growth, but the length and depth of the economic downturn likely well mean that the IMF projections prove to be too optimistic when the final data for 2009 are known. Indeed, in mid-February, the European Union announced that the rate of economic growth in the EU in the fourth quarter of 2008 had slowed to an annual rate of negative 6% [13]

Table 2. Projections of Economic Growth in Various Countries and Areas (real GDP growth, in percent change)

	2007	2008	2009	2010
	Actual	Projected		
World	5.2	3.4	0.5	3.0
United States	2.0	1.1	-1.6	1.6
Advanced Economies	2.7	1.0	-2.0	1.1
Emerging Economies	8.3	6.3	3.3	5.0
European Union	3.1	1.3	-1.8	0.5
Euro Area	2.6	1.0	-2.0	0.2
France	2.2	0.8	-1.9	0.7
Germany	2.5	1.3	-2.5	0.1
Italy	1.5	-0.6	-2.1	-0.1
Spain	2.4	-0.3	-2.6	0.6
United Kingdom	3.0	0.7	-2.8	0.2
Non-EU advanced	4.6	1.9	-2.4	2.2
Japan	2.4	-0.3	-2.6	0.6
Canada	2.7	0.6	-1.2	1.6

Source: World Economic Outlook, Update, the International Monetary Fund, January 2009.

THE FINANCIAL CRISIS AND THE EUROPEAN UNION

The cause and effects of the current financial crisis likely will be debated for years to come. This report does not attempt to provide a complete explanation of the causes of the financial crisis, since other CRS Reports address these issues [14]. While different individuals and organizations view the crisis from different perspectives, one way to view the crisis is as a series of policy events proceeding through four periods where the policy responses differed [15]. The periods are not necessarily discretely identifiable, because they overlap with other periods, or the policy responses have been repeated as the financial crisis has persisted. This has been especially true as the financial crisis has deepened over time and as the economic downturn and the financial crisis have become reinforcing events, compounding efforts to resolve either crisis.

The first phase of the crisis represents the early build-up to the crisis in which policymakers responded in an ad hoc manner to assist individually troubled banks and financial institutions. In the second phase, national governments, primarily through central banks, moved to address issues of liquidity that arose from wide-spread concerns over the viability of the financial system, rather than the more narrow concerns of individual institutions.

In the third phase, government finance ministries adopted policies to address issues of solvency as banks and other financial firms attempted to deleverage their positions by reducing their holdings of troubled assets and as credit markets essentially shut down. In the fourth phase, governments, through finance ministries and legislative bodies, shifted to address growing concerns over the economic downturn that has worsened the financial crisis.

According to reports by the International Monetary Fund (IMF) and the European Central Bank (ECB), many of the factors that led to the financial crisis in the United States created a similar crisis in Europe.16 Essentially low interest rates and an expansion of financial and investment opportunities that arose from aggressive credit expansion, growing complexity in mortgage securitization, and loosening in underwriting standards combined with expanded linkages among national financial centers to spur a broad expansion in credit and economic growth.

This rapid rate of growth pushed up the values of equities, commodities, and real estate. Over time, the combination of higher commodity prices and rising housing costs pinched consumers' budgets, and they began reducing their expenditures. One consequence of this drop in consumer spending was a slowdown in economic activity and, eventually, a contraction in the prices of housing.

In turn, the decline in the prices of housing led to a large-scale downgrade in the ratings of subprime mortgage-backed securities and the closing of a number of hedge funds with subprime exposure. Concerns over the pricing of risk in the market for subprime mortgage-backed securities spread to other financial markets, including to structured securities more generally and the interbank money market. Problems spread quickly throughout the financial sector to include financial guarantors as the markets turned increasingly dysfunctional over fears of under valued assets.

PHASE I — BUILD-UP

The first phase of the financial crisis is identified with a loss of confidence in credit markets that was associated with a downturn in the U.S. housing market caused primarily by rising defaults in subprime mortgages. In this stage, EU governments generally responded on a case-by-case basis, without a role for the broader Community. A sharp downturn in mortgage markets generally would be expected to have a negative impact on parts of the economy, but the current financial crisis quickly evolved into a more general liquidity crisis that spread well beyond the sub-prime mortgage market. Initially, only highly leveraged banks, investment firms, and other financial services providers seemed to be affected by the credit problems. During this phase in the United States, the Federal Deposit Insurance Corporation took control of IndyMac Bank.

The financial crisis that began in the United States as a result of a downturn in residential property values quickly spread to European banks through effects felt in the market for asset-backed commercial paper (ABCP) [17]. European banks were either directly holding the securities or they were holding them indirectly through conduits and structured investment vehicles with similar holdings. As the ABCP market collapsed, banks holding such securities were forced to step in with additional funding, which squeezed liquidity in the global financial market through the interbank market. Over time, banks and other financial firms found that it was impossible to price the value of assets that were being used to back commercial paper. During this phase, the British government nationalized housing lender Northern Rock and Bradford & Bingley, a mortgage lender. Belgium, France, and Luxembourg governments and shareholders provided capital to Dexia, the world's largest lender to municipalities, and Belgian, Dutch, and Luxembourg governments injected $16.4 billion into banking and insurance company Fortis to head off the first major bank crisis in the Euro area.

PHASE II — LIQUIDITY ISSUES

In the second phase, policy shifted from an ad hoc focus on the fate of individual firms to concerns over troubled markets as central banks intervened to lower interest rates, to provide liquidity, and to provide foreign currency. In the United States, as generally is the case in most countries, the Federal Reserve, or the central bank, holds a monopoly over the conduct of monetary policy, mainly as a means of keeping such policy-making independent from political pressure. Normally, it is not the role of the central bank to be the main provider of liquidity, but that role falls to the central banks as lenders of last resort during periods of financial crisis. In addition, central banks generally share regulatory and supervisory responsibilities, including providing assistance to individual firms or helping banks deleverage, with a number of different agencies that are more directly accountable to elected officials and are subject to change.

During this phase, governments attempted to stabilize the financial markets by expanding insurance on guarantees for depositors and, in some cases, guarantees for banks. Central banks also engaged in direct injections of capital to support the balance sheets of banks and removed some distressed assets from banks by acquiring the assets. Efforts to acquire distressed assets from the banks, however, raised questions concerning the value of the assets, since, in most cases, the value of the assets had fallen below the value indicated on the balance sheets of the banks. The Bank for International Settlements (BIS) indicates that governments in Europe varied their responses to the financial crisis, as indicated in Table 3.

In addition, the BIS indicates that there are considerable differences in the design and implementation of the rescue efforts and in the way foreign depositors are treated in the case of a bank failure.

In this phase, Iceland was especially hard hit by the financial crisis, with major Icelandic banks completely shutting down for a period of time [18]. On November 19, 2008, Iceland and the International Monetary Fund (IMF) finalized an agreement on an economic stabilization program supported by a $2.1 billion two-year standby arrangement from the IMF [19]. Following the IMF decision, Denmark, Finland, Norway, and Sweden agreed to provide an additional $2.5 billion. On January 26, 2009, public protests against the Icelandic government's handling of the crisis and the economy caused Iceland's Prime Minister Haarde to resign and the coalition government to fall.

Central Bank Operations

During this phase, U.S. mortgage markets continued to deteriorate, prompting the U.S. Treasury and Federal Reserve to engineer the acquisition of Bear Stearns by JPMorgan Chase and to announce that it was taking over the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Soon after this takeover, Lehman Brothers filed for bankruptcy, which led to a more wide-spread crisis of confidence, and which, in turn, led credit markets to freeze up and led to a lack of liquidity. Given Lehman's far-reaching exposure in the financial markets, its collapse likely would have had a negative impact on the financial markets under normal circumstances, but the impact was magnified by underlying weaknesses in the markets that had been building over time. In particular, Lehman was heavily involved in the $57 trillion credit default swap (CDS) [20]. market. Lehman's bankruptcy triggered clauses in CDS contracts that referenced Lehman, and it terminated contracts that Lehman had entered into as a counterparty [21]. Lehman also originated commercial paper and other forms of short term debt that a number of European banks held through Lehman's global presence.

Table 3. Elements of Banking System Rescue Plans in European Countries

Country	Expansion of retail deposit insurance	Guarantee of wholesale liabilities		Capital injections	Asset purchases
		New debt	Existing debt		
Austria	×	×		×	
Belgium	×	×			
Denmark	×	×	×		
Finland	×				
France		×		×	
Germany	×	×		×	×
Greece	×	×		×	
Ireland	×	×	×		
Italy		×		×	
Netherlands	×	×		×	
Norway					×
Portugal	×	×			
Spain	×	×		×	×
Sweden	×	×		×	
Switzerland				×	×
United Kingdom	×	×		×	×

Source: Fender, Ingo, and Jacob Gyntelberg, Overview: global financial Crisis Spurs Unprecedented Policy Actions, Quarterly Review, Bank for International Settlements, December 2008, p. 11.

As investors scrambled to redeem commercial paper, the Federal Reserve stepped in to the money markets and purchased commercial paper and other short term money market securities. Particularly hard hit by the Lehman bankruptcy was AIG (American International Group), which had been closely tied to the CDSs offered by Lehman. The Federal Reserve arranged for a $85 billion credit facility in exchange for an 80% equity stake in AIG.

Various governments, through their central banks, injected capital directly into banks and other financial firms during this phase to keep firms from failing and to arrange mergers by providing liquidity. The British government arranged for Halifax Bank of Scotland (HBOS) to be acquired by the Lloyds Banking Group. In the United States, the Office of Thrift of Supervision seized Washington Mutual Bank from Washington Mutual, Inc. and arranged for its sale to JPMorgan Chase. The Federal Reserve also approved the transformation of Goldman Sachs and Morgan Stanley into bank holding companies.

According to a paper prepared by staff at the International Monetary Fund (IMF), [22] one of the key issues facing central banks during the crisis has been distinguishing between troubled markets and troubled institutions. Troubled institutions can be dealt with on a case-by-case basis, as was done in the initial stages of the financial crisis. Troubled markets, however, require a more coordinated approach since the effects can span a range of countries and financial markets. The authors also concluded that central banks were able to respond quickly to the financial crisis as a result of various aspects of their operational framework that allowed them to respond without fundamentally changing their basic monetary policy. While it is important for central banks to be flexible when responding to a crisis, the study emphasized, central banks, “cannot come to be seen as the market maker of last resort in all markets nor the lender of last resort for all institutions.” The authors concluded that central bank policies should strike a balance between supporting the financial system during times of crisis and setting in motion the seeds of future crises. Also, the study indicated that certain types of central bank mechanisms proved to be more effective in providing liquidity and in coping with significant turbulence in the financial markets.

The European Central Bank provided large quantities of reserves through routine short-term open-market operations and through longer-term open market operations. Unlike the Federal Reserve, which normally conducts open market operations with a small set of primary dealers against a narrow range of highly liquid collateral, the ECB routinely conducts open market operations with a wide range of counterparties against a broad range of collateral. The ECB extended this strategy during this phase of the financial crisis with a longer term refinancing operation [23]. This greater flexibility, compared with the Federal Reserve, reportedly made it possible for the ECB to provide liquidity within its existing framework without resorting to extraordinary measures [24]. During this phase, the UK’s Financial Services Authority arranged for the sale of a large part of Bradford & Bingley to the Spanish bank Grupo Santander, while Fortis, a banking and insurance company received a capital injection from the Belgian, Dutch, and Luxembourg governments.

During this phase, the British Government announced a $850 billion multi-part plan to rescue its banking sector from the financial crisis, known as the Stability and Reconstruction Plan. The key feature of the plan, as promoted by British Prime Minister Gordon Brown, has the central government acquiring preferred shares in distressed banks for a specified amount of time, rather than acquiring the non-performing loans of the banks. The announcement of the Plan followed a day when British banks lost more than $25 billion on the London Stock Exchange. The biggest loser was the Royal Bank of Scotland, whose shares fell 39%, representing $15 billion, of lost value. In the downturn, other British banks lost substantial amounts of their value, including the Halifax Bank of Scotland which was in the process of being acquired by Lloyds TSB. The British plan is comprised of four parts:

- First was a coordinated cut in key interest rates of 50 basis points, or one-half of one percent (0.5) with the Bank of England, the Federal Reserve, and the European Central Bank all participating.
- Second was an announcement of an investment facility of $87 billion implemented in two stages to acquire the Tier 1 capital, or preferred stock, in “eligible” banks and building societies (financial institutions that specialize on mortgage financing) in order to recapitalize the firms. Under the financial plan, eight British banks – Abbey, RBS, Barclays, Hallifax Bank of Scotland, HSBC (Hong Kong and Shanghai Banking Corporation), Lloyds TSB, Standard Chartered, and Nationwide Building Society – signed up to participate in the recapitalization effort.
- Third, the British Government agreed to make available to those institutions participating in the recapitalization scheme up to $436 billion in guarantees on new

short- and medium-term debt to assist in refinancing maturing funding obligations as they fall due for terms up to three years.

- Fourth, the British Government announced that it would make available $352 billion through the Special Liquidity Scheme [25] to improve liquidity in the banking industry [26].

In addition to this four-part plan, the Bank of England announced that it had developed three new proposals for its money market operations. First, was the establishment of Operational Standing Facilities that are aimed at addressing technical problems and imbalances in the operation of money markets and payments facilities, although they did not provide financial support. Second, the establishment of a Discount Window Facility which allows banks to borrow government bonds or, at the Bank's discretion, cash, against a wide range of eligible collateral to provide liquidity insurance to commercial banks in stress. Third, a permanent open market for long-tem repurchase agreements (securities sold for cash with an agreement to repurchase the securities at a specified time) against broader classes of collateral to offer banks additional tools for managing their liquidity [27]. The plan was quickly implemented with the UK government taking a controlling interest in the Royal Bank of Scotland (RBS) and Hallifax Bank of Scotland (HBOS).

At the euro area summit on October 12, 2008, the euro area countries, along with the United Kingdom, urged all European governments to adopt a common set of principles to address the financial crisis [28]. The measures the nations supported were largely in line with those that had been proposed by the United Kingdom and included:

- Recapitalization: governments promised to provide funds to banks that might be struggling to raise capital and pledged to pursue wide-ranging restructuring of the leadership of those banks that are turning to the government for capital.
- State ownership: governments indicated that they will buy shares in the banks that are seeking recapitalization.
- Government debt guarantees: guarantees offered for any new debts, including inter-bank loans, issued by the banks in the euro zone area.
- Improved regulations: the governments agreed to encourage regulations to permit assets to be valued on their risk of default, instead of their current market price.

In addition to these measures, EU leaders agreed on October 16, 2008, to set up a crisis unit and they agreed to a monthly meeting to improve financial oversight [29]. Jose Manuel Barroso, President of the European Commission, urged EU members to develop a "fully integrated solution" to address the global financial crisis, consistent with France's support for a strong international organization to oversee the financial markets. The EU members expressed their support for the current approach within the EU, which makes each EU member responsible for developing and implementing its own national regulations regarding supervision over financial institutions. The European Council stressed the need to strengthen the supervision of the European financial sector. As a result, the EU statement urged the EU members to develop a "coordinated supervision system at the European level." [30]. This approach likely will be tested as a result of failed talks with the credit derivatives industry in Europe. In early January 2009, an EUsponsored working group reported that it had failed to get a commitment from the credit derivatives industry to use a central clearing house for credit default swaps. As an alternative, the European Commission reportedly is considering adopting a set of rules for EU members that would require banks and other users of the CDS markets to use a central clearing house within the EU as a way of reducing risk [31]

Interest Rates

On October 8, 2008, central banks in the United States, the Eurozone, the United Kingdom, Canada, Sweden, and Switzerland staged a coordinated cut in interest rates to improve liquidity, and they announced that they had a plan of action to address the ever-widening financial crisis [32].

Soon after, the U.S. Treasury, in coordination with the Federal Reserve, announced its Capital Purchase Program as part of its Troubled Asset Relief Program and arranged for an injection of capital in exchange for equity shares into eight major U.S. banks [33]. On October 29, 2008, the U.S. Federal Reserve cut key interest rates by half a percentage point, a move that was matched by China and Norway [34]. In response to these cuts, on November 6, 2008, the Bank of England cut its key interest rates by 1.5 percent points to 3%. The cut was three times larger than any seen since the central bank's monetary policy committee was established in 1997 [35]. At the same time, the European Central Bank (ECB), which sets interest rates for the 16 members of the Eurozone, cut its interest rates by half a percentage point to 3.25% [36]. The Czech Central Bank also cut its rates by a larger than expected three-quarters of a percentage point, while the Swiss National Bank lowered its rates by one-half of a percentage point. The cut in rates came as the IMF published an emergency update of its economic forecasts, predicting that the economies of the developed countries would shrink by 0.3% in 2009, down from a projection released in October that growth among the most developed economies would increase by 0.5%.

Currency Swap Facilities

In addition to reducing interest rates and providing liquidity by injecting capital directly into banks, the Federal Reserve and other central banks in Europe and elsewhere expanded short-term bilateral currency swap facilities by $180 billion to compensate for a dollar liquidity crisis. The dollar is used widely in international trade transactions and as a reserve currency by other central banks. The dollar is also used by many financial institutions outside the United States that have substantially increased their dollar investments, including loans to nonbanks and purchases of asset-backed securities issued by U.S. firms. Most financial institutions outside the United States have relied on interbank and other wholesale markets to obtain dollars. As credit markets seized up, however, these institutions found they did not have access to short-term dollar financing. European banks, in particular, had difficulties obtaining US dollar funding. Preceding the financial crisis, European banks had vastly expanded their accumulation of dollars in the interbank market and from official monetary authorities that had acquired dollar-denominated assets. In essence, European banks borrowed dollars short term in the interbank market in order to finance a rapid growth in investments in dollar-denominated assets with varying maturities in assets held by non-banks, such as asset-backed commercial paper, which left European banks with large short-term US dollar funding requirements. Such constant refinancing contributed to the squeeze in liquidity and to problems in obtaining dollars in the foreign exchange market and in cross-country currency swap markets [37].

The principal tool the Federal Reserve and the European Central Bank used to counter the currency shortage is a temporary currency swap, which allows central banks to borrow currency from each other in order to relend the currencies to banks in their jurisdictions. Typically, inter- central bank foreign exchange swap arrangements are used to support foreign exchange market intervention, rather than to alleviate shortages of foreign exchange in the short-term funding market. Prior to September 2008, the Federal Reserve had established inter-central bank currency swap lines with the Swiss National Bank and with the European Central Bank to deliver U.S. dollar funds, complimenting the Federal Reserve's Term Auction Facility. Between September 2008 and November 2008, the Federal Reserve established such arrangements with more than a dozen other central banks [38]

In addition to shortages of dollars, there have also been shortages of euros and Swiss francs. During the period when the European Central Bank was concluding swap arrangements with the Federal Reserve, it was also establishing currency swaps with the Czech central bank, the National Bank of Denmark, and the National Bank of Poland. Central banks in Europe responded to the currency shortage by providing currency from their own foreign exchange reserves and by borrowing from other central banks, principally from the central bank that issued the currency.

Depositor Guarantees

Ireland, Greece, and Germany also increased their guarantees to deposit holders to improve liquidity in the financial system, a move that was adopted by the EU as a whole to curtail a form of regulatory competition for depositors. The International Monetary Fund also approved a short- term liquidity facility to assist banks facing liquidity problems. The G-7 [39] group of countries met to discuss a coordinated approach to the crisis, [40] followed by the Euro area summit, at which the Euro area countries urged all European governments to help recapitalize banks, to have governments buy shares in banks, if needed, to guarantee the debt of banks, and to improve bank regulations [41]

On December 4, 2008, European central banks initiated another round of cuts in interest rates. The ECB cut its key rate by three-quarters of a percentage point to 2.5%, representing the largest one-day rate move in the bank's 10-year history. In turn, the Bank of England cut its key rate by a full percentage point to 2%. Sweden's central bank also cut interest rates by 1.75 percentage points to 2%, the largest single cut in rates in 16 years [42]. On January 8, 2009, the Bank of England reduced its Official Bank Rate by 0.5 percentage points to 1.5% [43]. In addition, on February 5, 2009, the Bank of England announced an additional cut in its official bank rate by 0.5% to 1.0% to stimulate economic growth [44]. On January 15, 2009, the ECB President Jean- Claude Trichet announced that the bank had cut its rates by 0.5% to 2.0% as a result of lower inflationary pressures and weakening economic prospects due to reduced exports and lower domestic demand within the EU countries [45]. In summing up, Trichet indicated that the reasoning behind the ECB's decision was based on a number of factors:

> This takes into account the latest economic data releases and survey information, which add clear further evidence to the assessment that the euro area is experiencing a significant slowdown, largely related to the effects of the intensification and broadening of the financial turmoil. Both global demand and euro area demand are likely to be dampened for a protracted period. All in all, the level of uncertainty remains exceptionally high [46]

PHASE III - SOLVENCY AND DELEVERAGING

In the third phase, the lack of confidence in credit markets and a lack of liquidity also sparked concerns over the adequacy of capital provisions of financial institutions and concerns over the solvency of banks and other financial firms. During this phase, financial firms attempted to deleverage by reducing the amount of troubled assets they held on their balance sheets. At the same time, the stocks of most financial firms in the United States and in Europe dropped markedly, and the value of their assets deteriorated, which weakened the financial position of an even larger number of firms.

In this phase, intervention by central banks continued, but national governments also began to intervene, typically through their respective Treasury departments, to take control of insolvent banks or otherwise to provide financial assistance. The U.S. Congress passed the Troubled Assets Relief Program as part of the Emergency Economic Stabilization Act (P.L. 110-343) initially intended to acquire up to $700 billion in troubled mortgage-related securities [47].

As the financial crisis persisted, U.S. Treasury Secretary Geithner announced on February 9, 2009, that the Financial Stability Plan that was being prepared at that time by the Treasury Department provided a “full arsenal of financial tools and the resources commensurate” to stress test banks; to provide for a public-private investment fund; to provide funds for consumer and business lending; and to ensure greater transparency, accountability, and monitoring of banks [48]

The "European Framework for Action"

On October 29, 2008, the European Commission released its “European Framework for Action” as a way to coordinate the actions of the 27 members of the European Union in addressing the financial crisis [49]. On November 16, 2008, the Commission announced a more detailed plan that brings together short-term goals to address the current economic downturn with the longer-term goals on growth and jobs that are integral to the Lisbon Strategy for Growth and Jobs that was adopted by the EU in 2000 and recast in 2005. The short-term plan focuses on a three-part approach to an overall EU recovery action plan/framework. The three parts to the EU framework are: 1) a new financial market architecture at the EU-level; 2) dealing with the impact on the real economy; and 3) a global response to the financial crisis.

- *A new financial market architecture at the EU level*. The basis of this architecture involves implementing measures that EU members have announced as well as providing for: 1) continued support for the financial system from the European

Central Bank and other central banks; 2) rapid and consistent implementation on the bank rescue plan that has been established by the member states; and 3) decisive measures that are designed to contain the crisis from spreading to all of the member states. As the financial system is stabilized, the next step is to restructure the banking sector and to return banks to the private sector. Proposals include: deposit guarantees and capital requirements; regulation and accounting standards; credit rating agencies, executive pay; capital market supervision, and risk management.

- *Dealing with the impact on the real economy*. The policy instruments that can be employed to address the expected rise in unemployment and decline in economic growth are in the hands of the member states. Nevertheless, the EU can assist by adding short-term actions to its structural reform agenda, while investing in the future through: 1) increasing investment in R&D innovation and education; 2) promoting "flexicurity" [50] to protect and equip people rather than specific jobs; 3) freeing up businesses to build markets at home and internationally; and 4) enhancing competitiveness by promoting green technology, and overcoming energy security constraints and achieving environmental goals. In addition, the Commission will explore a wide range of ways in which EU members can increase their rate of economic growth.
- The impact of the financial crisis on the real economies of the EU members likely will require adjustments in the fiscal and monetary policies of the EU members. The Stability and Growth Pact [51] of the EU members should serve as the blueprint for members facing higher than expected levels of fiscal or monetary stimulus so that such policies should be accompanied by structural reforms. Such reforms should aim to sustain domestic demand in the short-run, ease transitions within and into the labor market, and increase potential growth by directing investment into areas that will sustain employment and advance productivity. Reforms in the finance sector should focus on enhancing the competitive position of the European industry and finance the needs of small and medium-sized firms. The Commission will also attempt to counter an expected increase in unemployment by using funds provided under the European Social Fund [52] to reintroduce unemployed workers back into the work force.
- *A global response to the financial crisis*. The crisis has raised questions concerning global governance that are relative to the financial sector and to the need to maintain open trade markets. The EU intended to use the November 15, 2008 multi-nation economic summit In Washington D.C. to promote a series of measures to reform the global financial architecture. The Commission argued that the measures should include: 1) strengthening international regulatory standards; 2) strengthening international coordination among financial supervisors; 3) strengthening measures to monitor and coordinate macroeconomic policies; and 4) developing the capacity to address a financial crisis at the national regional and multilateral levels. Also, a financial architecture plan should include three key principles: 1) efficiency; 2) transparency and accountability; and 3) inclusion of representation from key emerging economies.

In concert with the European Framework for action, several European countries, including Germany, France, Italy, Austria, Netherlands, Portugal, Spain, and Norway announced plans to recapitalize banks and to provide government debt guarantees. European leaders agreed to increase the role of the IMF in preventing a future financial crisis, however, they could not agree on precisely what that role should be [53]. As a consequence, the leaders set a 100-day deadline to draw up reforms for the international financial system and asked the Bank for International Settlements (BIS) to develop a set of guidelines to ensure that banks hold enough capital to reduce the risks of a similar financial crisis.

On January 7, 2009, the BIS responded to the request by the G20 by publishing a first draft of its proposed guidelines [54] for "stress testing banks," or assessing the impact of various large shocks on the ability of banks to absorb losses. Stress testing is a risk management tool that is used by banks to assess the financial position of a bank under a severe but plausible scenario to absorb the impact of unexpected risks on the bank's capital position, which is comprised of common stock and retained earnings. Banks do not loan out their capital directly to borrowers, but use it as a cushion to help them absorb losses from loans and other banking activities. Currently, banks are required to engage in periodic stress testing as a risk management tool. The BIS guidelines provide a set of recommendations for bank supervisors as they review the conduct of stress tests within their banks in order to overcome shortcomings in the present system that failed to assess such risks as: the behavior of complex structured products; risks in relation to hedging strategies; pipeline or securitization risk; contingent risk; and funding liquidity risk.

"Bad Banks"

The United Kingdom, the Netherlands, Germany, and the European Central Bank are considering proposals to split off the bad assets of banks into a separate "bad bank" to prevent more banks from failing as did Sweden in the 1990s and Switzerland in 2008. The economic downturn is continuing to erode the value of the assets that banks are holding as capital, which is causing banks to curtail their lending and, in a growing number of cases, threatening the viability of the bank. The United Kingdom created such a bank when it took over Bradford & Bingley by selling off the healthy portion of the bank and holding "bad" assets. A hurdle that faces a bank with bad assets is that when the bank participates in such a bad asset program they are forced to lower the value they assign to their bad assets before they can move them to a bad bank, which further dilutes the value of the remaining shares of the bank and compounds the efforts by the bank to raise capital [55].

Germany is considering a plan that would shift bad assets from banks into special-purpose securities with government guarantees. Officials are also considering providing more generous accounting rules that would protect assets that experience a down grade in their value from having a negative impact on the value of the capital a bank uses to support its core business. In response to actions by Germany and the United Kingdom, the European Central Bank is drawing up guidelines for European governments that are considering establishing "bad" banks to forestall a competitive movement by EU governments. The ECB is also considering guidelines for some governments that are developing plans to guarantee the bad assets that remain on the books of banks to head off a move to gain a competitive advantage for some banks [56].

PHASE IV - FISCAL INTERVENTION

In the fourth phase, as the problems in credit markets persisted, the financial crisis spread to those activities in the real economy that are highly reliant on credit markets, and it reinforced concerns over the adequacy of capital provisions. Furthermore, the slowdown in economic growth weakened the capital position of financial institutions so that the financial crisis and the economic downturn have become negatively reinforcing. Governments have responded in this phase of the crisis by adopting macroeconomic stimulus measures to blunt the effects of the economic recession. In February 2008, Congress passed P.L. 110-185, the Economic Stimulus Act of 2008 to provide rebates to individuals on their income taxes in order to provide a fiscal boost to the U.S. economy [57].

Table 4. Recently Announced and Planned or Proposed Stimulus Packages

Date Announced	Country	$Billion	Status, Package Contents
12-Dec-08	European Union	256.00	Fund cross-border projects including clean energy and upgraded telecommunications architecture. Each EU member to contribute an amount equivalent to 1.5% of GDP to boost consumer spending. Members asked to boost spending in energy efficient equipment and clean technologies.
13-Jan-09	Germany	65.00	Infrastructure, tax cuts, child bonus, increase in some social benefits, $3,250 incentive for trading in cars more than nine years old for a new or slightly used car.
24-Nov-08	United Kingdom	29.60	Proposed plan includes a 2.5% cut in the value added tax for 13 months, a postponement of corporate tax increases, government guarantees for loans to small and midsize businesses, spending on public works, including public housing and energy efficiency. Plan includes an increase in income taxes on those making more than $225,000 and increase National Insurance contribution for all but the lowest income workers.
5-Nov-08	France	33.00	Public sector investments (road and rail construction, refurbishment and improving ports and river infrastructure, building and renovating universities, research centers, prisons, courts, and monuments) and loans for carmakers. Does not include the previously planned $15 billion in credits and tax breaks on investments by companies in 2009.
16-Nov-08	Italy	52.00	Awaiting final parliamentary approval. Three year program. Measures to spur consumer credit, provide loans to companies, and rebuild infrastructure. February 6, announced a $2.56 billion stimulus package that was part of the three-year program that includes payments of up to $1,950 for trading in an old car for a new, less polluting one and 20% tax deductions for purchases of appliances and furniture.
22-Nov-08	Netherlands	7.50	Tax deduction to companies that make large investments, funds to companies that hire temporary workers, and creation of a program to find jobs for the unemployed.
11-Dec-08	Belgium	2.60	Increase in unemployment benefits, lowering of the value added tax on construction, abolishing taxes on energy, energy checks for families, faster payments of invoices by the government, faster government investment in railroads and buildings, and lowering of employer's fiscal contributions.
27-Nov-08	Spain	14.30	Public works, help for automobile industry, environmental projects, research and development, restoring residential and military housing, and funds to support the sick.
14-Jan-09	Portugal	2.89	Funds to be provided to medium and small-sized businesses, money for infrastructure, particularly schools, and investment in technological improvement.
20-Nov-08	Israel	5.40	Public works to include desalination plants, doubling railway routes, adding R&D funding, increasing export credits, cutting assorted taxes, and aid packages for employers to hire new workers.
21-Dec-08	Switzerland	0.59	Public works spending on flood defense, natural disaster and energy-efficiency projects.
5-Dec-08	Sweden	2.70	Public infrastructure and investment in human capital, including job training, vocational workshops, and workplace restructuring.; extension of social benefits to part-time workers.
26-Jan-09	Norway	2.88	Investment in construction, infrastructure, and renovation of state-owned buildings, tax breaks for companies.

Source: Various news articles.

Notes: Amounts are in U.S. dollars. Currency conversions to U.S. dollars were done in the news articles or by using current exchange rates.

Then in July 2008, Congress adopted, and President Bush signed, P.L. 110-289, the Housing and Economic Recovery Act of 2008 to provide an additional fiscal stimulus to the U.S. economy. In February 2009, as the U.S. economy continued to post large monthly losses in jobs, Congress adopted, and President Obama signed, a compromise measure of H.R. 1, the American Recovery and Reinvestment Act of 2009 to provide an additional fiscal stimulus to the U.S. economy. The British, French, and German governments also announced fiscal stimulus packages. Various central banks announced additional cuts in key interest rates as another effort to stimulate economic growth. On March 5, 2009, the European Central Bank and the Bank of England announced a cut in key interest rates by 0.5% to 1.5% and 0.5%, respectively, approaching the Federal Reserve rate of 0.25%. In addition, the Bank of England announced a quantitative easing in monetary policy, or increasing the money supply, by $150 billion over three months to stimulate economic growth [58]

European Economic Recovery Plan

On November 27, 2008, the European Commission proposed a $256 billion Economic Recovery Plan [59] that would fund cross-border projects, including investments in clean energy and upgraded telecommunications infrastructure. In all, the European Economic Recovery Plan is comprised of two parts. First, each EU member is asked to contribute an amount equivalent to 1.5% of their GDP to boost consumer demand. Second, members are tasked to invest in energy efficient equipment to create jobs and save energy, invest in environmentally clean technologies to convert such sectors as construction and automobiles to low-carbon sectors, and to invest in infrastructure and communications. The members of the European Council approved the plan in a meeting on December 12, 2008. As Table 4 indicates, most European countries have announced some form of an economic stimulus package.

As part of the EC plan, budget rules imposed by the Stability and Growth Pact would be loosened to allow EU members to adopt economic stimulus plans to shore up their declining economic growth rates. The plan is intended to mesh with the goals and objectives outlined in the Lisbon Strategy to improve the rate of economic growth among EU members. This plan also proposes official support measures to increase the rate of employment and to focus investments on such high technology sectors as telecommunications and environmentally safe technologies. In addition to the proposed macroeconomic stimulus plan, various central banks have worked in concert to cut key interest rates in an effort to boost economic growth.

Germany

In an effort to confront worsening economic conditions, German Chancellor Angela Merkel proposed a package of stimulus measures, including spending for large-scale infrastructure projects, ranging from schools to communications. The stimulus package represents the second multi-billion euro fiscal stimulus package Germany has adopted in less than three months. The plan, announced on January13, 2009, reportedly was doubled from initial estimates to reach more than 60 billion Euros [60] (approximately $80 billion) over two years. The plan reportedly includes a pledge by Germany’s largest companies to avoid mass job cuts in return for an increase in government subsidies for employees placed temporarily on short work weeks or on lower wages [61]. Other reports indicate that Germany is considering an emergency fund of up to 100 billion Euros in state-backed loans or guarantees to aid companies having problems getting credit [62].

Chancellor Merkel has been criticized within her own government and by other leaders in Europe for not moving aggressively enough to address either the financial crisis, or the economic downturn [63]. Initially, Merkel attempted to block and then offered tepid support for the EU plan to provide an EU-wide economic package to stimulate growth. Chancellor Merkel indicated that she has a fundamental disagreement over the effectiveness of such macroeconomic stimulus measures especially given the protracted struggle in Germany to reduce its government deficit spending to meet the guidelines in the EU Stability and Growth Pact. Instead, Merkel has argued in favor of targeted actions taken independently by EU members to tackle their own unique set of circumstances. Some observers argue that such a plan could come at a high political cost to Merkel, who vowed when she was elected to balance Germany's government budget by 2011.

Overall, Germany's response to the economic downturn changed markedly between December 2008 and January 2009 as economic conditions continued to worsen. In a December 2008 article, German Finance Minister Peer Steinbruck defended Germany's approach at the time. According to Steinbruck, Germany disagreed with the EU plan to provide a broad economic stimulus plan, because it favored an approach that is more closely tailored to the German economy. He argued that Germany is providing a counter-cyclical stimulus program even though it is contrary to its long-term goal of reducing its government budget deficit. Important to this program, however, are such "automatic stabilizers" as unemployment benefits that automatically increase without government action since such benefits play a larger role in the German economy than in other economies. Steinbruck argued that, "our experience since the 1970s has shown that ...stimulus programs fail to achieve the desired effect...It is more likely that such large-scale stimulus programs – and tax cuts as well – would not have any effects in real time. It is unclear whether general tax cuts can significantly encourage consumption during a recession, when many consumers are worried about losing their jobs. The history of the savings rate in Germany points to the opposite." [64]

France

France, which has been leading efforts to develop a coordinated European response to the financial crisis, has proposed a package of measures estimated to cost over $500 billion. The French government is creating two state agencies that will provide funds to sectors where they are needed. One entity will issue up to $480 billion in guarantees on inter-bank lending issued before December 31, 2009, and would be valid for five years. The other entity will use a $60 billion fund to recapitalize struggling companies by allowing the government to buy stakes in the firms. On January 16, 2009, President Sarkozy announced that the French government would take a tougher stance toward French banks that seek state aid. Up to that point, France had injected $15 billion in the French banking system. In order to get additional aid, banks would be required to suspend dividend payments to shareholders and bonuses to top management and to increase credit lines to such clients as exporters. France reportedly was preparing to inject more money into the banking system [65].

On December 4, 2008, President Sarkozy announced a $33 billion (26 billion euros) package of stimulus measures to accelerate planned public investments [66]. The package is focused primarily on infrastructure projects and investments by state-controlled firms, including a canal north of Paris, renovation of university buildings, new metro cars, and construction of 70,000 new homes, in addition to 30,000 unfinished homes the government has committed to buy in 2009. The plan also includes a 200 Euro payment to low-income households. On December 15, 2008, France agreed to provide the finance division of Renault and Peugeot $1.2 billion in credit guarantees and an additional $250 million to support the car manufacturers' consumer finance division [67]. In an interview on French TV on January 14, 2009, French Prime Minister Francois Fillon indicated that the French government is considering an increase in aid to the French auto industry, including Renault and Peugeot [68]. The auto industry and its suppliers reportedly employ about 10% of France's labor force.

United Kingdom

On November 24, 2008, Britain's majority Labor party presented a plan to Parliament to stimulate the nation's slowing economy by providing a range of tax cuts and government spending projects totaling 20 billion pounds (about $30 billion) [69]. The stimulus package includes a 2.5% cut in the value added tax (VAT), or sales tax, for 13 months, a postponement of corporate tax increases, and government guarantees for loans to small and midsize businesses. The plan also includes government plans to spend 4.5 billion pounds on public works, such as public housing and energy efficiency. Some estimates indicate that the additional spending required by the plan will push Britain's government budget deficit in 2009 to an amount equivalent to 8% of GDP. To pay for the plan, the government would increase income taxes on those making more than 150,000 pounds (about $225,000) from 40% to 45% starting in April 2011. In addition, the British plan would increase the National Insurance contributions for all but the lowest income workers [70].

On January 14, 2009, British Business Secretary Lord Mandelson unveiled an additional package of measures by the Labor government to provide credit to small and medium businesses that have been hard pressed for credit as foreign financial firms have reduced their level of activity in the UK. The three measures are: 1) a 10 billion pound (approximately $14 billion) Capital Working Scheme to provide banks with guarantees to cover 50% of the risk on existing and new working capital loans on condition that the banks must use money freed up by the guarantee to make new loans; 2) a one billion pound Enterprise Finance Guarantee Scheme to assist small, credit-worthy companies by providing guarantees to banks of up to 75% of loans to small businesses; and 3) a 75 million pound Capital for Enterprise Fund to convert debt to equity for small businesses [71]

Prime Minister Brown has come under sharp criticism from abroad over the stimulus packages and from opposition party leaders at home over his handling of the economy before and during the financial crisis. He is also being criticized over the depreciating pound and the lack of evidence that the British economy is showing signs of responding to the economic rescue plan. German Finance Minister Peer Steinbruck, for one, called the British plan, "crass

Keynesianism” [72]. At home, the depreciating pound has undermined the credibility of Prime Minister Brown who previously had equated a weak currency with a weak economy and a weak government [73]. Depreciation in the exchange value of the pound puts upward pressure on domestic prices as a result of higher import prices, but it helps boost exports by reducing the cost of British goods in foreign markets.

OUTLOOK

The financial crisis has underscored the growing interdependence between financial centers and has tested the ability of EU members to cooperate in developing an EU-wide response. The financial interdependence between the United States and the European Union means that the EU and the United States share common concerns over the global impact of the financial crisis and the economic downturn. It also means that they both support and hope to benefit from efforts by national governments to stimulate their economies. Such stimulus measures, however, could become a source of friction if some of the larger economies are viewed as not carrying their share of the burden for a global recovery by providing stimulus measures that are commensurate with the size of their economy. The EU and the United States also share common concerns over the stability of East European countries. These common concerns may eventually work to spur EU members to forge a common consensus regarding the necessity of providing financial assistance to East European countries, but some observers are concerned that such a consensus may come too late to forestall serious economic deterioration in the East European economies, with implications for negative effects on the economies in Europe and the United States.

In addition to these concerns, the United States and the EU members are share common concerns over the organization of financial markets domestically and abroad and seek to improve supervision and regulation of individual institutions and of international markets. Extensive cross- border banking activities by a number of EU countries has demonstrated that serious problems in one country can have a substantial impact on the financial system elsewhere, while governments may face potentially large liabilities that are associated with branches in another country [74]. One solution that is being considered is in developing the organizational structures within national economies that can provide oversight of the different segments of the highly complex financial system. Such oversight is viewed by many as critical, because financial markets are generally considered to play an indispensible role in allocating capital and facilitating economic activity. Some observers argue, however, that the complexity of the financial system has outstripped the ability of national regulators to oversee effectively.

The financial crisis also has revealed extensive interdependency across financial market segments both within many of the advanced national financial markets and across national borders. As a result, the United States and members of the EU share mutual interests in solving both the financial crisis and the economic recession, because the two crises have become negatively reinforcing events. EU leaders are also especially concerned over the impact the economic crisis is having on the political stability and commitment to market reforms among the emerging economies of Eastern Europe. EU leaders are supporting a number of efforts to provide assistance to European economies, but they may have to expend considerably more resources if the economic crisis persists for an extended period of time.

The international nature of financial markets and capital flows likely means that efforts to address the current situation and to prevent future crisis require a coordinated response between the United States and the EU. A coordinated response likely will need to address such issues as financial market regulation, oversight of financial firms and institutions, greater transparency, and the role of independent credit rating and auditing institutions. Significant differences remain, however, among EU members and between some EU members and the United States over issues of financial supervision and regulation that could significantly complicate future efforts to craft a coordinated approach to supervising financial market at an international level. Some EU members favor a strong central authority that can monitor financial markets, while others favor strong national authorities with a weaker role for an international body. EU members recognize that economic integration means that financial and economic crises can spill across national borders, but their efforts to implement a coordinated response are being hampered by very real differences in the impact the economic recession is having on individual EU members.

The financial crisis also raises important questions about how a nation can protect its depositors from financial crisis elsewhere and about the level of financial sector debt that is manageable without risking system-wide failure. In addition, the failure of a number of large banks raises questions about bank supervision, primarily about how national governments should supervise foreign financial firms that are operating within their borders. This issue raises questions about how countries can protect their depositors when foreign-owned firms attempt to withdraw deposits from one market in order to offset losses in another. One approach focuses on broad levels of cooperation between national governments with each government addressing the crisis from its own perspective and in its own limited way. For a number of governments in Europe this approach is appealing, because their economies and their banks have felt little direct effect from the crisis.

An alternative approach argues in favor of a more integrated and coordinated response from national governments and central banks. This approach argues that a coordinated systemic approach is necessary, because financial markets in the United States and Europe have become highly integrated as a result of cross-border investment by banks, securities brokers, and other financial firms. As a result of this integration, economic and financial developments that affect national economies are difficult to contain and are quickly transmitted across national borders, as attested to by the financial crisis of 2008. As financial firms react to a financial crisis in one area, their actions can spill over to other areas as they withdraw assets from foreign markets to shore up their domestic operations. For instance, as Icelandic banks began to default, Britain used an anti-terrorism law to seize the deposits of the banks to prevent the banks from shifting funds from Britain to Iceland [75]. Banks and financial firms in Europe have felt the repercussions of the U.S. financial crisis as U.S. firms operating in Europe and as European firms operating in the United States have adjusted their operations in response to the crisis.

The financial crisis also raises questions about the cost and benefits of branch banking across national borders where banks can grow to be so large that disruptions in the financial market can cause defaults that outstrip the resources of national central banks to address. Such branch banking across national borders has significantly expanded financial opportunities for individual investors and firms alike and is unlikely to disappear as a result of the current financial crisis. Nevertheless, if some financial institutions are deemed to be too big to fail, financial regulators and national governments likely will need to address the issue of who and how such institutions should be supervised when their operations span national borders and they are engaged in a vast array of banking and investment operations.

The European Economic Recovery Plan calls for EU members to contribute an amount equal to 1.5% of their respective GDP to stimulate economic growth. Some observers argue, however, that the size of an economic stimulus package should be sufficient to address the size and nature of the relevant economic crisis, instead of being determined as a certain percentage of GDP. The nature of the current economic recession may well call for a larger stimulus package than that dictated by a pre-set percentage of heir economies. Furthermore, some EU members disagree over how best to implement a coordinated economic stimulus plan, due in part to deep philosophical differences among EU members over the conduct of macroeconomic policies.

Another important factor that is affecting the EU's response to the economic recession is the need to develop new policies in a manner that meshes with the carefully crafted and highly negotiated Directives that already exist within the EU framework. These Directives act as guiding principles for EU members. In particular, the call for economic stimulus has created a conflict for some EU Members who are politically and philosophically committed to the goals of the Growth and Stability Pact and with the development goals of the Lisbon Strategy. Arguably, these agreements have helped stabilize economic conditions in Europe by bringing down the overall rate of price inflation and by reducing government budget deficits. In addition to the Lisbon Strategy, EU members likely will consider proposals to examine financial supervision and regulation within the context of the EU's Directive on Financial Services and the Financial Services Action Plan (F SAP) when it engages in negotiations with the United States and the G20 later in 2009.

APPENDIX A: OVERVIEW OF THE EUROPEAN UNION

The European Union is a political and economic union of 27 member states, formally established in 1993 by the Treaty of Maastricht out of existing structures that had evolved in steps since the 1950s. The EU has worked to develop a single economic market through a standardized system of laws which apply across all member states and which provide the freedom of movement of people, goods, services and capital. This process of economic integration is complicated by a dual system that gives the members of the EU significant independence within the EU and broad discretion to interpret and implement EU directives. The EU maintains common trade, agricultural, and fisheries policies, and a regional development policy. EU economic integration is compounded further by sixteen member states, collectively known as the Eurozone [77], which have adopted the euro as a common currency and operate as a bloc within the EU. Major institutions and bodies of the EU include: the European Commission, the European Parliament, the Council of the European Union, the European Council, the European Court of Justice, and the European Central Bank (ECB). Through various Directives, the EU has moved to increase financial integration within the Union to make the monetary union represented by the Eurozone operate more efficiently and the help the EU members realize the full potential of the EU.

Within the EU, the European Commission operates as the executive branch and is responsible for proposing legislation, implementing decisions, upholding the Union's treaties, and the general day-to-day running of the Union. The Commission operates as a cabinet government, with one Commissioner from each member. One of the 27 is the Commission President (currently José Manuel Barroso) appointed by the European Council, with the approval of the European Parliament, for a term of five years. Relative to the financial sector, the EU process provides for each member to have its own institutional and legal framework, which complicates efforts to coordinate financial policies. Within the EU, there are a number of bodies that bring together the supervisors, finance ministers, and central bankers of the EU members. Within the European Council, the Economic and Financial Affairs Council (ECOFIN) is one of the oldest bodies with the Council. ECOFIN's responsibilities include economic policy coordination, economic surveillance, monitoring of budget policy and preparation of the EU's budget. The key bodies in the EU banking sector include the following:

- *European Banking Committee*. The committee consists of representatives of the ministries of finance of the EU members and advises the EU Commission on policy issues related to banking activities and on proposals in the banking area.
- *Committee of European Banking Supervision*. The committee is comprised of representatives of supervisory authorities and central banks and coordinates on regulatory and supervisory convergence.
- *European Central Bank*. The ECB's main role is financial stability and monitoring in cooperation with national central banks and supervisory agencies.
- *Banking Supervision Committee*. This committee brings together national central banks, banking supervisory authorities, and the ECB. It monitors and assesses developments in the euro area, analyses the impact of regulatory and supervisory requirements on financial system stability, and it promotes cooperation and exchange of information between central banks and supervisory authorities on issues of common interest.
- *Economic and Financial Committee*. The committee includes representatives of ministries of finance, the European Commission, the ECB, and central banks to promote high-level assessments of developments in financial markets.
- *Financial Stability Ta*ble. This body meets twice a year to discuss financial stability issues.
- *Financial Services Committee*. This committee is composed of representatives of the ministries of finance and the European Commission and discusses and provides guidance on cross-sector strategic and policy issues.

The euro area countries initially sketched out a broad response to the financial crisis. Since then, their response to bank foreclosures and to subsequent issues has been characterized by some as somewhat disjointed. The financial crisis and economic downturn have exposed deep fissures within the EU and even within the euro area countries over the policy course to follow. As a first response to the financial crisis, EU governments and their central banks focused policy initiatives on reassuring credit markets that there was an availability of credit and liquidity, by reducing interest rates, and by providing foreign currency, primarily dollars, through currency arrangements. In addition to continuing efforts to restore the financial markets, EU members also face a worsening economic climate that requires actions by individual central banks, international organizations, and coordinated actions by EU members and other governments.

Investment Services Directive

The EU has adopted a number of directives that provide a basic framework for EU members to coordinate financial regulation across the EU and to integrate financial sectors. One such directive is the Investment Services Directive (ISD) that entered into force on January 1, 1996. The ISD provided general principles for national securities regulations, with the goal of providing mutual recognition of regulations across the EU [78]. The ISD created a "European Passport" that provided for a cross-border right of establishment for non-bank investment firms and the freedom to provide services across borders for investment firms to carry out a wide range of investment business. Under the passport, firms were authorized and supervised by domestic authorities, but could still provide specified investment services in other EU countries. Such cross-border services included: collecting and executing buy and sell orders on an agency basis, dealing, managing and underwriting portfolios, and such additional services as providing investment advice, advising on mergers and acquisitions, safekeeping and administration of securities, and foreign exchange transactions.

The European "passport" provision required member states to dismantle restrictive legislation that prevented cross-border branching and freedom of services. Nevertheless, EU members retained the responsibility for determining their own domestic laws and regulations concerning such issues as fitness, authorization, capital requirements, and protection of client assets. EU members could also impose rules and regulations on investment firms using the European passport as long as the rules and regulations were, "in the interest of the general good," and applied to the business activities that the firms carried out in their state. The ISD opened up stock exchange membership in all member states to all types of investment firms, whether bank or non- bank entities. Another objective of the ISD was to eliminate the so-called concentration rule in order to allow member states that lacked their own securities trading floor to access electronic terminals with investment firms and banks in other member states, thereby allowing them to be members of the markets on a remote electronic basis.

Financial Services Action Plan

In 1999, the EU replaced the Investment Services Directive with the Financial Services Action Plan. The Plan consists of a set of measures that are intended to remove the remaining formal barriers in financial markets among EU members and to provide a legal and regulatory environment that supports the integration of EU financial markets [79]. Similar to the ISD, the FSAP process supports a two-pronged approach that combines EU directives with national laws. The EU directives provide for a general level of regulation concerning the provision of financial services across borders and the harmonization of national regulations governing cross-border activities. EU members, however, retain the right to regulate firms within their own borders, as long as those firms, whether foreign or domestic, are treated equally. The FSAP contains 42 articles, 38 of which were implemented, that are intended to meet three specific objectives: 1) a single wholesale market; 2) an open and secure retail market; and 3) state-of-the art rules and supervision. Wholesale measures relate to securities issuance and trading; securities settlement; accounts; and corporate restructuring. Retail measures relate to insurance; savings through pension funds and mutual funds; retail payments; electronic money; and money laundering.

Markets in Financial Instruments Directive

The cornerstone of the FSAP's achievement is the Markets in Financial Instruments Directive (MiFID), which became effective on November 1, 2007. The MiFID establishes a comprehensive, harmonized set of rules for Europe's securities markets so financial services firms can provide investment services in each of the EU member states. MiFID retained the principles of the EU "passport" and extended the list of services and financial instruments that are covered by the passport procedures, including investment advice. MiFID also removed the so- called concentration rule that required investment firms to route all stock transactions through established exchanges.

MiFID introduced the concept of 'maximum harmonization' which places more emphasis on home state supervision. This is a change from the previous EU financial service legislation which featured a "minimum harmonization and mutual recognition" concept. Minimum harmonization provides for a law or a regulation that sets a floor, or a minimum standard, that EU countries were expected to meet in developing legislation. Maximum harmonization provides for a maximum level of a law or a regulation that sets the maximum allowable standard that can be adopted in domestic laws or regulations. At times some EU members have been accused of adopting domestic measures that exceed the EU standard in a manner that acted as a protectionist barrier.

Some key elements of the MiFID are:

- *Authorization, regulation and passporting*. Firms covered by MiFID are authorized and regulated in their "home state." Once a firm is authorized, it can use the MiFID passport to provide services to customers in other EU member states. These services are regulated by the "home state" in which the firm is authorized.
- *Client categorization*. MiFID requires firms to categorize clients as "eligible counter-parties," professional clients, or retail clients, with increasing levels of protection.
- *Client order handling*. MiFID places requirements on information that needs to be captured when firms accept client orders in order to ensure that a firm is acting in a client's best interests.
- *Pre-trade transparency*. MiFID requires the operators of various kinds of equity exchanges to make the best bid and offer prices available to potential buyers and sellers.

- *Post-trade transparency*. MiFID requires firms to publish the price, volume and time of all trades in listed shares, even if executed outside of a regulated market, unless certain requirements are met to allow for deferred publication.
- *Best execution*. MiFID will require that firms take all reasonable steps to obtain the best possible result in the execution of an order for a client. The best possible result is not limited to execution price but also includes cost, speed, likelihood of execution and likelihood of settlement and any other factors deemed relevant.
- *Systematic Internalizer*. A Systematic Internalizer is a firm that executes orders from its clients against its own book or against orders from other clients and are treated as mini-exchanges, which makes them subject to pre-trade and post-trade transparency requirements

Capital Requirements Directive

The Capital Requirements Directive, which became effective in January 2007, introduced a supervisory framework within the EU for investment management firms and banks. The purpose of the Directive is to move the EU towards complying with the Basel II80 rules on capital measurement, adequacy, and related market disclosure disciplines.

This Directive promotes a risk based capital management methodology through a “three pillar” structure that includes: 1) new standards that set out the minimum capital requirements that firms will be required to meet for credit, market, and operational risk; 2) firms and supervisors will be required to decide whether they are holding enough capital to address the risks realized under Pillar I and act accordingly; and 3) improve market discipline by requiring firms to publish certain details about their risks, capital, and risk management. The Directive also requires firms to make provision for a charge against their capital for operational risks in order to identify, monitor, manage, and report on certain types of external events that may have a negative effect on their capital. The Directive applies not only to internationally active banks, which is the main focus of the Basel II approach, but it also applies to all credit institutions and investment firms irrespective of the size, scope of activities, or levels of sophistication. Under the Directive, firms are required to meet rules governing the minimum amounts of their own financial resources they must have in order to cover the risks to which they may be exposed.

Lamfalussy Process

As the European Commission crafted a coordinated EU approach to the financial crisis, it has done so in accordance with a set of procedures known as the Lamfalussy Process. The Lamfalussy structure provides a framework for updating EU financial regulations and developing similar supervisory practices. While this process can be time consuming, it provides a process for EU members to follow so that policies that are considered through the process ultimately will be acceptable to all EU members and, therefore, will be more likely to be implemented. MiFID is the most significant piece of legislation that has been introduced under this process. Originally developed in March of 2001, it is named after the chair of the

EU advisory committee that created it, Alexandre Lamfalussy. The process is composed of four “levels,” each focusing on a specific stage of the implementation of legislation. Level 1 is traditional EU decision making, which means that decisions are adopted in the form of Directives or Regulations proposed by the Commission and then approved under the co-decision procedure by the European Parliament and the EU Council. Legislation adopted at this level primarily establishes the core values of a law.

At the second level, sector-specific committees and regulators provide advice on developing the technical details of the principles that were adopted in Level 1 and then bring the measure to a vote by the representatives of each EU member. These measures can be adopted, adapted and updated by the Commission after they have been submitted to the European Securities Committee (ESC), a committee composed mainly of members of Ministries of Finance, and to the European Parliament for their opinion. The Committee of European Securities Regulators (CESR), an independent advisory body made up of securities regulators, also advises the Commission on the technical implementing details to be included in Level 2 legislation.

This advice is provided in response to specific “mandates” from the Commission asking for help in particular areas. Level 2 implementing measures do not alter the principles agreed upon at Level 1, but simply provide the technical details that are necessary in order to make the principles operational.

At the third level, national regulators work on coordinating new regulations with other nations. At this stage, CESR may adopt non-binding guidelines or common standards regarding matters not covered by EU legislation, as long as these standards are compatible with the legislation adopted at Level 1 and Level 2.

The fourth level involves compliance and enforcement of the new rules and laws, including initiating proceedings on cases of non-conformity.

The Lamfalussy Process is intended to provide several benefits over traditional lawmaking, including more-consistent interpretation, convergence in national supervisory practices, and a general boost in the quality of legislation on financial services. Nevertheless, the Lamfalussy Process has sparked controversy, because some critics argue that the procedure can effectively bypass accountable oversight by the European Council and the elected European Parliament, thereby embodying a move away from representative democracy towards technocratic and participatory democracy.

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[51] The Stability and Growth Pact (SGP) is an agreement by European Union members to conduct their fiscal policy in a manner that facilitates and maintains the Economic and Monetary Union of the European Union. The Pact was adopted in 1997 and is based on Articles 99 and 104 of the European Community Treaty, or the Maastricht Treaty, and related decisions. It consists of monitoring the fiscal policies of the members by the European Commission and the Council so that fiscal discipline is maintained and enforced in the European Monetary Union (EMU). The actual criteria that member states must respect are 1) an annual budget deficit no higher than 3% of GDP , and 2) a national debt lower than 60% of GDP or approaching that value.

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TRANSATLANTIC REGULATORY COOPERATION: A POSSIBLE ROLE FOR CONGRESS*

Raymond J. Ahearn and Vincent Morelli

ABSTRACT

The United States and the European Union (EU) share a comprehensive, dynamic, and mutually beneficial economic relationship. Transatlantic markets are among the most open in the world and are deeply integrated. The current global economic crisis has begun to have a significant negative impact on the transatlantic economy. Nevertheless, the great stake each side has had in the other's economy affords both sides the ability to withstand each other's current economic down-turn. The key measure of the strength of the transatlantic relationship could be the ability of both sides to work with each other to weather the current financial storm.

One issue that has worked against a stronger economic relationship is the existence of regulatory barriers that limit an even more integrated market from materializing. The United States and the EU have engaged in a number of attempts to reduce remaining non-tariff and regulatory barriers to trade. In the most recent effort, then-President Bush and German Chancellor Merkel, serving as President of the EU, at the April 2007 U.S.-EU Summit agreed to establish the Transatlantic Economic Council (TEC). The TEC was directed to "advance the work of reducing or eliminating non-tariff barriers to transatlantic commerce and trade." The leaders also created an advisory group to "provide guidance and direction" to the TEC and invited the U.S. Congress, along with the European Parliament, to accept a new, more substantive role in transatlantic regulatory cooperation by becoming part of the advisory group. The Transatlantic Legislators' Dialogue (TLD) was appointed to represent the legislatures in the TEC advisory group.

Since it began nearly two decades ago, transatlantic regulatory cooperation has been mostly limited to the executive branches and regulatory bodies on both sides of the Atlantic. However, the idea of legislators assuming a more pro-active role in transatlantic economic and regulatory cooperation is not a new issue. At the 1995 launch of the New Transatlantic Agenda, the leaders of the U.S. and EU acknowledged that they "attached great importance to enhanced parliamentary links" and agreed to "consult with parliamentary leaders on both sides of the Atlantic regarding consultation mechanisms, including building on existing institutions, to discuss matters related to our transatlantic partnership." Advocates of the effort to achieve a more barrier-free transatlantic marketplace believe that ultimate success cannot be achieved without the strong commitment and active engagement of the U.S. Congress and the European Parliament.

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Although the Transatlantic Legislators' Dialogue has been in existence since 1999, there appears to be a lack of familiarity with its structure, membership, and function. With respect to its role in the TEC process, several questions have been raised including the make up of the TLD, the role of the standing committees in both the Congress and the Parliament, the staff, and the role of the U.S. Senate. A number of options for reform have been proposed. This report will provide background and analysis on the TEC process, the role of the Congress, and the TLD. This Report will be updated as events warrant.

For additional information see CRS Report RL347 17, *Transatlantic Regulatory Cooperation: Background and Analysis*, by Raymond J. Ahearn, and CRS Report RL30608, *EU-U.S. Economic Ties: Framework, Scope, and Magnitude*, by William H. Cooper.

INTRODUCTION

Since the end of the Cold War, the economies of the United States and Europe have experienced a period of accelerated integration interlinked by growing ties in trade, investment, and related employment [1]. Today, despite the current global economic upheaval, the United States and the current 27-member European Union (EU) share a comprehensive, dynamic, and mutually beneficial economic partnership. Not only is the EU-U.S. commercial relationship, what advocates refer to as the transatlantic economy, the largest in the world, for many practitioners in the transatlantic community it is also arguably the most important [2].

The transatlantic economy has dominated the world economy by its sheer size and prosperity. The combined population of the United States and EU now approaches 800 million people who generate a combined gross domestic product (GDP) of $26.8 trillion ($13.6 trillion in the EU and $13.2 trillion in the U.S.) [3]. Transatlantic markets are among the most open in the world and are deeply integrated through investment flows, affiliate sales and related-party trade [4]. The transatlantic economy generates an estimated $4 trillion in commercial activity per year and accounts for close to 60% of global gross domestic product (GDP) and roughly 40% of world trade [5]. The United States and EU are each other's largest overall markets for a host of goods and services, ranging from agricultural products to high tech goods and services. Large values of similar goods such as chemicals, transportation equipment, computers, and processed food as well as transportation and financial services are traded in record amounts.

More significant as the pillars of transatlantic commercial activity and the driving forces behind deepening transatlantic economic integration over the past decade have been foreign direct investment (FDI) and the interrelated activities of foreign affiliates [6]. In contrast to trade, mutual U.S. and European FDI results in "direct participation in each other's domestic economies" [7]

The fact that each side has a major ownership stake in the other's market may be the most distinctive aspect of the transatlantic economy. At the end of 2007, the total stock of two-way direct investment reached $2.7 trillion (composed of $1.4 trillion of U.S. direct investment in EU countries and $1.3 trillion of EU direct investments in the U.S.), making U.S. and European companies the largest investors in each other's market. Roughly 47% of all U.S. foreign direct investment is located in Europe, while EU member states supply 42% of global

FDI in the United States. European affiliate income in the U.S. reached $82 billion in 2007 while U.S. affiliate income in Europe increased to $147 billion during that same period [8]. However, the global economic down-turn has resulted in U.S. foreign affiliate income earned in Europe peaking in 2007 and actually declining by 2% by mid-2008. European affiliate earnings in the U.S. are reported to be flat in 2008 [9].

This massive amount of ownership of companies in each other's markets translates into billions of dollars of sales, profits, production, and expenditures on research and development. In addition, an estimated six to seven million Americans are employed by European affiliates operating in the United States and almost an equal number of EU citizens work for American companies in Europe [10]. In the current global economic crisis, these figures are likely to decline somewhat but will still constitute significant transatlantic economic activity.

The combined weight of these two economic superpowers means that how the U.S. and EU manage their relationship and the difficult issues involving domestic regulations, competition policy, and foreign investment could well help determine how the rest of the world deals with similar issues. As the figures might suggest, both the U.S. and EU have implemented policies that are receptive to expanding the commercial relationship. In theory, both sides have appeared to acknowledge that there is nothing to gain from protectionist investment policies. This theory is being tested in the current global financial environment as both sides of the Atlantic have flirted with some forms of protectionist policies (ie. "buy America" provisions included in the U.S. stimulus legislation). Leaders in both Washington and Brussels have cautioned and urged restraint on implementing such policies to ensure that cooperation to address the current crisis is not impeded in any manner.

The success of economic integration achieved thus far, however, does not guarantee that the transatlantic economies will continue to deepen. The current global economic crisis has begun to have a significant negative impact on the transatlantic economy. Nevertheless, the great stake each side has had in the other's economy affords both sides the ability to withstand each other's current economic down-turn. Despite the current situation, economic integration will likely continue to grow. In addition, differences do exist in terms of regulatory irritants and barriers to greater commercial ties on both sides of the Atlantic that remain to be adequately addressed. The key measure of the strength of the transatlantic relationship could be the ability of both sides to work with each other to weather the current financial storm in such a way that would permit further integration and would promote expanded regulatory cooperation.

This report is intended to serve as a companion piece to CRS Report RL34717, *Transatlantic Regulatory Cooperation: Background and Analysis*, by Raymond J. Ahearn, which provides an introduction and primer on the issue of transatlantic regulatory cooperation [11].

The main focus of this report is on (1) the creation of the Transatlantic Economic Council; (2) the role of legislatures in the regulatory process; and, (3) the Transatlantic Legislators' Dialogue and its new role as an advisor to transatlantic regulatory efforts.

TRANSATLANTIC REGULATORY BARRIERS

Because many U.S. and European industries are already deeply integrated with each other and most tariffs are low, non-tariff and regulatory barriers are increasingly recognized as the most significant trade and investment impediments to the creation of a more integrated transatlantic market. However, some observers believe that while regulatory divergence does present an obstacle to trade, it does not automatically mean that the alignment of regulations in all sectors is possible or even desirable. In addition to domestic regulations, non-tariff barriers consist of elements such as safety norms, differences in health, environmental or engineering standards, rules of origin, or labeling requirements [12]. Such measures are due in part to different societal preferences and priorities, but also to a significant degree, a lack of coordination or adequate information exchange between regulators and legislators on each side of the Atlantic who are subject to different legal mandates or engaged in different oversight procedures [13]. One problem in addressing these different perspectives is the fact that in both the United States and Europe, there are very different regulatory processes and structures that make attempts at regulatory convergence difficult [14]

There have been a number of previous attempts to reduce existing non-tariff and regulatory barriers to trade. The aim of such efforts has been to reduce costs to businesses on both sides of the Atlantic, improve consumer welfare, and facilitate higher levels of economic growth. In June 2005, a report issued by the Organization for Economic Cooperation and Development (OECD) estimated that certain structural reforms in both the U.S. and EU that included the reduction of competition-related regulations, tariff barriers, and restrictions on foreign direct investment could lead to permanent gains in GDP per capita on both sides of the Atlantic of up to 3 to 3.5 percent [15]

Attempts to seek meaningful regulatory cooperation began in 1995 when U.S. and European leaders launched the New Transatlantic Agenda (NTA). This initiative was designed to raise the U.S.-EU relationship to a new level of dialogue and decision-making in four areas including economic cooperation. Since then, the U.S. and the EU have launched several additional initiatives such as Mutual Recognition Agreements (1997), the Positive Economic Agenda (2002), the Transatlantic Economic Partnership (2004), and the Transatlantic Economic Agenda (2005). Each of these projects has contributed in some way to achieving limited progress towards reducing regulatory burdens. However, both European and U.S. companies heavily engaged in the transatlantic marketplace argue that the results have not proved materially significant. For instance, there seems to have been some improvements in areas such as competition policy and financial services, but progress in other areas such as chemicals has not been accomplished [16]

CREATION OF THE TRANSATLANTIC ECONOMIC COUNCIL

In January 2007 Germany's Chancellor Angela Merkel, upon assuming the rotating six-month presidency of the EU, proposed further liberalization of transatlantic trade and investment barriers by elevating the existing cooperation among U.S. and EU regulatory agencies. Building on the Merkel initiative, the April 2007 U.S.-EU Summit adopted a *Framework* for Advancing Transatlantic Economic Integration. The *framework* affirmed the importance of further deepening transatlantic economic integration, particularly through efforts to reduce or harmonize regulatory barriers to international trade and investment. A new institutional structure, a Transatlantic Economic Council (TEC), was established to advance the process of regulatory cooperation and barrier reduction by encouraging both U.S. and EU regulators to move forward on issues outlined in the *framework*.

The creation of the TEC was predicated on the premise that past efforts to achieve regulatory cooperation or convergence had been inadequate due to the technical nature of the work, the caseby-case ad hoc approach often assumed by regulatory agencies, and a lack of political leadership committed to having the regulators cooperate. The TEC is headed on both sides by ministerial- level appointees with cabinet rank [17]. Given that the two TEC leaders are cabinet-level appointees, the TEC was expected to have the high-level political support that previous efforts at economic integration may have lacked. Many observers believe the TEC, with its requirement to report annually to the US-EU Summit, would receive that support. Such clout, it is argued, is needed to persuade domestic regulators to yield some of their authorities or to better cooperate with their counterparts across the Atlantic in harmonizing regulatory approaches [18]. The TEC, in theory, is designed to enable U.S. and European regulators to anticipate and discuss potential differences in thinking about new regulations before they become actual obstacles to transatlantic commerce. These efforts include a wide range of alternatives including dialogues and information exchanges among regulators, mutual recognition agreements, cost-benefit analysis, recommendations for voluntary principles, and proposals for binding agreements.

The mandate of the TEC is to accelerate on-going efforts to reduce or harmonize regulatory barriers. The TEC was directed to accomplish this mandate, in part, by including broader participation of stakeholders, including for the first time, legislators, in the discussions and meetings. In particular, the *framework* document instructed the TEC to establish an “advisory group” that draws upon the heads of the “existing transatlantic dialogues” to provide input and guidance on priorities for pursuing transatlantic economic integration. The existing transatlantic dialogues include the Transatlantic Legislators’ Dialogue TLD, (the U.S. Congress-European Parliament exchange), the Transatlantic Business Dialogue (TABD), and the Transatlantic Consumers Dialogue (TACD). The TEC meets twice annually and reports to the annual U.S.-EU Summit on both achievements and areas where more progress is needed. To date, the advisory group has met with the TEC at each of the three TEC meetings held as of December 2008.

The 2007 *Framework* presented the TEC with two priorities. The first was to build upon the established sectoral dialogues which had been taking place between U.S. and European Commission regulatory experts. These dialogues have included issues involving pharmaceuticals, automobile safety, cosmetics, consumer product safety, food safety, energy efficiency, and medical devices. The second priority was identified as the “Lighthouse Priority Projects.” These included a review of policies on intellectual property rights and piracy, secure ports and trade, financial markets, innovation and technology, and investment.

The first meeting of the TEC took place on November 9, 2007, in Washington, D.C. A second meeting was held on May 13, 2008, in Brussels, and the third meeting took place on December 12, 2008, in Washington. For some observers, the results of these first meetings have been mixed. At the first meeting, the TEC agreed that in the field of financial accounting standards, both sides should pursue an agreement to accept the mutual recognition of each others accounting methods. At the second meeting, the TEC issued a joint statement affirming the commitment of both the U.S. and EU to promote open investment policies and to refrain from protectionist policies. The third meeting, the last of the Bush Administration, reviewed the operation of the TEC over its first 18 months and reaffirmed progress in areas such as investment and accounting standards, among others. The TEC also noted the importance of identifying issues suitable for TEC consideration and the need to avoid having the TEC agenda become too diffuse and unmanageable. The third TEC meeting did convene as the global financial crisis began to have a significant impact on the transatlantic economy, highlighting for some, the need for a stronger and more sustained transatlantic partnership.

The difficulty of harmonizing regulatory activities or resolving disputes embedded in regulatory differences, however, was underscored at all three TEC meetings by the failure to resolve a longstanding dispute involving U.S. exports of poultry to the EU. The outcomes of the three meetings thus far, while not seen as resolving any of the regulatory issues before the TEC, have at least demonstrated that both sides remain committed to greater transatlantic economic integration and regulatory cooperation. In January, 2009, the new Obama Administration came into office seeking to address both U.S. economic challenges as well as the global financial crisis. The new Administration appears to have acknowledged the importance of the transatlantic economic partnership and the potential role of the TEC when it relatively quickly designated Michael Froman, Deputy Director of the National Economic Council, as the Administration's point man for the TEC. In February, Mr. Froman met with the U.S. Director of the Transatlantic Business Dialogue, a major stakeholder in the TEC process, to discuss business issues and the future of the TEC [19]. It also appears that President Obama will meet with the EU leadership in Prague in early April after he attends the G-20 meeting and the NATO summit. It is expected that in the context of the discussions about the global economic crisis, the TEC could be on the agenda.

For those advocates of the concept of the transatlantic marketplace free of artificial barriers and impediments to increased commercial and investment activity, the creation of the TEC was seen as a necessary measure. The goals and responsibilities established for the TEC as outlined by the U.S. and EU leadership seemed designed to achieve that objective. According to some, the TEC promises to break new ground by enabling regular communication and exchange of information at a higher level on a variety of issues [20]. The dilemma for the TEC, however, may continue to be the uncertainty over its role. Is the TEC to be a dispute settlement body putting out fires in transatlantic trade or is it primarily designed to promote regulatory convergence? The TEC also seems limited in its structure to deal with national interests or to overcome domestic political opposition to items on its agenda. Whether the TEC will prove a more successful entity for actually accomplishing a reduction in remaining transatlantic regulatory and non-tariff barriers to trade remains uncertain [21].

One question that is raised is why regulatory cooperation should be done just in the context of transatlantic relations. Some advocates point out that many of these regulatory issues, such as regulating financial services industries, are global in nature and apply to regions such as Asia and Latin America, as well as Europe. For many, this is a legitimate question and is answered by some who point out that as highly developed economic systems, both the U.S. and the EU, could set the global standards for future regulation in broad economic categories.

THE ROLE OF THE LEGISLATURES

Since it began nearly two decades ago, transatlantic regulatory cooperation has been mostly limited to the executive branches and regulatory bodies on both sides of the Atlantic. However, the idea of legislators assuming a more pro-active role in transatlantic economic and regulatory cooperation is not a new issue. At the 1995 launch of the New Transatlantic Agenda, the leaders of the U.S. and EU acknowledged that they “attached great importance to enhanced parliamentary links” and agreed to “consult with parliamentary leaders on both sides of the Atlantic regarding consultation mechanisms, including building on existing institutions, to discuss matters related to our transatlantic partnership” [22]. For those interested in the transatlantic economic relationship, this broad mandate to include the legislators has resulted in an increased interest in the role the U.S. Congress and the European Parliament can or should play in regulatory cooperation and convergence.

Representatives of Congress and European Parliament have long argued for greater legislative participation at least in the annual U.S. – EU Summit process. Numerous pieces of legislation have been introduced and even passed in both Congress and the Parliament over the past seven years calling for enhanced dialogue and coordination between the Congress and the European Parliament in matters related to the transatlantic economic relationship. In 2004 and 2005, the European Parliament passed resolutions supporting the completion of the transatlantic market by 2015. In 2006 the U.S. Senate passed a similar resolution in S.Res. 632.

Rationale for Including the Legislatures

Despite the NTA declaration regarding participation of legislators, and past legislative initiatives approved by Congress and the Parliament, incorporating the legislatures into the regulatory process has been met with questions and mixed views. Advocates of the effort to achieve a more barrier-free transatlantic marketplace believe that ultimate success cannot be achieved without the strong commitment and active engagement of the U.S. Congress and the European Parliament. Some of these advocates have decried the low level of engagement by Congress and the Parliament thus far in the overall economic integration and regulatory cooperation process and believe congressional committees need to be more active in the oversight process. These groups believe that, through more active oversight, Congress can articulate its support for, or concerns about, a particular regulatory direction before the regulators proceed too far down the negotiation path. They believe more enhanced oversight could serve to help Congress and the Parliament develop as stronger partners by understanding at an earlier stage, the rationale for traveling or not traveling down a certain regulatory path.

These advocates also believe Congress, through its authorization and appropriation roles, can prod the regulators to move the cooperative efforts forward and can provide the funds necessary to carry out that mandate. Some within this group have even suggested going further and inviting legislators to actively participate in high-level regulatory dialogues in addition to their role in the TEC advisory group [23]. Those in this general camp point to the “open skies” agreement laboriously negotiated between the U.S. and EU which was intended to make airline travel to and from and within both Europe and the United States more competitive. One key provision, that would have allowed 49% foreign ownership of U.S. airlines, was drastically scaled back at the eleventh hour by congressional action. Supporters of this agreement felt this outcome might have been avoided had Congress been included in the process at an earlier stage.

On the other hand, there are many in the business and regulatory communities who are concerned about the autonomy of the U.S. regulatory process even though that process is sometimes influenced by legislative direction. Others worry that the TEC process will undermine the sovereignty of both the U.S. and European regulatory processes. These groups accept the congressional and Parliament responsibility to conduct oversight. However, some in this group seem reluctant to encourage more active engagement of legislators in the regulatory reform process beyond oversight hearings. This group does not believe Congress or the Parliament is at the point politically where they can discuss proposed regulatory changes in the context of the impact on the transatlantic relationship.

Some believe that involving the legislators as advisors alongside the business and consumer communities is not an appropriate role for legislators who will frequently need to be called upon to make changes to legislation, such as the 100 percent cargo screening requirement, in order to accomplish the TEC agenda [24]. These skeptics also point to the recent expressions of concern over free trade and globalization, “buy America” provisions in U.S. legislation, and the recent negative reaction to European participation in the Air Force air refueling acquisition program as indications that further transatlantic economic integration may not yet be a concept that is fully accepted by a majority of the Congress. This group also raises concerns of what happens when the legislatures decide to take, what for some would be regulatory matters, into their own hands without close consultation with transatlantic regulatory bodies or the outside stakeholders that may be impacted. This group has referred to the Sarbanes-Oxley legislation passed by Congress or the Registration, Evaluation, and Authorization of Chemicals (REACH) directive adopted by the European Parliament, as examples of well intentioned initiatives that have ultimately caused some regulatory problems that affected the transatlantic relationship. Many doubt, however, that the TEC process could have prevented such legislative actions no matter how engaged the regulators were with the legislatures at the time these issues arose.

Concerns with the Legislatures

Not every regulatory proposal on the U.S.-EU agenda would need legislative action by Congress. But, the ability of Congress or the Parliament to disapprove of, reverse through legislation, or prohibit the expenditure of funds to implement a regulatory change is a power that has been recognized and which must be considered. The debate between the two competing groups seems to have shifted recently to a matter of how and when to engage the legislators, not if they should be included.

One problem that has arisen since 1995 regarding the dialogue with the legislators, at least in the United States, has been that successive Administrations have had difficulty deciding who it is to consult with, how to do it, and when. No single congressional committee exercises jurisdiction over the broad array of issues on the regulatory agenda. And, the committees that have the primary authority to oversee the transatlantic political relationship, the House Foreign Affairs Committee under House Rule X and the Senate Foreign Relations Committee under Senate Rule XXV have no authority on the specific regulatory issues under consideration.

Another concern that is raised is the question of whether the legislators, themselves, are prepared to take on a more substantive partnership in the transatlantic regulatory process. Given the nature of regulatory cooperation, the multiple layers of agencies involved, the sometimes slow pace of reform, and normal legislative demands, some observers feel the Congress may not be adequately prepared to apply a transatlantic dimension to this process. In the House, the decision taken in 2000 to create a Subcommittee in the then International Relations Committee solely dedicated to Europe, along with the formation of a Members Caucus on the EU in 2005, have provided important new venues for a more focused discussion of transatlantic relations. Beginning with the launch of the New Transatlantic Agenda, organizations such as the Transatlantic Policy Network, the German Marshall Fund and other think-tanks and public policy groups, have become more involved in developing the transatlantic knowledge base of the Congress. Publications, such as the annual transatlantic economic report, issued by the Center for Transatlantic Relations, have served to bring the economic message to the forefront. On-going efforts by groups such as the Transatlantic Business Dialogue, the U.S. Chamber of Commerce and the European-American Business Council have injected more specificity to the debate.

Whether the attempt from these outside organizations to increase the level of awareness and interest among at least a portion of the Congress, including within congressional committees that have jurisdiction over the issues involved, will have a significant impact on both regulatory cooperation or transatlantic relations, is unclear. Most observers understand that the transatlantic impact of legislation is not often a central consideration during the legislative process. Nor do many believe Congress would submit its own legislative initiatives to any form of a transatlantic impact statement or cede its authority to react to a national crisis, such as a terrorist attack, banking or corporate failure, without first consulting the EU. Some in Congress are not sure what their role in the transatlantic regulatory process should be. Even those Members of Congress initially contacted and asked to participate in the TEC advisory group expressed uncertainty over their role and continue to seek more clarity on exactly what they are expected to provide to the TEC [25]

Nevertheless, some observers believe the efforts to elevate congressional awareness of the expanding U.S.-EU partnership, the magnitude of the transatlantic economic relationship, and the increasing dialogue involving transatlantic economic integration and regulatory cooperation over the past several years has given rise to a growing desire by some in Congress to become more engaged in that process.

The TEC was created by those who supported the importance of a structured, institutionalized dialogue between the transatlantic business and consumer communities, the European Parliament and the U.S. Congress. Supporters anticipate that under this structure, legislators can become more aware of the potential impact on transatlantic trade and investment stemming from their legislative work and may be more sensitive to initiatives that might strengthen or undermine further transatlantic economic integration efforts [26]

THE TRANSATLANTIC LEGISLATORS' DIALOGUE

History

According to the Transatlantic Legislators' Dialogue (TLD) website [27] (found only on the European Parliament's website), formal exchanges between the U.S. House of Representatives and the European Parliament can be traced back to 1972 when the first group of Members of the House traveled to Brussels for the express purpose of meeting and exchanging views with the Parliament. This parliamentary exchange, which only involved the House, became known as the US-EU Community Inter-parliamentary Group. Since 1972, with few exceptions, the parliamentary exchange has met twice annually, once in the United States and once in Europe.

Given the transatlantic nature of the exchange, the U.S.-EU group came under the jurisdiction of the House Foreign Affairs Committee. Its annual meetings initially focused more on a foreign policy agenda dedicated to the issues involving the cold war and the evolving nature of the European Union. In response to the launch of the New Transatlantic Agenda in 1995, the delegations of the U.S. House and the European Parliament, at their 50th meeting in January 1999 agreed to change the group's name to the 'Transatlantic Legislators' Dialogue. In announcing the formation of the TLD, the two delegations stated that the Dialogue "will constitute the formal response of the European Parliament and the U.S. Congress to the commitment in the New Transatlantic Agenda to enhance parliamentary ties between the European Union and the United States." [28]. In response to the decision to change the group's name to the Transatlantic Legislators' Dialogue, the U.S. House in November 1999, during consideration of the Consolidated Appropriations Act for Fiscal Year 2000 (H.R. 3194/P.L. 106-113), amended Section 109(c) of the Department of State Authorization Act for Fiscal Years 1984/1985 (22U.S.C. 276) to officially change the name of the group. Since then the TLD's agenda for each meeting has included a broader discussion of economic and trade issues.

Although formal engagement between the U.S. House and the European Parliament has occurred regularly for some 36 years, some observers believe the TLD remains little known both within and outside the House. This has been disappointing to some because over the past years many delegations have traveled to Europe and several senior Members of the House have participated in exchange activities or knew of the exchange sessions. For instance, in 1987, then-Speaker Jim Wright attended the exchange meetings in Madrid. Between 1994 and 2000, the Chairman of the House International Relations Committee also served as the U.S. Chairman of the TLD. In 2007, the visiting EU TLD delegation was received by House Speaker Pelosi and Senate Majority Leader Reid [29].

The lack of knowledge of the TLD seemed to contribute to the surprise of many in the transatlantic community when the TEC leadership invited the TLD to be a key member of its Advisory Group. In fact, there has been little evidence that anyone at the White House at the time of the 2007 U.S.-EU Summit thought to inform the House leadership that the Administration was about to unilaterally assign a new role to the legislative branch. Nor did it appear prior to the announcement in the summer of 2007 that anyone had informed the USTLD Chair that the group was to be handed a new, rather far-reaching responsibility—that of formally representing the views of Congress in the transatlantic economic integration and regulatory cooperation process [30]

According to some, the lack of familiarity with the TLD, its membership, its function, and its understanding of the TEC process, may be due to the fact that unlike several other parliamentary exchanges that operate in the Congress, such as the NATO Parliamentary Assembly and the British-American Parliamentary Group, the TLD has never been statutorily authorized. Apparently, this circumstance has caused some concern within the transatlantic community with respect to the TLD's ability to carry out its new role as advisor to the TEC.

The TLD Structure

One question which has risen is the issue of what Members actually belong to the TLD. In the European Parliament there is a formal group of thirty-two members that constitute the Delegation for Relations with the United States. Participants to the TLD meetings are drawn from this delegation. In the U.S. Congress, other than the appointment of the Chair and Vice-Chair by the Chairman and Ranking Member of the House Foreign Affairs Committee, there is no formal nomination of any other USTLD member. While many Members have participated in past meetings, participation in the USTLD often seems to be on an ad hoc basis, involving little continuity of participants and, in some instances, largely dependent on the ability of the Chairman to convince Members to attend the annual meetings [31]. Observers believe this has led to an inability on the part of the TLD to attract and maintain a broad group of Members willing to participate on a permanent basis. This is an important issue for many because frank and open exchanges of views often come more easily through long-term relationships that rely on personal interactions developed between legislators over time and through familiarity. Often it seems that regular communication only takes place between the U.S. and EU Chairs or their staff. Some EU participants have observed that if they had a particular issue that was of interest to them they might not know any other member of the U.S. delegation that they could contact for discussion. For the transatlantic business and consumer community this also presents a problem in that there is no permanently established group of TLD members with whom these outside interest groups can meet to discuss issues on the regulatory agenda on a regular basis [32]. There have been several ideas put forward to help restructure the TLD. One such suggestion involves creating a political committee and an economic committee within the TLD. Members from both the U.S. and Europe would be assigned as Chairs and Vice-Chairs of each. Rapporteurs might also be assigned to report on specific issues. This structure would at least offer Members/MEPs of the TLD the opportunity to focus some of their attention on issues for which they may have a particular interest or expertise. The committee Chairs would report to the entire body at some point during the TLD meetings on the issues discussed in the committees. Assigning Members/MEPs as Chairs, Vice-Chairs, and rapporteurs would also convey a sense of responsibility within the TLD and could guarantee a more consistent group of attendees.

A second question that has been raised involves the capacity of the TLD, as currently structured, to dedicate more time and effort to addressing those economic and regulatory issues that will appear on the TEC agenda and how the TLD will interface with standing committees of jurisdiction. While the TLD, at its past annual meetings, has engaged in a broad discussion of issues, foreign policy matters often seemed to dominate the agenda.

However, the current U.S. and EU Chairs of the TLD, at the October 2007 and May and December 2008 meetings, did include the more specific TEC process as a regular agenda item.

Some observers fear, however, that as the regulatory dialogue proceeds on issues such as the mutual recognition of accounting standards, supply chain security, copyright and patent protection, preferred traveler programs, cosmetics testing and medical device certification, an unstructured TLD may find itself further down the learning curve than its transatlantic business and consumer partners in the TEC and may be reluctant to become more specialized in economic and regulatory matters at the expense of other broader transatlantic policy issues, especially because the regulatory process moves slowly and the TEC meets only twice per year.

Role of the Committees [33]

With respect to the committees of jurisdiction, until the beginning of the 111th Congress the current USTLD Chair and Vice Chair sat on the Trade Subcommittees of the House Committee on Ways and Means and the Committee on Energy and Commerce, respectively, positions from which they both can speak on trade and regulatory issues. Neither, however, sat on the Foreign Affairs Committee which has jurisdiction over the TLD. This situation changed with the new Congress when the U.S. Chair was appointed to the Committee on Foreign Affairs and its Europe Subcommittee. From the position of this new assignment, the U.S. Chair should be able to address the broader issue of transatlantic relations and the specific issues of regulatory cooperation with the EU. Despite the greater connection between the USTLD Chair and the Foreign Affairs Committee, it still remains unclear whether other committees, such as the House.

Committee on Financial Services, the Committee on the Judiciary, or the Committee on Homeland Security that have jurisdiction over issues such as financial services, technology innovation, intellectual property and homeland security will defer to the TLD to provide advice and guidance to the TEC on behalf of those committees or how an information sharing process between the TLD and the committees would be accomplished. When the TEC meets and issues its recommendations on how the U.S. and EU might deal with issues such as the mutual recognition of accounting standards, poultry, consumer product safety or port security functions, they will likely do so with what they believe will have been the best guidance, not from two or three individual Members of Congress or EU Parliament who happen to be the TLD Chairs and Vice- Chairs, but from the House of Representatives and the Parliament as a whole. The challenge then, for the TLD is how to develop a relationship with the appropriate House and Senate standing committees, and the House and Senate Leadership for that matter, that would provide for a useful exchange of views on what the Committees are thinking on the issues under consideration by the TEC and how the TLD can present those views formally to the U.S. executive branch and European Commission with some degree of authority without at the same time diminishing the traditional and rightful authority of the Committees.

Staffing the TLD

A third question for those actively engaged in the transatlantic regulatory process seems to involve the issue of who the business and consumer communities should deal with at the congressional staff level on an everyday basis for issues related to the TEC process. There are two principal staff assigned to the TLD. These staff are part of the House Foreign Affairs Committee structure and have their own portfolio of responsibilities beyond the TLD. Observers note that while the Foreign Affairs Committee staff are highly professional for what they do for the committee and knowledgeable of transatlantic relations, none of the top issues listed in the U.S.- EU "*framework*" or those likely to be addressed by the TEC over the next few years, are issues that fall under Rule X of the Foreign Affairs Committee. For some observers, it may be a real stretch to expect that Foreign Affairs staff who are responsible for following issues and events in places like Georgia, Kosovo, Ukraine, and elsewhere throughout Europe can somehow also find the time to become proficient on automobile crash testing, container scanning, toy safety or hedge fund transparency. Realistically, it would seem that neither the Foreign Affairs Committee nor the TLD Co-Chairs, could hire a whole cadre of staff with the kind of expertise needed to be responsive to the TEC process.

For the transatlantic business and consumer community it is unclear how they are to work with the staff of the committees of jurisdiction on the specific technicalities of a TEC agenda while at the same time working with the Foreign Affairs Committee staff assigned to the TLD. A way may have to be found that would allow the Members and staff of the TLD to tap into the expertise of the professional staff of the committees that exercise jurisdiction over these issues. This may be difficult currently as it appears many committee staff outside of the Foreign Affairs committee are unfamiliar with the TLD, the TEC, or the new congressional responsibility as an advisor to the transatlantic regulatory process and may be less inclined to share the work they are doing for their committees with the staff of the TLD [34].

Role of the Senate

Finally, some observers have raised the question of what role the Senate will play in this process. The fact that the Senate has a co-equal role in regulatory oversight, but is not included as part of the TLD, seems to have been missed by the decision-makers who agreed to include the TLD in the TEC Advisory Group. As of January, 2009, the TEC has met for three sessions with the Advisory Group yet there does not seem to be a formal mechanism within the TLD to include the Senate in its activities nor within the TEC Advisory Group to solicit Senate opinion. Thus, while the TLD over time could develop some level of authority to represent the views of the House on issues addressed in the Advisory Group's meetings with the TEC, the TLD, as currently structured, could not claim to speak on behalf of the Senate. This oversight will have to be addressed if the TEC intends to receive the advice of the whole Congress.

STRUCTURAL OPTIONS

Most observers of the TEC process thus far maintain that the Transatlantic Business Dialogue (TABD) and the Transatlantic Consumer Dialogue (TACD) can and will support the TEC process even as both organizations have been critical of certain aspects of transatlantic regulatory cooperation. There is, however, uncertainty about the role of Congress and its representative, the TLD. The TLD is an inter-parliamentary entity, and as such, does not have, at this point, a mandate to formally represent Congress as a whole or even the House separately. Until the TLD and Congress itself, have a better understanding of what is expected of it and how it will carry out its mandate as an advisor to the TEC, doubts will remain. Some engaged in the transatlantic regulatory process have suggested that the TLD as a whole, and the USTLD specifically, be restructured in order to make it a more effective partner in the TEC advisory role. At the very least, this group believes the TLD should be formally authorized and given a status slightly different than the other parliamentary groups in the Congress [35]. There are several options which the TLD, itself, could explore in an attempt to make it more responsive.

One option may be for the U.S. and EU TLD co-chairs to announce the creation of their own TLD/ TEC Working Group. The co-chairs could appoint one U.S. and one EU member who have regularly attended the TLD meetings to co-chair the group. The co-chairs would recruit other regular TLD participants or members of the appropriate committees of jurisdiction for the working group. In the case of the USTLD, recruitment could also come from groups such as the EU Caucus. Other than the co-chairs, the members of this group would not have to agree to join the TLD on a regular basis but would work closely with other standing committee members, the TEC, and the two other advisory partners, the TABD and the TACD. The working group would brief the TLD co-chairs prior to any formal meeting of the TEC. The U.S. working group co-chair could also attempt to reach out to colleagues in the Senate to help provide Senate input into this process. The downside of this option may be the fact that recommendations to the TEC would still come from an inter-parliamentary group that, while reflective of the views of their wider legislative bodies, would still not have a mandate to speak on behalf of those bodies.

A second option might involve the TLD reaching out to the members of groups with similar interests, such as the Transatlantic Policy Network (TPN) which includes members of both the House and Senate. The TPN, which is a mix of legislators and private sector representatives, already has a Task Force on the Bi-lateral Economic Partnership. The TLD could invite that TPN Task Force to serve as an informal advisor to the TLD. The co-chairs of the TPN Task Force are Members of Congress and the European Parliament and several of the TPN members have participated in past TLD meetings. Much of the work of the Bi-lateral Economic Task Force mirrors the work of the TEC with respect to regulatory reform. The TPN Task Force would continue with its own independent work which could be shared with the TEC, but periodically, the co-chairs and/or their staff could meet with the TLD co-chairs and/or their staff to share ideas, information and recommendations. A briefing for the TLD co-chairs by the TPN Task Force could be arranged in advance of each TEC meeting. The TPN Task Force could also be invited to make a formal presentation to the regular TLD meetings. Downsides of this option would again be the issue of a parliamentary group speaking for Congress, whether the TPN would be willing to share its work with the TLD, and the fact that the TPN Task Force may not include key Committee Chairmen who would be omitted from the process.

A third option could involve the Chair and Vice-Chair of the USTLD requesting that the House and Senate Leadership appoint a special bi-partisan, bi-cameral, “Regulatory Cooperation Advisory Group” to the TLD. This group would consist of the TLD leadership plus representatives of the appropriate House and Senate standing committees, including committee or subcommittee chairmen with jurisdiction over the issues identified as being of interest to the TEC. This advisory group and their committee staff would follow the work of the TEC through the agencies these committees oversee. Periodic meetings between the TEC staff and committee staff could take place to update the TEC process. Once an agenda is clarified for an upcoming TEC meeting, the TLD Chair and Vice-Chair could convene only those advisory group members whose issues were identified on the TEC agenda. Such a Leadership appointed advisory group would elevate the TEC process and the TLD role to a higher level to one that would now include the House and Senate Leadership as a stakeholder in the process. The downsides to this option could include the potential conflict between the legislatures and the regulators over agenda setting, the potential for partisan conflict due to the make up of the advisory group to the TLD, and disagreements over jurisdiction among the committees.

Whether any of these options, or others are pursued, some observers of the TEC process who support Congressional participation in the Advisory Group believe the TEC could receive a real boost if the Obama Administration sent a clear signal to the Congressional leadership that the role of the Congress in the transatlantic regulatory cooperation process was important and that a stronger representation from the Congress through an enhanced TLD participation in the TEC Advisory Group would be welcome.

CONCLUSION

As the TEC process attempts to move regulatory cooperation toward the ultimate goal of a well functioning, unencumbered transatlantic marketplace, the role the Congress will or should actually play has raised several questions among those participating in that process. These issues have led many observers to believe that the TLD, although never intended to be anything more than a mechanism for exchanging views among parliamentarians, currently welds little influence or authority as a transatlantic policy resource and in not a representative of Congress’ views on economic integration. Nevertheless, the decision to include an advisory group with representation from the transatlantic legislative communities, through the Transatlantic Legislators’ Dialogue, has been viewed by some as a real opportunity for the Congress and Parliament to assume a more direct role as a stakeholder in the long-term development and completion of the transatlantic marketplace. Despite some short-comings in the current structure of the USTLD, all indications are that the current Chair and Vice Chair, along with their counterpart EU Chair, are fully committed to making the TLD a more active partner in the TEC process [36].

If the identified concerns with the TLD, along with its responsibilities as a member of the TEC Advisory Group are more fully addressed, the TLD might become an organization capable of taking on a more substantive role in regulatory cooperation. For many observers, this could lead the TLD to become, over time, a more important stakeholder in regulatory cooperation and a voice for transatlantic relations in the Congress. In the near term, however, these observers believe the TLD's role as a force for the promotion of greater transatlantic economic integration and regulatory cooperation, on behalf of the U.S. Congress, will remain its greatest challenge.

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EU appointed Gunter Verheugen, Vice President of the European Commission and Commissioner for Enterprise and Industry. David Price, Assistant to the President for International Economic Affairs replaced Hubbard. The Obama Administration has appointed Michael Froman, Deputy Director of the National Economic Council as U.S. TEC chair.

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ICELAND'S FINANCIAL CRISIS*

James K. Jackson

ABSTRACT

On November 19, 2008, Iceland and the International Monetary Fund (IMF) finalized an agreement on a $6 billion economic stabilization program supported by a $2.1 billion loan from the IMF. Following the IMF decision, Denmark, Finland, Norway, and Sweden agreed to provide an additional $2.5 billion. Iceland's banking system had collapsed as a culmination of a series of decisions the banks made that left them highly exposed to disruptions in financial markets. The collapse of the banks also raises questions for U.S. leaders and others about supervising banks that operate across national borders, especially as it becomes increasingly difficult to distinguish the limits of domestic financial markets. Such supervision is important for banks that are headquartered in small economies, but operate across national borders. If such banks become so overexposed in foreign markets that a financial disruption threatens the solvency of the banks, the collapse of the banks can overwhelm domestic credit markets and outstrip the ability of the central bank to serve as the lender of last resort. This report will be updated as warranted by events.

BACKGROUND

Table 1. Iceland: Main Economic Indicators and Projections (in billions of dollars and in percent)

	2004	2005	2006	2007	2008	2009
	Actual				Projected	
GDP (in $billions)	$9.9	$10.6	$11.1	$11.8	NA	NA
Real GDP growth	7.7%	7.4%	4.4%	4.9%	0.3%	–3.1%
CPI	3.2%	4.0%	6.8%	5.0%	12.1%	11.2%
Interest rates	7.5%	7.7%	9.3%	9.8%	11.4%	10.3%

Source: World Economic Outlook, October 2008, *International Monetary Fund; and Economic Outlook, Preliminary Edition*, June 2008, Organization for Economic Cooperation and Development.

* This is an edited, reformatted and augmented version of CRS Report RS22988, dated November 20, 2008.

Iceland [1] is the smallest economy within the Organization for Economic Cooperation and Development (OECD) with a gross domestic product (GDP) in 2007 of about $11.8 billion, as indicated in Table 1. Historically, Iceland's economy has been based on marine and energy resources.

More recently, Iceland has developed a strong services sector, which accounts for two-thirds of the economic output. Since 2000, Iceland has experienced particularly strong growth in its financial services sector. Trade accounts for a large share of Iceland's GDP, with imports and exports of goods and services equivalent in value to 46% and 35%, respectively, of GDP. Fish and other marine products were Iceland's main export item until 2006, when Iceland began to capitalize on its abundant thermal energy resources to produce and export aluminum. As the data in Table 1 indicate, Iceland is expected to experience a slowdown in its rate of economic growth in 2008 and is projected by the International Monetary Fund to experience a negative rate of growth in 2009. Iceland also has battled a high and rising rate of inflation, as measured by the consumer price index (CPI) and interest rates, as measured by the long-term government bond rates.

RECENT ECONOMIC ACTIVITY

A combination of economic factors over the early to mid-2000s led to Iceland's current economic and banking distress. In particular, access to easy credit, a boom in domestic construction that fueled rapid economic growth, and a broad deregulation of Iceland's financial sector spurred the banks to expand rapidly abroad and eventually played a role in the eventual financial collapse. Iceland benefitted from favorable global financial conditions that reduced the cost of credit and a sweeping liberalization of its domestic financial sector that spurred rapid growth and encouraged Iceland's banks to spread quickly throughout Europe.

In 2004, Iceland's commercial banks increased their activity in the country's mortgage market by competing directly with the state-run Housing Financing Fund (HFF), which had been the major provider of mortgage loans. In contrast to the Housing Financing Fund, the commercial banks began offering loans with lower interest rates, longer maturities, and a higher loan to value ratio. Also, the banks did not require a real estate purchase as a precondition for a loan, which made it possible for homeowners to refinance existing mortgages and to access the equity in their homes for consumption or investment purposes. These measures spurred an expansion in credit and caused real estate prices to soar. In addition, the improving economic conditions led to an expansion in consumer spending which resulted in rising inflation and a larger trade deficit. As a further stimulus to the economy, the Icelandic government reduced both direct and indirect taxes, which provided further impetus to consumer spending.

By 2004, Iceland's central bank began tightening monetary policy by raising interest rates in an attempt to curtail inflationary pressures. Between 2004 and 2007, the Bank raised nominal short-term interest rates from 5% to 15%. The increase in interest rates, however, was not reflected in the interest rates the Housing Financing Fund charged for mortgages. As a result, the comparatively low interest rates charged by the HFF pushed up demand for housing which, in turn, further inflated the price of homes in Iceland. In addition, since the commercial banks were willing to make loans based on the equity in a home, the rising equity values in housing allowed consumers to finance a higher level of consumption, with the attendant pressure on inflation and interest rates. At the same time, the higher domestic interest rates made bond issues in krona attractive to foreign investors who could borrow abroad at low interest rates, which placed upward pressure on the value of the krona and worsened the trade deficit.

As Iceland deregulated its commercial banks, those banks expanded to the United Kingdom, the United States, Scandinavia, continental Europe, and elsewhere. Iceland has five commercial banks: Glitnir, Kaupthing, Nyi Landsbanki, Straumur Investment Bank, and Icebank, which serves as the clearing house for the 20 locally-run savings banks. The three largest banks, Kaupthing, Landsbanki, and Glitnir, have total assets of more than $168 billion, or 14 times Iceland's GDP. Iceland also has 20 savings banks, with assets at the end of 2007 valued at $9 billion.

After Iceland deregulated its commercial banks, the banks expanded their operations abroad by acquiring subsidiaries in commercial banking and in securities brokerages. At the end of 2007, almost half of the total assets of the largest commercial banking groups were accounted for by foreign subsidiaries, most of them located in Northern Europe, and in 2007 about 58% of their overall income was generated from their subsidiaries located abroad. By the end of 2007, Iceland's three largest banks relied on short-term financing for 75% of their funds, mostly through borrowing in the money markets and in the short-term interbank market. Iceland's banks are a hybrid between commercial and investment banks, with relatively large exposure to market risk. By March 2008, investors had become wary of Iceland's banks due to their large funding needs and high dependence on short-term funds in money markets. Even before the financial crisis erupted in fall 2008, the Central Bank of Iceland and other institutions forecasted a slowdown or a contraction in Iceland's rate of economic growth in 2008 and 2009.

BANKING COLLAPSE

Between October 7 and 9, 2008, Iceland's Financial Supervisory Authority (FSA), an independent state authority with responsibilities to regulate and supervise Iceland's credit, insurance, securities, and pension markets, took control of, without actually nationalizing them, three of Iceland's largest banks: Landsbanki, Glitnir Banki, and Kaupthing Bank. The takeover occurred prior to a scheduled vote by shareholders to accept a government plan to purchase the shares of the banks in order to head off the collapse of the banks. At the same time, Iceland suspended trading on its stock exchange for two days [2].

The takeover of the banks was orchestrated in an attempt to quell a sharp depreciation in the exchange value of the Icelandic krona. The krona depreciated relative to the euro and the dollar between January 2008 and July 2008; the depreciation became more pronounced after July 2008. For Iceland, which relies heavily on trade, a sharp depreciation in its currency increases the costs of its imports and adds to domestic inflationary pressures.

The demise of Iceland's three largest banks is attributed to an array of events, but primarily stems from decisions by the banks themselves. Some observers argued that the collapse of Lehman Brothers set in motion the events that finally led to the collapse of the banks, [3] but this conclusion is controversial. Some have argued that at the heart of Iceland's banking crisis is a flawed banking model that is based on an internationally active banking sector that is large relative to the size of the home country's GDP and to the fiscal capacity of the central bank [4]. As a result, a disruption in liquidity threatens the viability of the banks and overwhelms the ability of the central bank to act as the lender of last resort, which undermines the solvency of the banking system.

By the time of the acknowledged start of the global financial crisis in mid-2007, Iceland's central bank and Iceland's banks themselves had begun to recognize the vulnerability of the banks. In particular, officials in Iceland as well as financial observers in Europe had begun to reassess the risks associated with various financial instruments, and to raise questions about the asset strength of the banks and the asset size of the banks relative to the size of Iceland's economy. In addition, by late 2007, various organizations had begun to recognize the imbalances that were becoming apparent in Iceland's economy and had forecast a slowdown in Iceland's torrid pace of economic growth for 2008 and 2009 [5].

When Lehman Brothers collapsed, the international financial markets had already begun to reassess the risks associated with a broad range of financial instruments. Eventually, this reassessment of risks undermined the remaining amount of trust that existed in the credit markets, which caused banks and other financial firms to grow unwilling to make loans to short-term money markets and to engage in interbank lending, which caused those activities to freeze up. For Iceland's three largest banks, this collapse in short-term borrowing meant that they found that it was increasingly difficult to finance debts in the interbank market.

In addition, Iceland's Landsbanki and Kaupthing Bank experienced a sharp rise in the cost of private deposit insurance. This withdrawal of credit eliminated a major source of the bank's funding and threatened their ability to finance the nation's trade deficits. Typically, this situation is remedied by the central bank, which stands as the bank of last resort. In Iceland's case, however, the debts of the commercial banks were so large that Iceland's central bank was unable to guarantee the banks' loans, which lead to the collapse of the banks. In turn, the krona experienced a serious depreciation in its value, which raised the cost of imports and threatened to fuel domestic inflation. The large foreign debts held by Iceland's banks proved to be unsupportable once they could not utilize the interbank market to refinance their substantial loans.

The FSA transferred part of the three banks' operations to new bank entities that it formed and that are fully owned by the Icelandic Government. As part of these actions, the FSA dismissed the members of the boards of directors and appointed individuals to serve on a Receivership Committee. The respective committees assumed supervision of the assets and operations of the newly-formed banks. During the same two-day period, Iceland's central bank abandoned its attempt to maintain the value of the krona. With the take-over of the three major banks, the central bank effectively shut down the last clearing houses for trading krona.

On October 15, 2008, the Central Bank of Iceland set up a temporary system of daily currency auction to facilitate international trade. Without a viable currency, there was no way to support the banks, which have done the bulk of their business in foreign markets.

The financial crisis also created problems with Great Britain, because hundreds of thousands of Britons hold accounts in online branches of the Icelandic banks and fear those accounts will all default. The government of British Prime Minister Gordon Brown has used powers granted under anti-terrorism laws to freeze British assets of Landsbanki until the standoff is resolved.

On November 19, 2008, Iceland and the International Monetary Fund (IMF) finalized an agreement on an economic stabilization program supported by a $2.1 billion two-year standby arrangement from the IMF [6]. Upon approval of the IMF's Executive board, the IMF released $827 million immediately to Iceland with the remainder to be paid in eight equal installments, subject to quarterly reviews. As part of the agreement, Iceland has proposed a plan to restore confidence in its banking system, to stabilize the exchange rate, and to improve the nation's fiscal position. Also, as part of the plan, Iceland's central bank raised its key interest rate by six percentage points to 18% on October 29, 2008 to attract foreign investors and to shore up its sagging currency [7].

The IMF's Executive Board had postponed its decision on a loan to Iceland three times, reportedly to give IMF officials more time to confirm loans made by other nations. Other observers argued, however, that the delay reflected objections by British, Dutch, and German officials over the disposition of deposit accounts operated by Icelandic banks in their countries. Iceland reportedly smoothed the way by agreeing in principle to cover the deposits, although the details had not be finalized.

In a joint statement, Germany, Britain, and the Netherlands said on November 20, 2008 that they would "work constructively in the continuing discussions" to reach an agreement [8].

Following the decision of IMF's Executive Board, Denmark, Finland, Norway, and Sweden agreed to provide an additional $2.5 billion in loans to Iceland.

CONCLUSIONS

The failure of Iceland's banks raises questions about bank supervision and crisis management for governments in Europe and the United States. This incident raises questions about how national governments should address the issue of supervising foreign financial firms that are operating within their borders and how to protect their depositors when a foreign-owned firm may attempt to withdraw deposits from one market in order to offset losses in another. One approach focuses on broad levels of cooperation between national governments with each government addressing the crisis from its own perspective and in its own limited way. For a number of governments in Europe this approach is appealing, because their economies and their banks have felt little direct effect from the crisis.

An alternative approach argues in favor of a more integrated and coordinated response from national governments and central banks. Proponents of this approach argue that a coordinated systemic approach is necessary, because financial markets in the United States and Europe have become highly integrated as a result of cross-border investment by banks, securities brokers, and other financial firms. As a result of this integration, economic and financial developments that affect national economies are difficult to contain and are quickly transmitted across national borders, as attested to by the financial crisis of 2008. As financial firms react to a financial crisis in one area, their actions can spill over to other areas as they withdraw assets from foreign markets to shore up their domestic operations. For instance, as Icelandic banks began to default, Britain used an anti-terrorism law to seize the deposits of the banks to prevent the banks from shifting funds from Britain to Iceland [9]. Banks and financial firms in Europe have felt the repercussions of the U.S. financial crisis as bank balance sheets have deteriorated and as U.S. firms and European firms have adjusted their operations in response to the crisis.

The Icelandic case also raises questions about the cost and benefits of branch banking across national borders where banks can grow to be so large that disruptions in the financial market can cause defaults that outstrip the resources of national central banks to address. Such branch banking across national borders has significantly expanded financial opportunities for individual investors and firms alike and is unlikely to disappear as a result of the current financial crisis. Nevertheless, if some financial institutions are deemed to be too big to fail, financial regulators and national governments may be called on to address the issue of how such institutions should be supervised when their operations span national borders and they are engaged in a vast array of banking and investment operations.

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THE GLOBAL FINANCIAL CRISIS: THE ROLE OF THE INTERNATIONAL MONETARY FUND (IMF)*

Martin A. Weiss

ABSTRACT

This report discusses two potential roles the International Monetary Fund (IMF) may have in helping to resolve the current global financial crisis: (1) immediate crisis control through balance of payments lending to emerging market and less-developed countries and (2) increased surveillance of the global economy through better coordination with the international financial regulatory agencies. This report will be updated as events warrant.

The current global financial crisis, which began with the downturn of the U.S. subprime housing market in 2007, is testing the ability of the International Monetary Fund (IMF), in its role as the central international institution for oversight of the global monetary system. Though the IMF is unlikely to lend to the developed countries most affected by the crisis and must compete with other international financial institutions [1] as a source of ideas and global macroeconomic policy coordination, the spillover effects of the crisis on emerging and less-developed economies gives the IMF an opportunity to reassert its role in the international economy on two key dimensions of the global financial crisis: (1) immediate crisis management and (2) long-term systemic reform of the international financial system.

The role of the IMF has changed significantly since its founding in July 1944. Late in World War II, delegates from 44 nations gathered in Bretton Woods, New Hampshire to discuss the postwar recovery of Europe and create a set of international institutions to resolve many of the economic issues—such as protectionist trade policies and unstable exchange rates—that had ravaged the international economy between the two world wars. As the global financial system has evolved over the decades, so has the IMF. From 1946 to 1973, the main purpose of the IMF was to manage the fixed system of international exchange rates agreed on at Bretton Woods. The U.S. dollar was fixed to gold at $35 per ounce and all other member countries' currencies were fixed to the dollar at different rates. The IMF monitored the macroeconomic and exchange rate policies of member countries and helped countries overcome balance of payments crises with short-term loans that helped bring currencies back

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in line with their determined value. This system came to an abrupt end in 1973 when the United States floated its currency and subsequently introduced the modern system of floating exchange rates. Over the past three decades, floating exchange rates and financial globalization have contributed to, in addition to substantial wealth and high levels of growth for many countries, an international economy marred by exchange rate volatility and semi-frequent financial crises. The IMF adapted to the end of the fixed-exchange rate system by becoming the lender of last resort for countries afflicted by such crises.

Current IMF operations and responsibilities can be grouped into three areas: surveillance, lending, and technical assistance. Surveillance involves monitoring economic and financial developments and providing policy advice to member countries. Lending entails the provision of financial resources under specified conditions to assist a country experiencing balance of payments difficulties. Technical assistance includes help on designing or improving the quality and effectiveness of domestic policy-making.

WHITHER THE IMF?

The current financial crisis represents a major challenge for the IMF since the institution is not in financial position to be able to lend to the United States or other Western countries affected by the crisis (with the possible exception of Iceland). The IMF's total financial resources as of August 2008 were $352 billion, of which $257 billion were usable resources [2]. The most the IMF ever lent in any one year period (the four quarters through September 1998 at the height of the Asian financial crisis) was $30 billion. The most lent during any two-year period was $40 billion between June 2001-2003 during the financial crises in Argentina, Brazil, Uruguay, and Turkey [3]. The IMF is wholly unequipped to provide by itself the necessary liquidity to the United States and affected industrialized countries. In addition, the United States and other Western countries, along with some Middle Eastern oil states, are the primary contributors to IMF resources, and it is unlikely that these countries would seek IMF assistance. The last time that developed countries borrowed from the IMF was between1976 and1978, when the United Kingdom, Italy, and Spain borrowed from the IMF to deal with the aftershocks of the 1973 increase in oil prices [4].

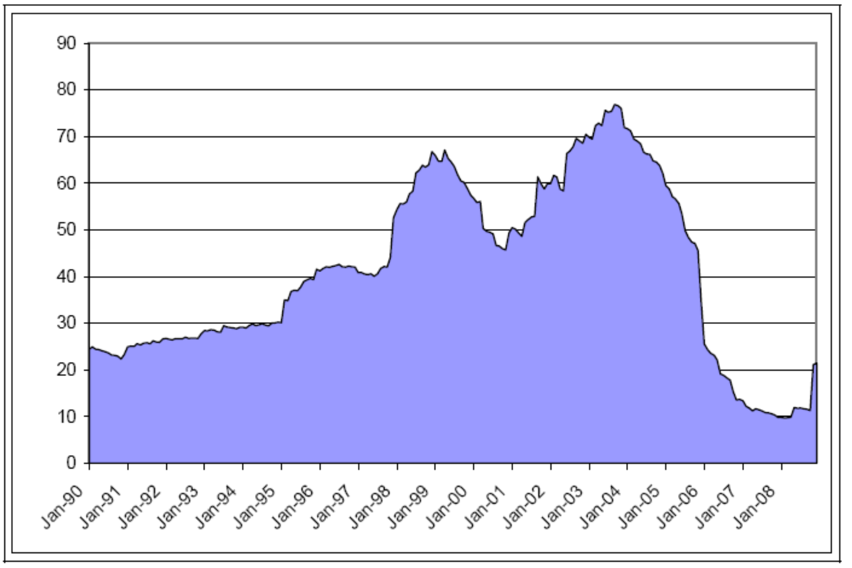
Since the financial crises of a decade ago, many emerging market economies, largely in response to their criticism of the policy conditions that the IMF required of countries receiving IMF loans, have built up extensive foreign reserve positions in order to avoid having to return to the IMF should such a crisis occur again [5]. From a level of around $1.2 trillion in 1995, global foreign exchange reserves now exceed $7 trillion. The IMF tabulates that by the second quarter of 2008, developing countries' foreign reserves were $5.47 trillion compared to $1.43 trillion in the industrialized countries.6 This reserve accumulation was driven by increasing commodity prices (such as oil and minerals) and large current account surpluses combined with high savings rates in emerging Asian countries [7].

Emerging market foreign reserve accumulation fueled by rising commodity prices and large emerging market trade surpluses, and net foreign direct investment flows has led to a decrease in demand for IMF lending and a weakening in the IMF's budget position. IMF lending peaked in 2003 with IMF credit outstanding totaling $110.29 billion. By September

30, 2008, outstanding IMF loans had decreased by $92.6 billion to $17.72 billion (see also Figure 1) [8].

Since the IMF earns income on the interest paid on its loans, the decrease in demand for IMF's lending led to a budget shortfall in 2007. The IMF is in the process of seeking authorization from national legislatures to sell a portion of gold that the IMF holds in reserve to create an investment fund whose profits can be used to finance IMF operations and delink IMF operations (such as its global surveillance programs) from profit earned on IMF lending. Congress is expected to face a vote in FY2009 on whether or not to authorize this proposal.

The rise of emerging market countries over the past decade, has created new challenges for the IMF. Many emerging market economies argue that their current stake in the IMF does not represent their role in the world economy.



Source: International Monetary Fund Notes: The Special Drawing Right (SDR) is an international reserve asset, created by the IMF in 1969. SDRs are allocated to member countries in proportion to their IMF quotas. The SDR also serves as the unit of account of the IMF and some other international organizations. Its value is based on a basket of key international currencies (the U.S. dollar, Euro, Japanese yen, and pound sterling). The SDR currency value is calculated daily and the valuation basket is reviewed and adjusted every five years.

Figure 1. Outstanding IMF Credit (1990-2008, SDR).

Several countries, particularly in East Asia and South America, believe that their new economic weight and status should afford them a larger quota and a greater voice at the institution. In addition, many poor countries believe that the IMF 's quota system is prejudiced against them, giving them little voice even though they are the majority of the IMF's borrowers. In response to these concerns, the IMF embarked in 2006 on a reform process to increase the quota and voice of its emerging market country members [9].

While the IMF has struggled to define its role in the global economy, the global financial crisis has created an opportunity for the IMF to reinvigorate itself and possibly play a constructive role in resolving, or at the least mitigating, the effects of the global downturn, on two fronts: (1) through immediate crisis management, primarily balance of payments support to emerging- market and less-developed countries, and (2) contributing to long-term systemic reform of the international financial system.

Immediate Crisis Management

IMF rules stipulate that countries are allowed to borrow up to three times their quota over a three- year period, although this requirement has been breached on several occasions where the IMF has lent at much higher multiples of quota [10]. While many emerging market countries, such as Brazil, India, Indonesia, and Mexico, have stronger macroeconomic fundamentals than they did a decade ago, a sustained decrease in U.S. imports resulting from an economic slowdown could have recessionary effects overseas. Emerging markets with less robust financial structures have been more dramatically affected, especially those dependent on exports to the United States. Increased emerging market default risk can be seen in the dramatic rise of credit default swap (CDS) prices for emerging market sovereign bonds. Financial markets are currently pricing the risk that Pakistan, Argentina, Ukraine, and Iceland will default on their sovereign debt at above 80% [11] On October 26, the IMF announced a $16.5 billion agreement with Ukraine. On October 27, the IMF announced a $15.7 billion loan to Hungary. On November 19, the IMF announced a $2.1 billion loan to Iceland. On November 24, the IMF announced a $7.6 billion loan to Pakistan [12]. On December 23, 2008, the IMF announced a $2.35 billion dollar loan for Latvia. Other potential candidates for IMF loans are Serbia, Kazakhstan, Lithuania, and Estonia [13].

IMF Managing Director Dominique Strauss-Kahn has stressed that the IMF is able and poised to assist with crisis loans. At the IMF annual meetings in October 2008, Managing Director Strauss- Kahn announced that the IMF had activated its Emergency Financing Mechanism (EFM) to speed the normal process for loans to crisis-afflicted countries [14]. The emergency mechanism enables rapid approval (usually within 48-72 hours) of IMF lending once an agreement has been reached between the IMF and the national government. As noted before, while normal IMF rules are that countries can only borrow three times the size of their respective quotas over three years, the Fund has shown the willingness in the past to lend higher amounts should the crisis require extraordinary amounts of assistance.

A second instrument that the IMF could use to provide financial assistance is its Exogenous Shock Facility (ESF). The ESF provides policy support and financial assistance to low-income countries facing exogenous shocks, events that are completely out of the national government’s control. These could include commodity price changes (including oil and food), natural disasters, and conflicts and crises in neighboring countries that disrupt trade. The ESF was modified in 2008 to further increase the speed and flexibility of the IMF’s response. Through the ESF, a country can immediately access up to 25 % of its quota for each exogenous shock and an additional 75% of quota in phased disbursements over one to two years.

On October 29, 2008, the IMF announced that it plans on creating a new three month short-term lending facility aimed at middle income countries such as Mexico, South Korea, and Brazil. The IMF plans to set aside $100 billion for the new Short-Term Liquidity Facility (SLF). In a unprecedented departure from other IMF programs, SLF loans will have no policy conditionality [15]. Under the SLF, countries with track records of sound policies, access to capital markets and sustainable debt burden can draw up to five times their IMF quota for three months and up to two additional three-month periods. To date, no country has drawn on the SLF. For many middle-income countries this is likely due to the associated stigma of accepting IMF assistance. Concerns have also been raised that by creating a new lending mechanism the IMF is dividing potential borrowers into those that qualify for the SLF and those that would be forced to accept regular IMF lending with its associated policy conditionality [16]. To counter this stigma, some analysts have proposed coordinating an SLF package for several countries at the same time. Another option may be to coordinate an SLF loan with the newly created Federal Reserve swap arrangements for developing countries. On the same day that the IMF announced the SLF, the U.S. Federal Reserve approved $30 billion in reciprocal swap arrangements with four emerging- market countries: Brazil, Korea, Mexico, and Singapore.

At the 2009 Davos World Economic Forum, John Lipsky, the IMF's First Deputy Managing Director, said that to be able to effectively lend to all the potential countries affected by the crisis, the IMF should double its lending resources to around $500 billion [17]. In addition to potential resources freed up by the sale of IMF gold reserves, two additional financing options for the IMF are seeking additional capital from its member countries and selling bonds. The government of Japan has agreed to lend the IMF $100 billion dollars and it is reported that the agreement is almost finalized [18]. According to Mr. Lipsky, the Japanese loan would be structured in a way that is similar to two IMF programs: the General Arrangements to Borrow (GAB) and the New Arrangements to Borrow (NAB), which provide up to $50 billion in additional funding if the IMF were to exceed that amount available in its core resources. The second option would be for the IMF to issue bonds, which it has never done in its 60 year history. According to Mr. Lipsky, the IMF bonds would be sold to central banks and government agencies. According to economist and former IMF chief economist Michael Mussa, the United States and Europe blocked attempts by the IMF to issue bonds since it could potentially make the IMF less dependent on them for financial resources and thus less willing to take policy direction from them [19]. However, several other multilateral institutions such as the World Bank and the regional development banks routinely issue bonds to help finance their lending.

The IMF is not alone in making available financial assistance to crisis-afflicted countries. The International Finance Corporation (IFC), the private-sector lending arm of the World Bank, has announced that it will launch a $3 billion fund to capitalize small banks in poor countries that are battered by the financial crisis. The Inter-American Development Bank (IDB) announced on October 10, 2008 that it will offer a new $6 billion credit line to member governments, as well as increase its more traditional lending for specific projects.20 In addition to the IDB, the Andean Development Corporation (CAF) announced a liquidity facility of $1.5 billion and the Latin American Fund of Reserves (FLAR) has offered to make available $4.5 billion in contingency lines. While these amounts may be insufficient should Brazil, Argentina, or any other large Latin American country need a rescue package, they could be very helpful for smaller countries such as those in the Caribbean and Central America that are heavily dependent on tourism and property investments [21].

In Asia, where countries were left no choice but to accept IMF rescue packages a decade ago, efforts are under way to promote regional financial cooperation, so that governments can avoid having to borrow from the IMF in a financial crisis. One result of these efforts is the Chiang Mai Initiative, a network of bilateral swap arrangements among east and Southeast Asian countries. In addition, Japan, South Korea, and China have backed the creation of a $10 billion crisis fund. Contributions are expected from bilateral donors, the Asian Development Bank (ADB), and the World Bank [22].

Lastly, economic conditions over the past decade have created a new class of bilateral creditors who could challenge the IMF's role as the lender of last resort. The rise of oil prices has created vast wealth among Middle Eastern countries and persistent trade surpluses in Asia have created a new class of emerging creditors. These countries either have the foreign reserves to support their own currencies in a financial crisis, or they are a potential source of loans for other countries.

Reforming Global Macroeconomic Surveillance

In addition to revising its emergency lending assistance guidelines to make the IMF's financial assistance more attractive to potential borrowers, there is a role for the IMF to play in the broader reform of the global financial system. Efforts are underway to expand the IMF's ability to conduct effective multilateral surveillance of the international economy. In addition, there are efforts to increase cooperation with the international financial standard setters as the Financial Stability Forum (FSF), the Bank for International Settlements (BIS), as well as in various international working groups such as the Basel Committee on Banking Supervision and the Joint Forum on Risk Assessment and Capital. The deepening interconnectedness of the international economy may call for such increased cooperation between the IMF, which performs global macroeconomic surveillance, and the individual global financial regulatory bodies.

The IMF Articles of Agreement require (Article IV) that the IMF "oversee the international monetary system in order to ensure its effective operation" and to "oversee the compliance of each member with its obligations" to the Fund. In particular, "the Fund shall exercise firm surveillance over the exchange rate policies of member countries and shall adopt specific principles for the guidance of all members with respect to those policies." Countries are required to provide the IMF with information and to consult with the IMF upon its request. The IMF staff generally meets each year with each member country for "Article IV consultations" regarding the country's current fiscal and monetary policies, the state of its economy, its exchange rate situation, and other relevant concerns. The IMF's reports on its annual Article IV consultations with each country are presented to the IMF executive board along with the staff's observations and recommendations about possible improvements in the country's economic policies and practices.

As the global financial system has become increasingly interconnected, the IMF has conducted multilateral surveillance beyond two bi-annual reports it produces, the World Economic Outlook and the Global Financial Stability Report, four regional reports, and regular IMF contributions to intergovernmental fora and committees, including the Group of Seven and *Group of Twenty, and the Financial Stability Forum*. These efforts at multilateral surveillance, however, have been criticized as being less than fully effective, too focused on bilateral issues, and not fully accounting for the risks of contagion that have been seen in the current crisis. A 2006 report by the IMF's internal watchdog agency, the Independent Evaluation Office (IEO) found that, "multilateral surveillance has not sufficiently explored options to deal with policy spillovers in a global context; the language of multilateral advice is no more based on explicit consideration of economic linkages and policy spillovers than that of bilateral advice."23 Participants at an October 2008 IMF panel on the future of the IMF reiterated these concerns, adding that many developed countries have impeded the IMF's efforts at multilateral surveillance by largely ignoring IMF's bilateral surveillance of their own economies and not fully embracing the IMF's first attempt at multilateral consultations on global imbalances in 2006. According to Trevor Manuel, South Africa's Finance Minister, "one has to start from the fundamental view that if you accept public policy and you accept the interconnectedness of the global economy, then you need an institution appropriate to its regulation."24 Analysts argue, however, that developed countries have long ignored IMF advice on their economic policy, while at the same time pressuring the IMF to use its role in patrolling the exchange rate system to support their own foreign economic goals.

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FUTURE OF THE BALKANS AND U.S. POLICY CONCERNS[*]

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ABSTRACT

The United States, its allies, and local leaders have achieved substantial successes in the Balkans since the mid-1990s. The wars in the region have ended, and all of the countries are undertaking political and economic reforms at home and orienting their foreign policies toward Euro-Atlantic institutions. However, difficult challenges remain, including dealing with the impact of Kosovo's independence; fighting organized crime, corruption, and enforcing the rule of law; bringing war criminals to justice; and reforming the economies of the region.

The goal of the United States and the international community is to stabilize the Balkans in a way that is self-sustaining and does not require direct intervention by NATO-led forces and international civilian officials. The United States has reduced the costs of its commitments to the region, in part due to competing U.S. and international priorities, such as the war on terrorism, and efforts to stabilize Iraq and Afghanistan, which have placed strains on U.S. resources. SFOR and KFOR, the NATO-led peacekeeping forces in Bosnia and Kosovo, were reduced in size. In December 2004, SFOR's mission was concluded, and European Union troops took over peacekeeping duties in Bosnia. No U.S. combat troops remain in Bosnia. About 15,500 troops remain in Kosovo as part of KFOR, including 1,500 U.S. soldiers.

Since the September 11, 2001 attacks on the United States, the war on terrorism has been the United States' main foreign policy priority, including in the Balkans. Before September 11, Al Qaeda supporters operated from Bosnia and Albania. However, the Bush Administration said that these countries and others in the region "actively supported" the war on terrorism, shutting down terrorist front organizations and seizing their assets. Although their efforts are hampered by the weakness of local government institutions, U.S. anti-terrorism efforts in the Balkans are aided by U.S. military and intelligence assets in the region, as well as a reservoir of good will among local Muslims of all ethnic groups.

Congress has played an important role in shaping U.S. Balkans policy. Some Members supported Clinton Administration efforts to intervene to stop the fighting in the region in the mid and late

1 990s, while others were opposed. Members were leery of an open-ended commitment to the region and sought to contain these costs through adoption of benchmarks and limiting U.S. aid and troop levels to the region. The end of the wars in

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the Balkans and the shift in U.S. priorities in the wake of the September 11 attacks has moved the Balkans to the periphery of congressional concerns, at least when compared to the situation in the 1 990s. However, Congress has continued to have an impact on such issues as Kosovo's status, conditioning some U.S. aid to Serbia on cooperation with the International Criminal Tribunal for the Former Yugoslavia, and supporting NATO membership for the countries of the region. On May 12, 2009, the House passed H.R. 171, which calls on Bosnia to make constitutional reforms and on the Administration to appoint a special envoy to the Balkans. In late May 2009, Vice President Joe Biden will reportedly visit Kosovo, Bosnia, and Serbia to discuss the situation in the region.

INTRODUCTION: THE ROLE OF THE BALKANS IN U.S. FOREIGN POLICY

The United States and the international community have achieved substantial successes in the Balkans since the 1990s. The wars in the former Yugoslavia were ended. All of the countries of the region are undertaking political and economic reforms and orienting their foreign policies toward Euro-Atlantic institutions. U.S. officials have stated that ensuring the stability of the Balkans is an important part of a U.S. vital interest in securing a Europe whole, free, and at peace.

For more than thirteen years, the United States has provided significant aid and troop deployments to the Balkans in support of this goal. Both aid amounts and the U.S. troop commitments have declined as the region has stabilized and more pressing U.S. foreign policy priorities have emerged. At the same time, the European Union has increased its role, with the ultimate goal of extending EU membership to the countries of the region. However, analysts believe the United States still may have an important role to play in the Balkans. Observers note that the United States has political credibility in the region, particularly among Bosniaks and Albanians, which the Europeans may lack. In particularly, some analysts say that greater U.S. diplomatic engagement is needed to re-energize constitutional reforms in Bosnia, which have languished since 2006. The region may have a higher strategic profile given U.S. use of military bases in Romania and Bulgaria, which could be useful for U.S. operations in the Middle East. Continued U.S. attention may also be needed to uproot possible terrorist networks in the region.

CURRENT CHALLENGES IN THE REGION

Impact of Kosovo's Independence

On February 17, 2008, Serbia's Kosovo province declared its independence. The United States and 22 of the 27 European Union countries (including key states such as Britain, France, Germany, and Italy) have recognized Kosovo as an independent state. In all, at least 58 countries have recognized Kosovo so far. Serbia, which considers Kosovo as part of its territory, sharply condemned the move, and declared it to be null and void. Belgrade downgraded diplomatic relations with the United States and other countries that recognized Kosovo. Serbia has been joined in its opposition by Russia, China, and five EU countries

(Spain, Greece, Cyprus, Romania and Slovakia, which have ethnic minority concerns of their own, and/or are traditional allies of Serbia).

When it declared independence, Kosovo pledged to implement a status settlement plan proposed by U.N. envoy Martti Ahtisaari. The plan calls for an independent Kosovo to be supervised by the international community for an undefined period.[2] Kosovo is not permitted to merge with another country or part of another country. The document contains provisions aimed at safeguarding the rights of ethnic Serbs and other minorities in Kosovo. Six Serbian-majority municipalities are to be given expanded powers over their own affairs. Local police in these areas are to reflect the ethnic composition of the locality. The judiciary and central government have to reflect the ethnic composition of Kosovo, and all laws having a special impact on an ethnic minority can only be adopted by a majority of that ethnic group's representatives in parliament. International missions led by the European Union supervise Kosovo's compliance with the Ahtisaari plan.

The pro-Western government that took power in Belgrade in July 2008 remains dedicated to opposing Kosovo's independence by diplomatic means. It scored a notable success on October 8, 2008, when the U.N. General Assembly voted to refer the question of the legality of Kosovo's declaration of independence to the International Court of Justice. A decision on the case is not expected for several years.

Many experts believe Serbia is aiming at (and has largely achieved) a de facto separation of the Serbian-dominated northern part of Kosovo from the rest of the country. Local Serbs recognize only the authority of the Serbian government, and receive subsidies from Belgrade. On the other hand, the Serbian government reluctantly acquiesced in the deployment in December 2008 of EULEX, an EU-led law and order mission, to northern Kosovo. Belgrade was able to negotiate terms that formally placed EULEX under the U.N. umbrella, thereby politically distancing Serbia from the Ahtisaari plan, which recognizes Kosovo's independence. The security situation in Kosovo has stabilized somewhat since February 2008 although sporadic outbreaks of violence continue to occur. If there is large-scale violence between Serbs and Albanians in Kosovo, large numbers of Serbs could leave the province, particularly those living in isolated enclaves in the southern part of Kosovo.

Serbia hopes that the ICJ case will keep the Kosovo status issue open by discouraging additional diplomatic recognitions. Indeed, the diplomatic stalemate over Kosovo's independence could indefinitely delay Kosovo's entry into the United Nations (due to the opposition of Russia) and, in the long term, into the EU and NATO. On the other hand, keeping Kosovo open as a diplomatic issue could negatively affect Serbia's EU membership prospects as well, given that all but 5 EU countries have already recognized Kosovo. Such countries currently support Serbia's early steps toward EU integration, despite differences on Kosovo. However, they could decide in the more distant future that Serbian membership itself should wait until Belgrade recognizes Kosovo, in order to avoid importing an intractable ethno-territorial dispute into the EU and foreclosing Kosovo's own possible future membership.

Some observers have suggested that one possible way out of the impasse is a partition of Kosovo, presumably at the current de facto dividing line. Partition has been raised as a possibility (although not advocated) by Serbian President Boris Tadic. However, partition is

[2] Ahtisaari's report to Secretary General Ban Ki-Moon on the plan can be found at http://www.un.org/Docs/sc/unsc_presandsg_letters07.htm.

vociferously opposed by Kosovo's leaders, who insist that their government must have sovereignty over all of Kosovo. The United States and the EU also oppose partition. Some experts fear that partition could destabilize the region by encouraging similar demands by Serbs in Bosnia or by ethnic Albanians in southern Serbia and perhaps Macedonia.[3]

Establishing Democracy and the Rule of Law

The domestic political situation in the Balkan countries has improved since the end of the Yugoslav wars in the 1990s. All the countries in the region have held largely free and fair elections, although some problems with elections still need to be addressed. Civil society groups and independent media express a wide variety of views, but sometimes face pressure from government authorities. The countries in the region have redrawn their constitutions along more democratic lines, but some constitutional provisions in Serbia and other countries are still less than ideal.

Serious problems remain. The legitimacy of democratic institutions is challenged by the weakness of government structures. The countries of the region lack effective, depoliticized public administration. The police and judicial systems in many countries are weak and often politicized. Government corruption is a serious problem in all of the countries of the region. Organized crime is a powerful force in the region and is often allied with key politicians, police, and intelligence agency officials. Albania, Macedonia, and other countries of the region have had problems in developing a stable, democratic political culture. This has resulted in excessively sharp tension between political parties that has at times hindered effective governance. Relatedly, ethnic tension remains a serious problem in many countries of the region, particularly in Bosnia, Kosovo, and Macedonia. Too often, party leaders, with their power to distribute patronage, contracts, and other sources of largesse, are the real power in these countries, overriding the rule of law. In countries where ethnic tensions are great, leaders of ethnically based parties can use such tensions as an additional means of popular manipulation and control.

Although the international community has provided large amounts of aid and advice to strengthen local institutions and the rule of law, it may itself be responsible for some of the problems. The United States and its European allies helped craft the decentralized political system of Bosnia, which was a product of post-war political compromise. Since the late 1990s, they have viewed the arrangement as an unworkable one that hinders the country's Euro-Atlantic integration, and have pushed for the strengthening of central government institutions, but have faced resistance and obstruction, mainly from Bosnian Serbs leaders. Some observers have asserted that political tensions within Bosnia could even lead to a resumption of violence, particularly if the Bosnian Serbs attempt to secede from Bosnia.[4] In both Bosnia and Kosovo, international officials frequently imposed policies from above, perhaps fostering a culture of dependency and political irresponsibility among local elites. Given these problems, the region's transition to democracy and the rule of law is likely to be lengthy and difficult.

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[3] For more on Kosovo, see CRS Report RS21721, Kosovo: Current Issues and U.S. Policy, by Steven Woehrel.

[4] For more information, see CRS Report R40479, Bosnia: Current Issues and U.S. Policy, by Steven Woehrel.

ECONOMIC REFORM AND IMPROVING LIVING STANDARDS

The economies of the region face the burden of a Communist legacy as well as well as resistance to economic transparency by many local leaders. Some of the region's economic problems are closely related to its political problems. Weak and corrupt state structures have been an obstacle to rationalizing tax and customs systems to provide adequate revenue for social programs and other government functions. The absence of the rule of law has hampered foreign investment in some countries due to concern over the sanctity of contracts. In Bosnia, the lack of a strong central government and the division of the country into two semi-autonomous "entities" has hindered the development of a single market.

Substantial progress has been made in economic reforms in many countries since the 1990s. Fiscal and monetary austerity, with the assistance of international financial institutions, permitted many countries to avoid hyperinflation and stabilize their currencies. The countries of the region embarked on the privatization of their industries. However, the process remains incomplete and there have been concerns within these countries and among foreign investors about corruption and a lack of transparency in some deals. High unemployment and poverty are serious problems in all of the countries of the region.

Until the global economic crisis, the countries of the region experienced substantial economic growth and increases in real wages. They also attracted increasing foreign investment, although totals remain low when compared to those of central European countries that joined the EU in 2004. Croatia has been particularly successful in economic reform and in attracting foreign investment, and expects to join the EU in 2011. Indeed, in per capital income, structural reforms, and foreign direct investment, Croatia has already surpassed several current EU member states, particularly Romania and Bulgaria.

Although positive signs have emerged in recent years, the economic challenges faced by the countries of the region mean that many years could be required before the poorer countries even approach average EU living standards. As in the case of political reform, which is closely linked to successful economic reform, a long-term international commitment of aid, advice, and the prospect of EU membership may be required to build and maintain a local consensus for often painful measures.

The global economic crisis has dealt a painful setback to the region. The countries of the region generally have had large balance of payments deficits, due to a boom in imports. Since the economic crisis has hit, foreign financing has dried up. Many of the countries of the region have a narrow export base, vulnerable to downturns in western Europe. Exports have plummeted. Tourism, key for countries such as Croatia and Montenegro, is also likely to be heavily affected by the crisis. Remittances from persons working abroad, very important countries such as Albania and Kosovo, are also dropping. Currencies of many countries in the region have been under heavy pressure. Domestic tax revenues are declining. Unemployment, already a serious problem, is increasing.

In order to make ends meet, governments in the region have unveiled austerity policies, including sharp budget cuts. Such cuts could be politically destabilizing, given widespread poverty in the region. The countries are also seeking assistance from international financial institutions. In April 2009, the IMF agreed to give Serbia a $4 billion loan, which could unlock additional EU aid. On May 5, Bosnia and the IMF reached agreement on a $1.6 billion loan. However, Bosnia may have difficulty in meeting IMF conditions, due to the inability of a dysfunctional government in the Federation of Bosnia and Herzegovina, one of the two "entities" within Bosnia, to agree on deep cuts in social spending.

U.S. POLICY CONCERNS

Creating Self-Sustaining Stability in the Balkans

The main goal of the United States and the international community in the Balkans is to stabilize the region in a way that does not require direct intervention by NATO-led forces and international civilian officials, and puts it on a path toward integration into Euro-Atlantic institutions. The United States and EU countries support a leading role for the EU in the region, with a smaller role by the United States, at least as far as troop levels and aid are concerned. These goals have been given greater urgency by competing U.S. and international priorities that have emerged since September 11, 2001, such as the war on terrorism, and efforts to stabilize Iraq and Afghanistan, which have placed strains on U.S. resources.

Since the deployment of U.S. troops to Kosovo in 1999, U.S. officials have maintained the position that the U.S. peacekeeping forces went into the Balkans with the Europeans and would leave together with them. Nevertheless, as the situation in the region has stabilized, the United States and its allies have withdrawn troops from the region. Currently, about 1,500 U.S. troops are deployed in Kosovo.

In December 2004, the mission of SFOR, the NATO-led peacekeeping force in Bosnia, came to an end. Peacekeeping duties were handed over to a European Union force (EUFOR), now composed of about 2,000 troops. The EU force is tasked with helping to maintain a secure environment in Bosnia and support Bosnia's progress toward integration with the EU. No U.S. combat troops remain in Bosnia. Currently, there are about 15,500 NATO-led troops in KFOR in Kosovo, including the U.S. contingent.

Filling a Possible Security Gap

An important concern facing both Balkan deployments is who, if anyone, will fulfill the tasks that they are currently performing as military forces are withdrawn. EUFOR and KFOR do not play a direct role in policing duties in Bosnia and Kosovo. However, they do provide "area security" by regular patrolling. In Bosnia, an EU Police Mission monitors, inspects, and provides advice to promote multi-ethnic, professional police forces that act according to European standards. The Office of the High Representative (OHR), the leading international civilian body in Bosnia, has attempted to increase central government control over the police, reducing the role of the semiautonomous "entities" within Bosnia. The United States and the EU believe such a move would make the police more efficient and effective, and increase Bosnia's unity. However, progress toward this goal has been slow, due to strong resistance from the Republika Srpska, the largely Serb entity. RS leaders see the police as a key bulwark of their power and do not want give up control over it. Police reforms passed by the Bosnian parliament in April 2008 were considerably weaker than those originally urged by the international community.

March 2004 riots in Kosovo exposed serious weaknesses in policing and security in Kosovo. With notable exceptions, the local Kosovo Police Service did not perform very well, sometimes melting away in the face of the rioters and in a few cases joining them. CIVPOL, the U.N. police contingent in Kosovo, was hampered by a lack of cohesion and leadership. There were many reports of KFOR troops, outnumbered by the rioters and unwilling to fire on them, refusing to intervene to stop the destruction and looting of property. Some KFOR units reportedly failed even to protect Serb civilians and U.N. police from violence.[5] KFOR officers have said the Alliance has taken steps to deal with these problems, including by supplying its forces with non-lethal riot control equipment, establishing clearer lines of authority, and consistent rules of engagement.

KFOR and CIVPOL performed better during the violence in Mitrovica in northern Kosovo on March 17, 2008. U.N. police stormed a courthouse occupied by Serbian protestors. The police and KFOR stood their ground as rioters attacked them with rocks, Molotov cocktails, automatic weapons, and grenades. One U.N. policeman was killed, and more than 60 U.N. police and about 30 KFOR troops were hurt, as were 70 rioters. Since then sporadic, smaller-scale outbreaks of violence between Serbs and Albanians in Mitrovica have continued, and are likely to occur in the future.

In December 2008, EULEX personnel replaced U.N. police in Kosovo. Some observers have questioned the effectiveness of EULEX in northern Kosovo, given the small numbers of personnel deployed and continued opposition by local Serbs to their presence. EULEX sees as its primary mission to monitor and mentor the Kosovo Police Service (KPS), although it has the authority to take on police tasks if necessary. However, local Serbs refuse to work with the KPS, as they believe doing so would constitute recognition of Kosovo's independence.

EUFOR and KFOR have also played important roles in overseeing the military forces of Bosnia and Kosovo. EUFOR inspects military arsenals in Bosnia. NATO and the Office of the High Representative have worked together to reform the two Bosnian entity armies and reduce them in size. These reforms include the unification of Bosnia's armies under a single command structure, including a Minister of Defense and Chief of Staff. However, although Bosnia now nominally has a unified armed forces, military units are not integrated at lower levels.

EU leaders are considering a drastic reduction of EUFOR from about 2,000 troops to about 200. A decision may be made later this year. The remaining forces would support defense reform and would not have a peacekeeping role. Germany, France, and other supporters of the move say their forces are overstretched, given deployments in Afghanistan and elsewhere. They assert that the risk of conflict in Bosnia is slight. Other EU countries are more cautious, saying that withdrawing EUFOR would send a bad political signal while Bosnia's political situation remains unsettled.

KFOR's presence deters possible Serbian aggression or military provocations against Kosovo, although an invasion of Kosovo by Serbian troops appears unlikely. Nevertheless, KFOR has been deployed to deal with violence in such flashpoints as the divided town of Mitrovica in northern Kosovo, and may face similar challenges in the future. KFOR also oversees the establishment of Kosovo's new army, the Kosovo Security Force, as foreseen

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5 For a detailed account of the riots and the response of UNMIK and KFOR to them, see International Crisis Group, "Collapse in Kosovo," April 22, 2004, at the ICG website, http://www.crisisgroup.org/home/index.cfm?.

by the Ahtisaari plan.. Press reports have quoted sources in several NATO governments as saying that they expect KFOR to be reduced significantly in late 2009, although NATO officials stress no decision has yet been made. Some countries, such as Spain, have already made a unilateral decision to withdraw their troops, citing an improved situation in Kosovo and a more pressing need for troops in Afghanistan. On the other hand, advocates of a continued strong troop presence in Kosovo caution that a substantial withdrawal may be inadvisable considering the continuing likelihood of violence in northern Kosovo and the vulnerability of Serbian enclaves elsewhere.

Restructuring the International Role in the Region

Another issue, linked to EUFOR and KFOR's future, is how to reorganize the international civilian presence in the region. U.S. and European officials say that the ad hoc arrangements cobbled together at the end of the conflicts in Bosnia and Kosovo, under which local authorities are supervised and sometimes overruled by international bureaucracies (the Office of the High Representative in Bosnia, the EU-led missions in Kosovo) should be phased out. They believe that the two main forces for Euro-Atlantic integration, the European Union and NATO, should have a clear leading role in the region, but through advice and aid, not direct rule.

European Union

At the June 2003 Thessaloniki EU summit with the countries of the Western Balkans, EU leaders recognized the countries of the region as prospective EU members. The EU has granted EU membership candidate status to Croatia and Macedonia. Croatia has made good progress in its membership negotiations, and hopes to join the EU in 2011. However, in 2009, Croatia hit a roadblock in its membership efforts, due to a border dispute with EU member state Slovenia. The EU has recognized Macedonia as a membership candidate, but has not started formal talks with Skopje, due to concerns about the pace of reforms there. A long-standing dispute between Macedonia and Greece has also been an important factor holding up progress.

The EU has concluded Stabilization and Association agreements (SAA) with the other countries in the region. The SAA provides trade concessions, aid, and advice aimed at accelerating reforms and integrating the recipients more closely with the EU, with the goal of eventual EU membership. Albania signed an SAA in 2006. In April 2009, Albania formally submitted its membership application to the EU. Montenegro signed an SAA in 2007, and submitted an application for EU membership in 2008..

The EU signed an SAA with Serbia on April 29, 2008. The move appeared to be aimed at strengthening the hand of pro-Europe forces in Serbia's May 2008 parliamentary elections. However, at the insistence of the Netherlands and Belgium, the agreement will not be implemented until all EU countries agree that Serbia is cooperating with the International Criminal Tribunal for the former Yugoslavia (ICTY).

After the Bosnian parliament approved police reform legislation in April 2008, the EU announced that it would sign an SAA with Bosnia on June 16, 2008. The move was a softening of the EU's prior approach, as the police reform was a watered-down version of previous proposals and other EU conditions appear to have been dropped or postponed. Like the EU's decision to grant an SAA to Serbia, the signing of an SAA with Bosnia may have been intended to stabilize the region in the wake of Kosovo's independence.

Before Kosovo became independent, it participated in an SAA "tracking mechanism" that provides it with advice and support, with the aim of bringing Kosovo closer to the EU. Now that Kosovo is independent, it may be considered for a Stabilization and Association Agreement. However, a lack of consensus within the EU on Kosovo's recognition, as well as Kosovo's institutional weakness may slow this process.

The global economic crisis may slow possible EU membership for the countries of the region (with the possible exception of Croatia, which is already well along in the process), in part due to increasing political resistance to enlargement in major EU countries. In turn, the lack of a credible EU membership "carrot" could slow reform efforts in the region. Even shorter-term "carrots," such as visa-free travel to the EU, may be delayed by the political climate in many EU countries. On the other hand, some reforms may be required by the IMF in exchange for stabilization loans.

NATO

NATO's future role in the region will take place in part through the Partnership for Peace (PFP) program, which promotes the reform of the armed forces of these countries and their interoperability with NATO. In addition, the Membership Action Plan (MAP) process prepares selected PFP members for possible future NATO membership by providing them with detailed guidance on improving their qualifications. MAP participants Albania and Croatia were invited to join NATO at the Alliance's summit in Bucharest in April 2008. A membership invitation to Macedonia, also a MAP country, was withheld due to the dispute with Greece over the country's name. NATO countries pledged to admit Macedonia to the Alliance once the name issue is resolved.

Serbia and Bosnia and Herzegovina were long excluded from PFP due to their failure to cooperate with the International Criminal Tribunal for the former Yugoslavia (ICTY). However,

in what many experts viewed as an unexpected reversal of policy, they were permitted to join PFP by NATO in December 2006. This may have been done for the same reasons that motivated the EU to sign SAAs with these countries in 2008 – to bring them closer to Euro-Atlantic institutions as Kosovo's status was close to resolution and in order to encourage further reform. In the case of Serbia, both moves may have also been timed to assist pro-Western parties in upcoming elections. Montenegro is also a PFP participant.

At the April 2008 NATO summit, Bosnia and Montenegro were offered an "Intensified Dialogue," a step toward Membership Action Plan status. The Alliance said it would consider Serbia for an "Intensified Dialogue," if it requests one. However, Serbia's interest in NATO membership appears to have waned in the wake of the recognition of Kosovo's independence. As an independent state, Kosovo is setting up its own security force under KFOR tutelage. Kosovo may join PFP in the future, but may be blocked by disagreement within NATO over recognition of Kosovo's independence.

International Supervisory Bodies in Bosnia and Kosovo

The Office of the High Representative (OHR) in Bosnia may be eliminated by the end of 2009, if the country makes sufficient progress on a package of reforms and conditions that has been outlined by the international community. After OHR's departure, an EU Special

Representative will remain but will likely not have powers to impose legislation and dismiss officials as OHR had. OHR has used these "Bonn powers" powers more sparingly in recent years. Nevertheless, it remains to be seen if aid conditionality and the distant prospect of EU membership will be sufficient to move the reform process forward in Bosnia.

After Kosovo declared independence in February 2008, the European Union began to deploy an International Civilian Office (ICO), which would oversee Kosovo's implementation of the Ahtisaari plan. The role and powers of the ICO appear to be modeled on those of OHR in Bosnia. The head of the Office, the International Civilian Representative (ICR) was chosen by an international steering group of key countries. The ICR also serves as EU Representative in Kosovo. An American serves as his deputy. The ICR is the final authority on the implementation of the settlement, and has the power to void any decisions or laws he deems to be in violation of the settlement, as well as the power to remove Kosovo government officials who act in a way that is inconsistent with the settlement. The ICR's mandate will last until the international steering group determines that Kosovo has implemented the settlement. The first review of settlement implementation will take place in 2010.

A mission under the EU's European Security and Defense Policy (ESDP), dubbed EULEX monitors and advises the Kosovo government on all issues related to the rule of law, specifically the police, courts, customs officials, and prisons. It also has the ability to assume "limited executive powers" to ensure that these institutions work properly.

War Crimes Prosecutions

Responsibilities for prosecuting most war crimes in the region is shifting from the ICTY to local courts. U.S. and international officials have worked with local leaders and the ICTY to create a war crimes chamber to try lower-level war crimes suspects within Bosnia. The United States and other countries also assisted Serbia's efforts to set up its own war crimes court.

However, perhaps the most notorious ICTY indictee, former Bosnian Serb army chief Ratko Mladic, has not been turned over to the Tribunal. In addition to Mladic, two other ICTY indictees are at large, both Serbs. U.N. Security Council Resolution 1503 called for the ICTY to complete its trials by 2008 and all appeals by 2010. This could create a situation where Serbia could "run out the clock," if the ICTY is closed before the remaining indictees are brought to justice.

U.S. Role

The United States' role in the region, already substantially reduced since the 1990s, could be reduced even further as the EU's role increases. The United States could perhaps act largely through NATO and bilateral aid in selected areas, such as reform of intelligence and internal security bodies, military reform, and rule of law assistance. However, the prestige and credibility that the United States has in the region may still be needed to exercise political leadership in resolving some of the most difficult issues, such as creating viable central government institutions in Bosnia and ensuring the region's stability, given continuing tensions between Serbia and Kosovo. U.S. leadership is especially needed in cases where divisions among EU countries make it difficult for the EU to make difficult decisions quickly.

U.S. AND INTERNATIONAL AID IN THE BALKANS

Since the end of the wars in the region, U.S. aid has gradually declined, in part due to a natural shift from humanitarian aid to technical assistance and partly due to a focus on assistance to other regions of the world. U.S. bilateral assistance appropriated in the account for political and economic reform in eastern Europe (which now exclusively focuses on Balkan countries) fell from $621 million in FY2002 to $293.6 million in FY2009. For FY2010, the Obama Administration requested just under $284.8 million for political and economic aid to the region.

The overall goal of U.S. aid to the Balkans is to prepare the countries for integration into EuroAtlantic institutions. U.S. programs are aimed at promoting good governance, fighting corruption, strengthening civil society and an independent media, enhancing market reforms, reducing threats of weapons of mass destruction, preventing trafficking in persons and contraband, and promoting the rule of law and human rights throughout the region.

U.S. officials see the EU as playing the leading role in providing assistance to reform Balkan countries along EU lines, eventually leading to EU membership. As these countries move closer to EU standards, the more advanced countries will "graduate" from U.S. assistance. For example, Croatia graduated from SEED assistance at the end of FY2006. In addition to SEED funding, all of the countries of the region receive a few million dollars each year in military aid to help their military reform and NATO integration efforts. In the case of many countries, the funding also supports their participation in ISAF, the NATO-led peacekeeping force in Afghanistan.

EU Aid to the Balkans

EU countries have a substantial interest in the stability of the Balkans. The region's problems already have a substantial impact on EU countries in such areas as trafficking in drugs and persons. The effect could be considerably worse if the region deteriorates into chaos and conflict. Some U.S. and European experts criticized what they view as a lack of vision by the EU in its policy toward the region. Under its Community Assistance for Reconstruction, Development, and Stabilization (CARDS) aid program for the region, the EU allotted 4.65 billion euro ($5.6 billion) from 2000-2006.[6]

Skeptics of EU policy said this level of resources appeared at odds with commitments made at the June 2003 Thessaloniki EU summit, when EU leaders recognized the countries of the region as prospective EU members. Critics pointed to generous EU pre-accession aid given to Central European countries and to neighboring Bulgaria and Romania as a model, saying more extensive aid would help the Balkan countries restructure their economies and legal systems more quickly to meet EU conditions for membership, while bringing local living standards somewhat closer to EU standards.[7] The EU took steps that appeared to be aimed at dealing with these problems. CARDS was folded into the Instrument for Pre-Accession Assistance (IPA), which helps all countries seeking EU membership. The EU

[6] CARDS financial statistics at the European Union website http://ec.europa.eu/enlargement /how-does-it-work/ financial-assistance/cards/statistics 2000-2006_en.htm.

[7] Discussions with U.S. and European Balkans experts.

allocated 11.47 billion euro (over $17.8 billion) for the IPA for 2007-2013. According to the EU Commission, between 2007 and 2012, the average allocation for the western Balkans under the IPA is around 800 million euro (over $1 billion) per year.[8]

The War on Terrorism and the Balkans

Since the September 11 attacks on the United States, the war on terrorism has been the United States' main foreign policy priority and has had an impact on U.S. policy in the Balkans. In the 1990s, wars and political instability provided an opportunity for Al Qaeda and other terrorist groups to infiltrate the Balkans. However, U.S. and European peacekeeping troops, aid, and the prospect of Euro-Atlantic integration helped to bring more stability to the region. Moreover, the September 11, 2001, attacks on the United States underscored for the countries of the region the dangers of global terrorism and resulted in increased U.S. attention and aid to fight the terrorist threat. In part as a result, many experts currently do not view the Balkans as a key region harboring or funding terrorists, in contrast to the Middle East, South Asia, Southeast Asia, and Western Europe.

However, experts note that the region may play a role in terrorist plans, as a transit point for terrorists, as well as for rest and recuperation. Moreover, they agree that the region's continuing problems continue to leave it vulnerable to terrorist groups. In October 2005, Bosnian police captured an Islamic terrorist cell that was plotting to blow up the British Embassy in Sarajevo.9

U.S. officials have cited the threat of terrorism in the Balkans as an important reason for the need for continued U.S. engagement in the region. In addition to the need to take steps to directly combat terrorist infrastructure in the region, U.S. officials say that U.S. efforts to bring stability to the region also help to fight terrorism. They note that political instability, weak political and law enforcement institutions, and poverty provide a breeding ground for terrorist groups. U.S. objectives are also outlined in the 9/11 Commission Report and the President's National Strategy for Combating Terrorism, which calls for the United States to work with other countries to deny terrorists sponsorship, support, and sanctuary, as well as working to diminish the underlying conditions that terrorists seek to exploit.

The United States has a variety of instruments to fight terrorism in the Balkans. One is the presence of U.S. troops in Kosovo and intelligence personnel in Bosnia. The United States also provides bilateral counterterrorism assistance to the countries of the region. The overall U.S. aid program to the region, aimed at bringing stability through strengthening the rule of law and promoting economic reform, also serves to combat the sometimes lawless climate in which terrorists can thrive. U.S. aid helps to develop export control regimes in the region, including over weapons of mass destruction and dual-use technology. The United States has encouraged regional cooperation on terrorism and international crime through the Southeast European Cooperation Initiative (SECI). In the longer term, efforts to stabilize the region, and

[8] EU Commission Staff Working Paper, EU Regionally-Relevant Activities in the Western Balkans 2008-9, February 3, 2009 at http://ec.europa.eu/enlargement/pdf /key_ documents/highlight/eu_regional_wester _balkans_2008-2009_en.pdf

[9] Rade Maroevic and Daniel Williams, "Terrorist Cells Find Foothold in the Balkans," *Washington Post*, December 1, 2005, p. 16.

thereby perhaps reduce its attractiveness to terrorists, are also dependent upon integrating it into Euro-Atlantic institutions.[109]

THE ROLE OF CONGRESS IN U.S. BALKANS POLICY

Congress has played an important role in shaping U.S. Balkans policy. Members of Congress spoke out strongly against atrocities by Serbian forces in Croatia and Bosnia in the early 1990s. Some Members pushed for lifting the arms embargo against the Bosniaks, so that they could better defend themselves. Congressional pressure may have encouraged the Clinton Administration to play a bigger role in stopping the fighting in Bosnia, ultimately culminating in the Dayton Peace Accords in 1995. Congress also played an important role in supporting the International Criminal Tribunal for the Former Yugoslavia and pressing for the arrest and transfer of indictees.

Despite the activism of some Members on these issues, many in Congress remained cautious about U.S. military involvement in the Balkans. The deployment of U.S. peacekeepers in Bosnia in 1995 and the air war in Kosovo in 1999 provoked heated debate in Congress, in part due to policy disagreements, in part due to partisan conflict between the Clinton Administration and a Republican-led Congress. However, despite sometimes harsh criticism, both military missions received full congressional funding. Nevertheless, concerns about the costs of open-ended missions led Congress to try several strategies to limit these uncertainties. These included pressing the Administration to set benchmarks for the deployments and to report on them. Congress also sought to limit U.S. engagement by pushing for greater burdensharing. As a result of legislation and congressional pressure, the U.S. aid and troop contributions in Bosnia and Kosovo were capped at no more than 15% of the total contributions of all countries.

The end of the wars in the Balkans and the shift in U.S. priorities in the wake of the September 11 attacks have moved the Balkans to the periphery of congressional concerns, at least when compared to the situation in the 1990s. However, Congress continues to have an important impact in several areas. Foreign operations appropriations bills have at times moderated SEED funding cuts proposed by the President.

Congress has also played a critical role in helping to bring Serbian war criminals to justice. Since FY200 1, Congress has included provisions in foreign operations appropriations bills that attached conditions on some U.S. aid to Serbia’s central government, requiring cooperation with the war crimes tribunal, ending support to Bosnian Serb structures, and respect for minority rights. It can be argued that these provisions were a key catalyst for former Serbian leader Slobodan

Milosevic ’s transfer to the tribunal in 2001, as well as the transfer of many others since then. However, the fear of suspected war criminals that they would be turned over to the Tribunal to comply with the aid criteria may have led to the murder of Prime Minister

[10] For more information on terrorism in the Balkans, see CRS Report RL33012, *Islamic Terrorism and the Balkans*, by Steven Woehrel.

Djindjic in March 2003.11 Three major indicted war criminals remain at large, including former Bosnian Serb army chief Ratko Mladic.

Another Balkan issue on which some Members focused on is the status of Kosovo. In the 108th Congress, several House and Senate resolutions (H.Res. 11, H.Res. 28, and S.Res. 144) were introduced that dealt with the issue, some of them supporting independence for Kosovo. However, while some Members have strongly favored Kosovo's independence, others have been leery of taking steps that they believe could destabilize the region. H.Res. 28 was discussed at a House International Relations Committee hearing on Kosovo's future in May 2003 and at a markup session on the resolution in October 2004, but was not voted on by the Committee and did not receive floor consideration in the 108th Congress.

The 109th Congress also took up the issue of Kosovo's status. On January 4, 2005, Representative Tom Lantos introduced H.Res. 24, which expresses the sense of the House that the United States should support Kosovo's independence. On October 7, 2005, the Senate passed S.Res. 237, a resolution supporting efforts to "work toward an agreement on the future status of Kosovo." The resolution said that the unresolved status of Kosovo is not sustainable. It did not express support for any particular status option but said that it should "satisfy the key concerns" of the people of Kosovo and Serbia and Montenegro. An identical House resolution was introduced on December 17, 2005 (H.Res. 634).

Legislation on Kosovo's status has been introduced in the 110th Congress. On January 5, 2007, Representative Lantos introduced H.Res. 36, which calls on the United States to express its support for Kosovo's independence. On March 29, 2007, Senator Lieberman introduced S.Res. 135, which expresses the sense of the Senate that the United States should support Kosovo's independence. It says that if the U.N. Security Council does not pass a resolution supporting the Ahtisaari proposal in a timely fashion, the United States and like-minded countries should recognize Kosovo's independence on their own. A companion House measure, H.Res. 309, was introduced by Representative Engel on April 17. On May 24, Representative Bean introduced H.Res. 445, which expresses the sense of the House that the United States should reject an imposed solution on Kosovo's status and not take any unilateral steps to recognize Kosovo's independence. The second session of the 110th Congress may also consider legislation on Kosovo's post-status development.

Congress has supported NATO enlargement into the Balkan region. In March 2007, Congress approved the NATO Freedom Consolidation Act (P.L. 110-17). The legislation offered support for the NATO membership aspirations of Albania, Croatia, and Macedonia, and designated them as eligible for U.S. military aid under terms of the NATO Participation Act of 1994 (P.L. 103-447).

[11] For more information, see CRS Report RS2 1686, *Conditions on U.S. Aid to Serbia*, by Steven Woehrel.

Source: Map Resources, Adapted by CRS.

Figure 1. Central Balkans Region.

On May 19, 2008, the Senate passed S.Res. 570, which congratulated Albania and Croatia on the invitations they received to join NATO at the Alliance's April 2008 summit, as well as invitations to Bosnia, Montenegro, and Serbia to have an Intensified Dialogue with NATO. In the 111th Congress, H.Res. 152, passed by the House on March 30, 2009, reaffirmed U.S. support for NATO, and said the admission of Albania and Croatia to the Alliance would add to NATO's capabilities and bolster its capacity to integrate former Communists states into a community of democracies. It said that NATO should "pace the process of NATO enlargement and remain prepared to extend invitations for accession negotiations to any appropriate European democracy meeting the criteria for NATO membership..."

There has been debate in Congress and elsewhere about whether greater U.S. diplomatic involvement in the region is needed in order to fight a perceived tendency of drift in U.S. and European policy in the Balkans that could potentially lead to the destabilization of the region. This discussion has focused largely on the failure of Bosnia to establish effective central government institutions, in part due to Bosnian Serb obstructionism. In the 111th Congress, Rep. Berman introduced H.Res. 171, which calls for constitutional reform in Bosnia. It calls for the Administration to appoint a special envoy to the Balkans to assist reform efforts in Bosnia, as well as elsewhere in the region. It also warns against a withdrawal of OHR before the international conditions are met, and asks the EU reconsider plans for a withdrawal of EUFOR. It calls on the United States to work with the EU in the EU's efforts to transition from the OHR to a leading role for the EU Special Representative in Bosnia in a way that will aid Bosnia's EU integration. H.R. 171 was passed by the House on May 12, 2009.

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LONG-RANGE BALLISTIC MISSILE DEFENSE IN EUROPE*

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ABSTRACT

Successive U.S. governments have urged the creation of an anti-missile system to protect against long-range ballistic missile threats from adversary states. The Bush Administration believed that North Korea and Iran represent strategic threats, and questioned whether they could be deterred by conventional means. The Bush Administration's position on this issue remained unchanged, even after the intelligence community assessed that the Iranian nuclear weapons program halted in 2003. The Bush Administration built long-range missile defense bases in Alaska and California to protect against missile threats, especially from North Korea. Although the system has been tested, most agree that further testing is necessary. The Bush Administration proposed deploying a ground-based mid-course defense (GMD) element of the larger Ballistic Missile Defense System (BMDS) in Europe to defend against an Iranian missile threat. The system would include 10 interceptors in Poland, a radar in the Czech Republic, and another radar deployed in a country closer to Iran, all to be completed by 2013 at a reported cost of at least $4 billion.

The proposed U.S. system has encountered resistance in some European countries and beyond. Critics in Poland and the Czech Republic assert that neither country faces a notable threat from Iran, but that if American GMD facilities were installed, both countries might be targeted by missiles from rogue states—and possibly from Russia. The Bush Administration signed agreements with both countries permitting GMD facilities to be stationed on their territory; however, the two countries' parliaments decided to wait to ratify the accords until after the Obama Administration clarified its intentions on missile defense policy. NATO has deliberated long-range missile defense, and has taken actions that many interpret as an endorsement of the U.S. GMD system.

The GMD plan has also affected U.S.-Russia relations. Former President Putin and his successor, Vladimir Medvedev, have argued that the proposal would reignite the arms race and upset U.S.- Russian-European security relations. U.S. officials dispute Russia's objections, noting that the interceptors are intended to take out Iranian missiles aimed at Europe or the United States and could not possibly act as a deterrent against Russia. Some argue that Russia has been attempting to foment discord among NATO allies. In mid-2007, Russia offered to cooperate on missile defense, proposing the use of a Russian-leased radar in Azerbaijan, but urging that U.S. facilities not be built in Eastern

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Europe. President Bush welcomed the idea in principle, but insisted upon the need for the European sites. Despite ongoing discussions over the issue, sharp Russian criticism of the program has continued. Medvedev has said that Russia might deploy Iskander tactical missiles to Kaliningrad, but later stated that Moscow would not do so if the United States reversed its plan to emplace GMD facilities in Poland and the Czech Republic.

For FY2008, Congress examined the European GMD proposal and eliminated proposed funding for initial site construction pending formal agreement with Poland and the Czech Republic, independent studies on missile defense options for Europe, and DOD certification of the proposed interceptor. The FY2009 request for the European site was $712 million, which Congress largely supported with funding for site construction available only after Czech and Polish ratification.

INTRODUCTION

In the FY2008 defense budget, the Bush Administration requested about $310 million to begin design, construction, and deployment of a ground-based midcourse defense (GMD) element of the Ballistic Missile Defense System (BMDS) in Europe.[3] According to the Administration, the proposed GMD European capability would help defend U.S. forces stationed in Europe, U.S.

friends and allies in the region, as well as to defend the United States against long-range ballistic missile threats, namely from Iran. For FY2009, the Administration requested $712 million for development, fielding, and military construction of the European GMD element.

The proposed system would include 10 silo-based interceptors to be deployed in Poland, a fixed radar installation in the Czech Republic, and another transportable radar to be deployed in a country closer to Iran. Deployment of the GMD European capability is scheduled to be completed by 2013 at a current estimated cost of $4 billion (includes fielding and Operation and Support), according to the Bush Administration.

The prospect of a GMD capability based in Europe raises a number of significant international security and foreign policy questions. Central to the debate for many is how the proposed U.S. system might affect U.S.-European-Russian relations. For FY2008, Congress eliminated funding to start construction of the European site pending final approval of international agreements with Poland and the Czech Republic and an independent study of alternative missile defense options for Europe.[4] Congress largely supported the Administration's request for FY2009, but restricted funding for site construction until after the Polish and Czech Parliaments ratify the agreements reached with the Bush Administration. Congress continued to withhold funding for deployment of the ground-based interceptor missiles until after the Secretary of Defense certifies to Congress that those interceptor missiles will work effectively.

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[3] Some were calling for such an effort in Europe before the Administration formally requested funding in early 2007. For instance, in October 2006, Sen. Sessions noted NATO steps in developing an Alliance-wide theater missile defense capability, and encouraged the deployment of a U.S. long-range missile defense system in Europe. See "U.S. Missile Defense Site in Europe Needed to Support Alliance Strategy," *Space News*, October 9, 2006, p. 19.

[4] "Rep. Ellen Tauscher Applauds House Passage of Defense Authorization Bill," Press Release, Office of Rep. Ellen Tauscher, December 12, 2007.

THE OBAMA ADMINISTRATION

During the 2008 presidential campaign, Senator Obama said he supported the deployment of ballistic missile defenses that were operationally effective. In her January 2009 nomination hearings for Undersecretary of Defense for Policy, Michele Flournoy said the Obama Administration will review plans to deploy elements of a missile defense system in Europe.[5] Flournoy said the plans should be reviewed as part of the QDR (Quadrennial Defense Review) and "in the broader security context of Europe, including our relations with Russia," noting that any final policy decision should consider it in the interest of the United States if Washington and Moscow could agree to cooperate on missile defense. Flournoy also said the final contours of any decision would require close consultations between the Administration and Congress. At his nomination hearing before the Senate Armed Services Committee for Deputy Secretary of Defense, William Lynn responded to a question suggesting he would support making the MDA's budgetary, acquisition, testing, and policy processes more open and similar to the military services. "I think that all our military programs should be managed through those regular processes," he said, and "that would include missile defense. I would think any exceptions should be rare and fully justified."[6] Representative Ellen Tauscher (D-Calif.), head of the House Armed Services Strategic Forces subcommittee, reportedly predicted such changes would be made in the new administration.[7] On the White House website, the Obama Administration says it "will support missile defense, but ensure that it is developed in a way that is pragmatic and cost- effective; and, most importantly, does not divert resources from other national security priorities until we are positive the technology will protect the American public."[8]

In April 2009, Defense Secretary Robert Gates announced a number of recommendations regarding the FY20 10 defense budget (currently scheduled to be sent to Congress on May 7, 2009). Although Secretary Gates provided some details about a number of BMD programs, little was said about the European 3rd site. Joint Chiefs of Staff Vice Chairman Gen. James Cartwright only offered that there are "sufficient funds in '09 that can be carried forward to do all of the work that we need to do at a pace we'll determine as we go through the program review, the Quadrennial Defense Review, and negotiations with those countries." Details were not provided, but will become available sometime after the President's Budget is released on May 7, 2009.

The Threat

The Bush Administration argued that North Korea and Iran constituted major strategic threats. North Korea claims to have tested a nuclear device and has a ballistic missile and satellite launch program. The Bush Administration argued that Iran continues to acquire and develop ballistic missiles of various ranges.[9] Iran successfully launched a small satellite into orbit for the first time in early February 2009. Until recently, the Bush Administration

5 Andrew Gray, "U.S. to Review Europe Missile Shield Under Obama," Reuters News, January 15, 2009.
6 Defense Daily, January 16, 2009.
7 Ibid.
8 http://www.whitehouse.gov/agenda/defense.
9 CRS Report RS22758, Iran's Ballistic Missile Programs: An Overview, by Steven A. Hildreth.

argued that Iran had an active nuclear weapons development program. In November 2007, a U.S. National Intelligence Estimate (NIE) stated that "in Fall 2003, Tehran halted its nuclear weapons program," but that Iran is also keeping open the option to develop nuclear weapons at some point. The Iranian nuclear weapons program reportedly also included developing a warhead that could fit atop an Iranian ballistic missile.[10]

The Bush Administration regarded both countries as unpredictable and dangerous, and did not believe they could be constrained by traditional forms of military deterrence, diplomacy, or arms control. On a trip to attend a meeting of NATO foreign ministers in early December 2007, Secretary of State Rice told reporters: "I don't see that the NIE changes the course that we're on" to deploy a European missile defense system.[11] Accompanying her on the trip, Undersecretary of State John Rood, lead U.S. negotiator for the European missile defense talks, added: "the missile threat from Iran continues to progress and to cause us to be very concerned.... Missile defense would be useful regardless of what kind of payload, whether that be conventional, chemical, biological, or nuclear."[12]

According to long-standing unclassified U.S. intelligence assessments, Iran may be able to *test* an ICBM (Intercontinental Ballistic Missile) or long-range ballistic missile capability by 2015 if it receives foreign assistance, such as from Russia or China. Many in Congress and elsewhere share this specific assessment, or that the potential threat may not emerge by 2015 but is sufficiently worrisome to address it now. Many therefore believe it prudent to move forward with plans to deploy a long-range missile defense system in Europe to defend U.S. forward deployed forces in Europe, friends and allies, and the United States against long-range ballistic missile threats. Some in the larger international security policy and ballistic missile proliferation community argue that evidence of an Iranian ICBM program is scant and unpersuasive. Additionally, the Iranian government reports (which cannot be verified) that Iran only has a limited missile capability with a range of about 1,200 miles[13] and that it has stopped development of ICBM range missiles.

Although some Europeans have expressed concern about Iran's suspected nuclear weapons program, some U.S. friends and allies in Europe question the Administration's assessment of Iran's potential ICBM threat. Hence, some question the need for a GMD element of the U.S. BMDS in Europe. In December 2008, the European Council of the European Union approved a two-year study of ballistic missile proliferation trends.

The System

The U.S. Department of Defense began deploying long-range missile interceptors in Alaska and California in late 2004 to address long-range missile threats primarily from North Korea. Currently, the U.S. GMD element of the BMDS includes more than two dozen silo-based interceptors in Alaska and several in California. As part of an integrated Ballistic Missile Defense System (BMDS) capability, the United States also has a number of ground-

10 David Sanger and Steven Lee Meyers "Details in Military Notes Led to Shift on Iran, U.S. Says," New York Times, December 6, 2007.

11 "Iran Report Won't Slow Missile Defense," CBS News, Brussels, Belgium, December 6, 2007.

12 "U.S.: Iran Still Poses Missile Threat," Associated Press, December 6, 2007.

13 There are reports that Iran is developing other medium-range ballistic missiles with ranges greater than those now deployed, but short of what is considered ICBM range (i.e., more than 5,500 kilometers).

based radars in operation around the world, space-based assets supporting the BMDS mission, command and control networks throughout the United States and the Pacific, as well as ground-mobile and sea- based systems for shorter-range BMD.

What remains necessary as part of the global BMDS, according to the Bush Administration, is an ability in the European theater to defend against intermediate-to-long-range ballistic missiles launched from Iran. The Department of Defense (DOD) argues it is important to U.S. national security interests to deploy a GMD capability in Europe to optimize defensive coverage of the United States and Europe against potential threats both into Europe and against the United States.

There have not been a large number of intercept flight tests of the deployed GMD element. Nonetheless, the Bush Administration and many U.S. military leaders expressed confidence in the deployed system.14 Most agree there is the need for further operational testing. Some observers continue to question how much confidence there should be in the system's potential operational or combat effectiveness based on the types of tests conducted and the test results to date.

The current GMD program began flight tests in 2002. This effort was built on several earlier long-range BMD programs with decidedly mixed results themselves since the early 1980s. Since 2002, a number of GMD intercept flight tests have taken place with mixed results.15I n each of these tests, most all other flight test objectives were met.

In 2002, the GMD moved to the operational booster and interceptor. The interceptor system flew two developmental tests in 2003 and 2004, and the GMD element of the BMDS was deployed in late 2004 in Alaska and California. Two planned intercept flight tests of the new configuration for December 2004 and February 2005 were not successful. After technical review, the interceptor successfully demonstrated a booster fly-out in 2005. In September 2006, a successful flight test exercise of the GMD element as deployed took place. (Although a missile intercept was not planned as the primary objective of this data collection test, an intercept opportunity occurred and the target warhead was successfully intercepted.) Additional intercept flight tests of the deployed element whose primary objectives were intercepts of long-range ballistic missile targets were originally scheduled for later in 2006, but then subsequently postponed. Then a May 2007 intercept test was scrubbed when the target missile failed to launch as planned. A follow-on attempt scheduled for summer 2007

14 For instance: (1) General Cartwright, Commander, U.S. Strategic Command, said the July 4, 2006 North Korean missile tests spurred a limited operational activation of the BMD System. "We learned that the ballistic missile defense system, procedures, and personnel performed well, and demonstrated a credible operational missile defense capability for homeland defense." Testimony before the Senate Armed Services Committee, March 21, 2007; (2) Admiral Mullen, on his nomination hearing to be Chairman of the Joint Chiefs of Staff, said he believes the U.S. "Has a viable initial operational capability and we are maturing the system toward a full operational capability." "Answers to Advanced Policy Questions," Senate Armed Services Committee, July 26, 2007; and (3) Dr. Charles McQueary, Director, Operational Test and Evaluation, said: "I can state that the ballistic missile defense system has demonstrated a limited capability against a simple foreign threat. Coupled with the successes of other element-level testing and MDA's integrated ground tests, the BMD system is definitely maturing. My assessment is bolstered by the fact that the MDA is increasing the operational realism of each successive test." Testimony before the Senate Armed Services Committee, April 11, 2007.

15 Two tests in March and October 2002 using an older interceptor successfully intercepted their intended targets. Three flight tests (IFT-10, IFT-13c and IFT-14) using the GBI in planned intercept attempts failed in those attempts for various reasons: (1) December 2002, the kill vehicle failed to deploy; (2) December 2004, the GBI launch aborted due to a software error in the interceptor; and (3) February 2005, the GBI did not launch due to problems with the test facility launch equipment. In the May 2007 flight test, the target missile second stage booster failed in flight, so the interceptor was not launched as planned. In September 2006 and 2007 successful intercepts were achieved.

was completed successfully on September 29, 2007. The Missile Defense Agency reported a successful intercept in December 2008, but some were critical of this assessment as the test objective was for the intercept to occur amidst a field of decoys, which decoys failed to deploy from the test target.

Supporters and many military officials express confidence in the deployed system, but others continue to question the system's potential effectiveness based on the mixed intercept flight test record. Most observers agree, however, that additional, successful flight testing is necessary. Supporters add that a significant number of non-flight tests and activities are conducted that demonstrate with high confidence the ability of the GMD element to perform its intended mission.16

What would the European element of the BMDS look like? The proposal is to deploy up to 10 Ground-based Interceptors (GBI) in silos at a former military base in Poland. It should be noted that the proposed GBI for the European GMD site will not be identical to the GBIs deployed now in Alaska and California. Although there is significant commonality of hardware, there are some differences. For example, the European GBI will consist of two rocket stages in contrast to the three-stage GBI deployed today.[17] This particular 2-stage configuration has not been tested and is a basis for additional questions about the proposed system's effectiveness. Proponents of the system would argue that the 2-stage version is fundamentally the same as the 3-stage system, however.[18] In Europe, the GBI reportedly will not need the third stage to achieve the range needed to intercept its intended target.[19] This issue has raised the question for some observers as to whether other U.S. systems designed for shorter or medium-range ballistic missile threats, such as Patriot, THAAD (Terminal High Altitude Area Defense), or Aegis (sea-based BMD) might be more appropriate for addressing the current and prospective Iranian ballistic missile threat to Europe. DOD's Missile Defense Agency (MDA) believes these systems would not be adequate to counter prospective Iranian ballistic missile threats over the mid-term and longer.

Deployment of the silos and interceptors in Poland is scheduled to begin in 2011 with completion in 2013. The interceptors will be deployed at Redzikowo, near the town of Slopsk in northern Poland. The field of the 10 interceptors itself is likely to comprise an area somewhat larger than a football field. The area of supporting infrastructure is likely to be similar to a small military installation.

In addition, a U.S. X-Band radar (a narrow-beam, midcourse tracking radar), that was being used in the Pacific missile test range, would be refurbished and transported to a fixed site at a military training base in the Czech Republic. The site currently identified is in the heavily forested Brdy Military Training Area, about 150 kilometers southwest of Prague.

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16 The Bush Administration maintained that since 2002 it has fielded a long-range BMD capability where none existed previously. Furthermore, the United States now has operationally capable upgraded early warning radars, command, control and battle management systems, Navy cruisers and destroyers capable of conducting long-range ballistic missile search and track missions, and about 20 GBI fielded in Alaska and California. This element of the BMDS was transitioned to alert in July 2006 when North Korea launched several ballistic missiles, including a long-range ballistic missile.

17 Boost Vehicle Plus. Report to Congress. March 1, 2007. Missile Defense Agency. For Official Use Only.

18 The Orbital Boost Vehicle 2 (OBV/2) is a modification of the existing, tested OBV/3 achieved by removing the 3rd stage from the existing missile.

19 More accurately, according to MDA, two stages provide the enhanced performance and burnout velocity required for the mission.

The X-Band radar with its large, ball-shaped radome (radar dome) is several stories in height.

A second, transportable forward acquisition radar would be deployed in a country to be determined, but closer to Iran. Some European press accounts once mentioned the Caucasus region, but the Bush Administration never publicly indicated where this radar might be located.

Additionally, the proposed GMD European capability would include a communications network and support infrastructure (e.g., power generation, security and force protection systems, etc.) A few hundred U.S. personnel would be engaged in securing and operating both the interceptor and radar sites. The Administration intends for the United States to have full command authority over the system.

The FY2008 request was $310.4 million for the proposed European GMD across several program elements of the Missile Defense Agency (MDA) budget. The total reported GMD costs for the European site are about $4 billion (FY2007-FY2013), including Operation and Support costs through 2013. Although relatively small in U.S. defense budget terms, the FY2008 request represented a significant commitment to the proposed European system. The FY2009 request was for $712 million.

In 2007, both the House and Senate Armed Services Committees asked for studies of alternatives to the Administration's proposed European GMD deployment (see "Congressional Actions"). This classified review was provided to Congress in August 2008. Some, such as Representative Tauscher, suggested the Administration consider instead a combination of sea-based (Aegis SM3) and land-based systems (PAC-3, THAAD). MDA Director General Henry Obering has argued that most of the current Aegis fleet would be required to defend Europe, and that the cost would be considerably greater than the current Bush Administration proposal.[20] MDA's assessments, however, assume the need for 24/7 coverage. Assessments based on deployment on a contingency basis or crisis reduce significantly the estimated cost of such alternatives. Separately, the Center for Naval Analyses (a federally funded research center) is conducting an analysis of alternatives for the Navy's next big surface combatant ship.[21] That review reportedly includes recommendations about future naval BMD requirements that might bear on any discussion of alternatives to the proposed European GMD plan.

THE LOCATION

In 2002 the Bush Administration began informal talks with the governments of Poland and the Czech Republic over the possibility of establishing missile defense facilities on their territory. Discussion of a more concrete plan—placing radar in the Czech Republic and interceptor launchers in Poland—was reported in the summer of 2006. The issue was increasingly debated in both countries. In January 2007, the U.S. government requested that formal negotiations begin. Agreements have been struck with both countries, and both the

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[20] See http://www.armscontrolwonk.com/1539/how-many-aegis-ships-to-defend-nato.

21 "U.S. May Build 25,000-ton Cruiser, Analysis of Alternatives Sees Nuclear BMD Vessel," Defense News, July 23, 2007, by Christopher P. Cavas.

Polish and Czech parliaments must now ratify the accords. The two governments have grappled with several issues as the debate has evolved.

Poland

Some analysts maintain that in Poland the notion of stationing American GMD facilities was more or less accepted early on in the discussions and that the main questions subsequently have revolved around what the United States might provide Warsaw in return. Some Poles believe their country should receive additional security guarantees in exchange for assuming a larger risk of being targeted by rogue state missiles because of the presence of the U.S. launchers on their soil. In addition, many Poles are concerned about Russia's response. Both of the past two Polish governments reportedly requested that the United States provide batteries of Patriot missiles to shield Poland against short- and medium-range missiles.22

Formal negotiations on the base agreement, which requires the approval of the Polish parliament, began in early 2007 under the populist-nationalist Law and Justice (PiS) party, led by Jaroslaw Kaczynski. As talks began, Civic Alliance (PO), then the leading opposition party, had questions about the system—particularly the command and control aspects—and urged the government to ensure that it be integrated into a future NATO missile defense program. The former ruling leftist party supported deployment of the missiles, but also called for greater transparency in the decision-making process. The smaller parties of the governing coalition expressed some skepticism, mainly for reasons of sovereignty, and indicated support for a public referendum.[23]

In snap elections held on October 21, 2007, Poles turned out PiS and replaced it with a center- right two-party coalition led by PO; its leader, Donald Tusk, became prime minister. During the campaign, Tusk indicated that his government would not be as compliant toward the United States as PiS, and that it would seek to bargain more actively on missile defense.

As he left office, former Prime Minister Kaczynski urged the incoming government to approve the missile defense proposal, arguing that an agreement would strengthen relations with the United States. In a post-election news conference, however, Tusk was cautious about the plan: "If we recognize that the anti-missile shield clearly enhances our security, then we will be open to negotiations.... If we recognize, jointly in talks with our partners from the European Union and NATO, that this is not an unambiguous project, then we will think it over." Two weeks later, however, newly minted Defense Minister Bogdan Klich stated that Poland should again "weigh the benefits and costs of this project for Poland. And if that balance results unfavorably, we should draw a conclusion from those results."[24] Foreign Minister Radek Sikorski later indicated that the new government would discuss the project with Russia.

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[22] U.S. Missiles in Poland—Risks and Benefits. *Rzeczpospolita*. In *BBC European Monitoring*. November 15, 2005. Sikorski Exit Is Bad For MD Bid. *Oxford Analytica*. February 8, 2007.

[23] Polish Politician Weighs Up Pros and Cons Of US Radar Plan. *Gazeta Wyborcza*, February 5, 2007. In: *BBC Monitoring European*. February 6, 2007. See also: Don't Take Poland For Granted. Radek Sikorski [former Polish Defense Minister and current Foreign Minister]. *Washington Post*. March 21, 2007.

24 Poland's Likely Next Prime Minister Open To Talks On U.S. Missile Defense. Poland Business Newswire. November 6, 2007. Poland's New Defense Chief Wants To Reconsider U.S. Missile Defense Request. AP. November 19, 2007.

Talks between Warsaw and Washington resumed in early 2008. Some observers forecast that the new Polish government would strongly renew the argument for the United States to provide additional air and/or short-range missile defenses.[25] On February 2, 2008, during a visit by Sikorski to Washington, D.C., U.S. Secretary of State Rice voiced support for strengthening Poland's air defenses. Although there was said to be agreement "in principle" on the missile defense issue, an accord was not signed when Prime Minister Tusk visited the United States in the following month.[26]

The major sticking point in the negotiations was the question of U.S. assistance for Poland's military "modernization," mainly in the form of PAC-3 air defense. During Prime Minister Tusk's visit to Washington DC in March 2008, however, President Bush declared, "Before my watch is over we will have assessed [Poland's] needs and come up with a modernization plan that's concrete and tangible." Nevertheless, the meeting of the two leaders did not result in a deal being struck. In addition, Poland was anxious that the two projects not be too explicitly linked, for fear of further alienating Russia. Concerning the likely future of the program, Polish Ambassador to the United States Robert Kupiecki in spring 2008 told a Polish parliamentary committee that "there are serious reasons to think that the project will be continued" by Bush's successor, no matter whom it might be. A Czech newspaper reported that MDA Director Obering "said [on April 2 that] the United States will be interested in stationing the radar in the Czech Republic even if it does not reach agreement with Poland."[27] What this might have meant for the overall system without the interceptors sited in Poland was not clear. However, some suggested that the radar would be useful if used in conjunction with other medium-range BMD systems, such as Aegis, in the absence of GMD interceptors based in Poland. In addition, Bush Administration officials reportedly held discussions on the interceptor basing issue with the government of Lithuania.28 In early July, the Polish media reported that a meeting in Washington between Foreign Minister Sikorski and Secretary Rice failed to produce an agreement.[29]

In a surprise move on August 14, Polish and U.S. government officials initialed an agreement; the formal accord was signed six days later by Rice and Sikorski. Some observers believe that the negotiations, which had stalled in July, received impetus from concerns over Russia's military incursion into South Ossetia in early August. While some U.S. officials denied an explicit linkage between the two events, U.S. Defense Secretary Gates on August 15 commented that Russia's neighbors have "a higher incentive to stand with us now than they did before, now that they have seen what the Russians have done in Georgia."[30] Under the agreement, Poland received from the United States enhanced security guarantees, which Minister Sikorski likened to a "kind of reinforcement of Article 5 [the NATO treaty's mutual

25 Poland Said Likely To Launch Tough Missile Defence Talks With USA. Gazeta Wyborcza [in: BBC Monitoring European.] December 5, 2007.

26 "Poland Says U.S. Shield a 'Foregone Conclusion.'" Reuters. July 16, 2007. Poland Signals Doubts About Planned U.S. Missile-Defense Bases On Its Territory. New York Times. January 7, 2008. No Poland-US Missile Deal Next Month: Defense Minister. AFP. February 2, 2008.

27 Bush, Poland's Tusk Discuss Missile Shield Plans. Agence France Presse. March 10, 2008. Game For US Shield Begins. Polish News Bulletin. March 14, 2008. Next U.S. Pres. Unlikely To Axe Proposed Central European Missile Defense Project—Polish Diplomat. Poland Business Newswire. April 2, 2008. Czech, USA Agree On Main Treaty On U.S. Radar On Czech Soil. CTK Daily News. April 3, 2008.

28 As Poles Balk, U.S. Eyes Lithuania As Site For Missile Shield. *New York Times*. June 19, 2008.

29 No Progress On Shield Talks. *Polish News Bulletin*. July 8, 2008. Date Of US-Poland Treaty On Missile Base Still Unknown. *Poland This Week*. July 11, 2008.

30 Russian Relations In Doubt, Gates Says. Washington Post. August 15, 2008.

defense clause].”[31] The United States also pledged to help modernize Poland’s armed forces, in part by providing a battery of Patriot air defense missiles, which reportedly would be re-deployed from Germany and would initially be manned by U.S. military personnel.

Most public opinion surveys have indicated that a majority of Poles disapprove of a missile defense base being established in their country. Most objections appear to be based on concerns over sovereignty, as well as over the belief that the presence of the system would diminish rather than increase national security and might harm relations with neighboring states and Russia. However, the Russian military action in Georgia and its subsequent threats to place tactical missiles in Kaliningrad (see below) may have increased support in Poland for the missile shield – and for the battery of Patriots.[32]

The Polish legislature did not immediately ratify the agreement. Parliamentary speaker Bronislaw Komorowski said that he would not “rush” the vote, and added that “it would be worth knowing if the election result in the U.S. would have an influence on the U.S. attitude towards this program.” In an August 19 news conference, Prime Minister Tusk said that he had requested Foreign Minister Sikorski to discuss missile defense with “both candidates John McCain and Barack Obama – and both conversations, although less decisively in the second case, indicated support for the project.”[33] President Kaczynski’s office criticized Prime Minister Tusk for postponing ratification until after elections. Despite the delay, U.S.-Polish negotiations on GMD continued. In addition, the Poles continued to hold high-level discussions with Moscow.[34]

Shortly after the U.S. elections, President-elect Obama spoke by phone with President Kaczynski; there was apparent confusion on the Polish side over whether or not President-elect Obama had made a commitment to continue with the GMD plan. During a meeting with residents of the village near which the interceptors would be based, U.S. Ambassador to Poland Victor Ashe reportedly said that the GMD project would likely be in suspension until such time as the Obama Administration had formulated its policies.[35]

In a mid-November 2008 interview, Foreign Minister Sikorski estimated the chances of the system’s continuation at more than 50 percent. He added, however, that budgetary pressure might lead to the project being “put on hold” – a regrettable possibility, in his view. Sikorski has also noted that, “[t]here are clauses in the agreement that say it can be cancelled if there’s no financing.” During an address delivered in Washington in late November, Sikorski said that he hoped the GMD project would continue, as it was a sign of transatlantic cooperation. He also implied that hosting the interceptor base would bolster Poland’s security, commenting that “everyone agrees that countries that have U.S. soldiers on their territory do

[31] US Missile Deal Gives Poland Patriots, Bolstered Defence Ties. AFP. August 20, 2008. Some analysts, however, have argued that the agreement’s special security guarantee may be questioned by other NATO allies, especially in central Europe. See Implications of the U.S.-Polish Defense Pact. By William L. T. Schirano. Center for European Policy Analysis. August 29, 2008.

32 With Russia Rising, Poles Look West. New York Times. August 21, 2008.

[33] Polish Lower House Speaker Refuses To Rush Ratification Of Polish-U.S. Missile Shield Deal. *Poland Business Newswire*. August 20, 2008. U.S. Presidential Candidates endorse Missile Shield Project, Obama Less Enthusiastic – Polish PM. *Poland Business Newswire*. August 19, 2008.

[34] Czechs See Anti-missile radar Ratified By Year-end. *Reuters*. July 9, 2008.

[35] U.S. Ambassador: Decision On Missile Shield Suspended. *Polish News Bulletin*. November 26, 2008.

not get invaded."[36] Polish President Kacyznski and Foreign Minister Sikorski both have expressed hope publically that the Obama Administration will continue the program. [37]

Some observers believe that Polish MPs, like their Czech counterparts, are reluctant to approve a treaty that may not be acted upon. Olaf Osica, a fellow at Warsaw's Natolin European Center, commented that "[o]ne of the worst scenarios for the Polish government would be if the agreement is ratified and then it turns out that Americans are no longer committed to it."[38]

Czech Republic

In September 2002, the Czech defense minister, a member of the Social Democratic Party (CS SD), announced that he had "offered the United States the opportunity to deploy the missile defense system on Czech soil."39 In June 2006, inconclusive elections toppled the CSSD government and replaced it with a shaky coalition led by the center-right Civic Democratic Party (ODS). As with the outgoing government, the new one voiced support for GMD. However, the CSSD, now in opposition, began to backpedal on its support as polls showed increasing public skepticism, and by mid-2006 only the ODS was unambiguously backing deployment. When a relatively stable ODS-led government was finally formed in January 2007, the ODS apparently persuaded its coalition partners to support GMD (the Greens made their agreement contingent upon NATO approval). In January 2007, it was announced that the United States had requested that official negotiations be started, and in March the Czech government formally agreed to launch talks.

In October 2007, U.S. Defense Secretary Robert Gates visited Prague to discuss several issues— including the planned radar installation—with Czech leaders. During the visit, he reportedly proposed that, in the interest of transparency, Russia be allowed to station personnel at the radar site. Czech Prime Minister Topolanek had no immediate comment but appeared to concur with Gates's observation that the presence of Russians on Czech territory would have to be approved by Czechs first. Gates also suggested that activation of the missile defense system could be delayed until such time as there was "... definitive proof of the threat—in other words, Iranian missile testing and so on." On the same day, however, President Bush delivered a speech in which he called the need for the missile defense project "urgent." Some analysts argued that the U.S. proposal to include Russia might complicate Topolanek's efforts to secure approval for an eventual agreement with the United States.[40] On March 19, 2008, a State Department official announced that the Czech Republic had agreed to join in proposing to Russia an agreement that would permit reciprocal inspections of missile defense radar facilities. However, during an April 7 interview, Czech Foreign Minister

36 Poland Won't Lobby Obama On Missile Defense. Washington Post. November 20, 2008. Sikorski: New US Administration May Put on Hold Anti-missile Shield Project. Polish News Bulletin. November 13, 2008.

37 Polish President Hopes Obama As U.S. President Will Treat Missile Shield As "Necessary." Polish Business Newswire. January 19, 2009.

38 , Democrats Likely To Pare back Missile Defense Plans To Save Money. CQ Today. November 17, 2008.

39 Czech Republic Seeks Joining Missile Defence Shield Project. BBC Monitoring European. September 17, 2002.

40 US May Delay Missile Defense System. AP. October 23, 2007. Administration Diverges On Missile Defense. Washington Post. October 24, 2007. Gates Causes Missile Defence Flap. Oxford Analytica. October 24, 2007.

Schwarzenberg said, “If Russians want to check something on our soil, they will have to speak with us first.”[41]

On December 5, 2007, the Czech Foreign Ministry issued a statement asserting that the U.S. intelligence community’s conclusion that Iran had suspended its nuclear weapons program in 2003 would not affect Prague’s decision to host the radar facility, as the threat has the potential to re-emerge in the future.[42] In late January 2008, Jiri Paroubek, leader of the opposition CSSD party, argued that, because of the high and increasing public resistance to the radar, the government should freeze negotiations until after the results of the November 2008 U.S. presidential elections were known. He also urged that Prime Minister Topolanek report on the substance of his upcoming talks on the issue with President Bush.[43]

During a visit to Washington in late February 2008, Topolanek said that the two sides were “three words” away from an agreement. On April 3, 2008, during the NATO summit in Bucharest, Czech media reported that Foreign Minister Karel Schwarzenberg had announced that Prague and Washington had reached an accord over the terms of the proposed U.S. radar base, and that a treaty would be signed in May. The signing was postponed due to scheduling conflicts, and finally took place on July 8, during a visit by Secretary of State Rice. As part of the deal, the United States reportedly agreed to provide ballistic missile defense—from Aegis system-equipped U.S. Navy vessels—for the Czech Republic.[44]

The agreement must now be ratified by the parliament, and approval is not a foregone conclusion. In April 2008, Schwarzenberg said that he thought “the conclusions of the NATO summit regarding US MD should be sufficient for the junior government Green party to vote in favor of the radar.” However, a Czech newspaper stated that “[a]t the moment the government lacks at least five votes.” Although the Green Party leadership reportedly called for its members to oppose the radar despite the NATO summit declaration, some members reportedly intend to support the project.[45] On July 9, 2008, Czech Deputy Foreign Minister Tomas Pojar expressed confidence that parliament would ratify the treaty by the end of the year or early in 2009, and added that “it is probable that the [ratification] vote will be after the election in the United States, however, that does not mean that it would be after the new (U.S.) President takes office.”

At the end of October, the Czechs announced that ratification would take place after the inauguration of the next President. Prime Minister Topolanek explained that “We want a delay to make sure about the attitude of the new American administration.” In mid-November, Miloslav Vlcek, chairman of the lower house of parliament—a member of the opposition CCSD— confirmed that a ratification vote would not be held until after Barack Obama had been inaugurated; in addition, he expressed doubts that the treaty would be approved, and also suggested that the radar deployment might face a constitutional challenge. Although the Czech Senate on November 26 ratified the agreement by a vote of 49-

41 US Offers Mutual MD Checks. Oxford Analytica. March 20, 2008.

42 Czechs Say Report On Iran Nuclear Program Not To Influence Missile Defense Talks. Associated Press. December 5, 2007.

43 Select Briefing Europe East. Center for Strategic and International Studies. Vol. 5, No. 3. February 1, 2008.

44 Czechs, USA Agree Radar Treaty To Be Signed In May. BBC Monitoring European. April 3, 2008. U.S. To Give Czechs Ballistic Missile Defense. Washington Post. July 16, 2008.

45 Czech Minister Sees ‘Virtually No Opposition’ in NATO, EU to US Missile Shield. BBC Monitoring European. April 7, 2008. US Set To Sign Main Czech Radar Deal: Embassy. AFP. April 7, 2008. Czech Senator To Vote For Radar Base Against Greens’ Call. CTK Daily News. April 15, 2008.

31, it still must pass muster in the chamber of deputies, where approval is less certain.[46] A scheduled March 18, 2009, vote on the treaty was postponed—likely until after the Obama Administration has indicated whether or not it intends to proceed with the plan. Parties on both sides of the issue are hopeful that the new U.S. government will validate their position on missile defense.[47]

In addition to the changes in the U.S. government, the missile defense issue is being complicated by the current crisis in Czech political life. On March 24, 2009, the Czech ruling coalition failed a narrow no-confidence vote, and Prime Minister Mirek Topolanek offered his government's resignation. The turnaround came as a complete surprise to most observers, who had reasoned that the various factions and parties would make efforts to patch over their political differences during the time (January-June 2009) that Prague is holding the six-month revolving European Union (EU) presidency. President Vaclav Klaus must now work with the political parties to form a new government, a process that may take up to three months; if a governing coalition cannot be formed, new elections must be held.[48] In the meantime, the Topolanek cabinet will continue to run the government in a caretaker role. The effort to form a new government may be hampered by disagreements within as well as between political parties. Recent polls show the opposition CSSD with a lead. Observers believe that the next parliamentary elections will be held after the Czech Republic has completed its EU presidency in June.[49]

The political crisis adds some uncertainty to the future of the missile defense agreement, as the CSSD has opposed the planned radar. Public opinion surveys consistently have shown strong (60%-70%) opposition to the plan among Czechs, who share many of their Polish neighbors' concerns.[50] With memories of the Nazi occupation and the harsh 1968 Soviet crackdown still fresh in the minds of many Czechs, the public has been resistant to the notion of any foreign troops—unfriendly or allied—being stationed on their soil.

POLICY ISSUES

U.S. proponents of the missile defense program note that the bases being planned would be part of a limited defensive system, not an offensive one. The missiles would not have explosive payloads, and would be launched only in the event that the United States or its friends or allies were under actual attack. Critics respond that Europe does not currently face a significant threat from Iran or its potential surrogates, but that Polish and Czech participation in the European GMD element would create such a threat. If American GMD

46 Czech Govt Wants Vote On Missile Shield After US Election. Agence France Presse. October 29, 2008. US Base's Chance In Czech Parliament Diminishing – Vlcek in Russia. CTK Daily News. November 17, 2008. Czech MPs Delay U.S. Shield Deal Debate Until Obama's Inauguration. RIA Novosti. November 28, 2008. Missile Defense Deal With US Clears Czech Senate, Faces Tougher test In Lower Chamber. Associated Press Newswires. November 27, 2008.

47 Czech Politicians Disagree On U.S. Radar Plans Under Obama. CTK Daily News. January 20, 2009.

48 Czech Republic: Government Crisis Will Be Hard To Fix. Oxford Analytica. March 30, 2009.

49 Czech President Klaus-PM Topolanek Relations Tense For Long. CTK Daily News. March 26, 2009.

50 Czech Poll Indicates Number Of Missile Defense Radar Opponents Declines. *AP*. September 26, 2007. But see also: Many Czechs Love U.S., But Say 'Hold the Radar.' *New York Times*. October 1, 2007. Poll: 70 Percent of Czechs Oppose U.S. Missile Defense Plan. *Associated Press*. January 8, 2008. Majority of Czechs Against U.S. Anti-missile Radar System. *Poland Business Newswire*. July 9, 2008.

facilities were installed, they argue, both countries would likely be targeted by terrorists, as well as by missiles from rogue states— and possibly from Russia—in the event of a future confrontation.

DEBATE IN POLAND AND THE CZECH REPUBLIC

Some proponents of the proposed GMD European capability system assert that cooperation would help consolidate bilateral relations with the United States. In Poland in particular there is a sense, based in part on historical experience, that the United States is the only major ally that can be relied upon. Therefore, some Poles argue, it would be beneficial to strengthen the relationship by becoming an important U.S. partner through joining the missile defense system. In addition, some Czechs and Poles believe that the missile defense sites would become a prestigious symbol of the two countries' enhanced role in defending Europe. Some would argue that the Czechs and the Poles see this formal U.S. military presence as an ultimate security guarantee against Russia; when asked shortly before Poland's October 21, 2007, parliamentary elections about the missile defense issue, former Prime Minister Kaczynski singled out Russia as a threat.[51]

Opponents, however, contend that this is not a valid reason for accepting missile defense facilities because the two countries, which joined NATO in 1999, already enjoy a security guarantee through the alliance's mutual defense clause. Polish missile defense skeptics also maintain that their country does not need to improve its bilateral security relationship with the United States because it has already shown its loyalty through its significant contributions to the military operations in Iraq and Afghanistan and the global war on terrorism. Some Polish and Czech political leaders reason that the United States may proceed with missile defense with or without them, so they may as well be on board. However, the missile bases are unpopular among the Czech and Polish public, and any government that agreed to host such facilities might lose political support. In addition, some Czechs and Poles may be speculating whether it would be worthwhile to expend political capital on the GMD bases, as the issue may become moot. One Polish observer asserted that if the project is discontinued, "Poland will become an international laughingstock."[52] A Czech member of parliament noted that, if the U.S. Congress determines not to fund a European arm of missile defense, "[t]he USA will thus solve the problem for us."[53]

Some Czechs and Poles have argued that the extra-territorial status of the proposed bases would impinge upon national sovereignty. However, the Czech position is that the base "would be under the Czech Republic's jurisdiction."[54] In addition, some have raised questions over command and control—who would decide when to push the launch button and what

51 Polish PM: Hosting U.S. Shield May Counter Russia. Reuters. October 18, 2007.

52 Polish Daily: US Missile Defence in Poland Means 'Local Arms Race' With Belarus. BBC Monitoring European. November 18, 2005.

53 USA Wants To Deploy Missile Defence Radar On Czech Territory—Foreign Minister. CTV [Czech news agency]. In: BBC Monitoring European. November 29, 2006.

54 That Missile Debate of Ours. Pravo. September 9, 2006. In: BBC Monitoring European. September 12, 2006. Any US Missile Base On Czech Territory Subject To Czech Laws—Czech Ministry. BBC Monitoring European. August 18, 2006. State Security Council Okays US Radar. Pravo. In: BBC European Monitoring. January 26, 2006. Czech Premier Reminds Opposition Its Cabinet Started Talks On US Radar Base. CTK Czech News Agency. In: BBC European Monitoring. February 1, 2007.

would the notification system be? Polish and Czech government leaders reportedly acknowledge that the time between the detection of the launch of a missile by a hostile regime and the need to fire off an interceptor would be so brief as to preclude government-to-government consultations.

Opponents have also cautioned that the interception of a nuclear-tipped missile over Polish or Czech territory could result in a rain of deadly debris. Supporters argue that an enemy missile would not be intercepted over Eastern Europe, and that even if it were, the tremendous kinetic energy of impact would cause both projectiles to be obliterated and any debris burnt upon atmospheric reentry. Skeptics point out, however, that testing of these systems is never performed over populated areas.

EUROPEAN/RUSSIAN RESPONSE

The proposed U.S. system has encountered resistance in some European countries and beyond. Some critics claim that the program is another manifestation of American unilateralism and argue that, because of opposition by major European partners, Polish and Czech participation in the GMD program could damage those countries' relations with fellow EU members.[55] Supporters, however, counter that the establishment of a missile defense system would protect Europe as well as the United States.

Some European leaders have asserted that the Bush Administration did not consult sufficiently with European allies or with Russia on its GMD plans. German Foreign Minister Frank-Walter Steinmeier faulted the Bush Administration for failing to adequately discuss the proposal with affected countries. Former French President Chirac cautioned against the creation of "newdivisions in Europe." Bush Administration officials, however, maintained that these arguments were disingenuous, as they had held wide-ranging discussions on GMD with European governments, and with Russia, both bilaterally and in the framework of the NATO-Russia Council.[56] In addition, critics charged that establishing a European GMD base to counter Iranian missiles implied a tacit assumption on the part of the Bush Administration that diplomatic efforts to curb Iran's nuclear and ballistic missile aspirations were doomed to failure, and that Iran's future leaders would be undeterred by the prospect of nuclear annihilation. Finally, an analyst with the Swedish Transnational Foundation Research Center has argued that the U.S. missile defense system is being built in order to enable the use of a first strike.[57]

Europeans also have raised questions about the technical feasibility of the program as well as its cost-effectiveness. According to a wire service report, "Luxembourg's Foreign

55 Missile Shield: Poland's Security Better Served By Supporting Ukraine's Western Ambitions Than By Building Another Maginot Line. Polish News Bulletin. December 22, 2005.

56 Where Does Germany Stand? *Spiegel Online*. March 26, 2007. US Build Pressure On Europe Over Bases. *Financial Times*. February 21, 2007. France Calls For Dialogue on US Anti-Missile System. *Agence France Presse (AFP)*. February 21, 2007. U.S. Officials Brief On Missile Defense. February 23, 2007. U.S. Embassy Warsaw.

57 Swedish Expert Says US Missile Shield Meant To Allow Nuclear First Strike. BBC Monitoring. January 8, 20080.

Minister Jean Asselborn called the U.S. [missile defense] plan an 'incomprehensible' waste of money.... "[58]

Other European leaders, however, including the former prime ministers of Denmark and Britain, indicated that they supported the missile defense project as a means to protect Europe from threats from rogue states. In addition, some European allies do not appear to be averse to the missile defense concept per se. Foreign Minister Steinmeier indicated that Germany and other countries were interested in building a comparable system, but lacked the technological know-how.[59]

NATO also has been deliberating strategic missile defenses. A feasibility study of such a program called for in the 2002 Prague Summit was completed in 2005. In the final communiqué of their 2006 Riga summit, NATO leaders stated that the alliance study had concluded that long-range BMD is "technically feasible within the limitations and assumptions of the study," and called for "continued work on the political and military implications of missile defence for the Alliance including an update on missile threat developments." Supporters contend that the U.S. facilities intended for placement in Eastern Europe would be a good fit—and therefore not inconsistent with—any future NATO missile defense. However, other policymakers have recommended that the establishment of any anti-missile system in Europe should proceed solely under NATO auspices rather than on a bilateral basis with just two NATO partners. A Bush Administration official declared that "the more NATO is involved in [GMD], the better."[60]

Some observers have suggested that the Bush Administration chose not to work primarily through NATO because consensus agreement on the system was unlikely. However, in mid-June 2007, alliance defense ministers did agree to conduct a study of a complementary "bolt-on" anti-missile capability that would protect the southeastern part of alliance territory that would not be covered by the planned U.S. interceptors. Bush Administration officials interpreted the move as an implied endorsement of the U.S. GMD plan and an adaptation of NATO plans to fit the proposed U.S. system. In addition, NATO Secretary General Jaap de Hoop Scheffer stated "The roadmap on missile defense is now clear.... It's practical, and it's agreed by all."[61]

The Bush Administration hoped that NATO would endorse missile defense at its 2008 summit meeting, held April 2-4 in Bucharest, Romania.[62] The Summit Declaration stated that the alliance acknowledges that ballistic missile proliferation poses an increasing threat. It further affirmed that missile defense is part of a "broader response," and that the proposed U.S. system would make a "substantial contribution" to the protection of the alliance. It declared that the alliance is "exploring ways to link [the U.S. assets] with current NATO efforts" to couple with "any future NATO-wide missile defense architecture." The declaration

58 NATO Stepping Up Talks On Missile Defense Amid Concerns Over US Plans. Associated Press. March 12, 2007.

59 Danish PM Supports US Anti-Missile Shield. *AFP*. March 7, 2007. Blair: We Need To Look At Missile Options. *Press Association National Newswire*. February 28, 2007. Europe Considers Missile Defense System: German Minister. *AFP*. February 19, 2007.

60 This program should be distinguished from the theater missile defense system intended to protect deployed forces, which the alliance has already approved. See Riga Summit Declaration. NATO web page. http://www.nato.int/docu/pr/ 2006/p06-150e.htm Missile Defense and Europe. *Foreign Press Briefing*. U.S. Department of State. March 28, 2007.

61 NATO Considers Missile Defenses For Southeastern Flank In Tandem With U.S. Shield. Associated Press. June 14, 2007. U.S. Wins NATO Backing On Missile Defense. New York Times. June 15, 2007.

62 NATO Debates BMD Ahead Of April Bucharest Summit. WMD Insights. April, 2008.

also directed the development, by the time of the 2009 summit, of “options” for anti-missile defense of any alliance territory that would not be covered by the planned U.S. installations. These options would be prepared “to inform any future political decision.” In addition, the document declared support for ongoing efforts to “strengthen NATO-Russia missile defense cooperation,” and announced readiness to look for ways to link “United States, NATO and Russian missile defense systems at an appropriate time.” Finally, alliance members stated that they are “deeply concerned” over the “proliferation risks” implied by the nuclear and ballistic missile programs of Iran and North Korea, and called upon those countries to comply with pertinent UN Security Council resolutions.[63]

The Bush Administration interpreted the Summit Declaration as an endorsement of its missile defense project; Secretary of State Condoleezza Rice hailed the statement as a “breakthrough document.” Concerning the question of whether ballistic missiles from rogue states were a threat, National Security Advisor Stephen Hadley declared, “I think that debate ended today.”[64] Representative Tauscher welcomed “NATO’s acknowledgment of the contribution that the long- range interceptor site could make to Alliance security” and to make “cooperation with NATO a cornerstone of its missile defense proposal.”[65]

In the final communiqué of their December 3, 2008, meeting, the foreign ministers of NATO member states reiterated the language on missile defense that had been included in the Bucharest summit declaration, while also noting “as a relevant development the signature of agreements by the Czech Republic and the Republic of Poland with the United States regarding those assets.” The communiqué also called upon Moscow “to refrain from confrontational statements, including assertions of a sphere of influence, and from threats to the security of Allies and Partners, such as the one concerning the possible deployment of short-range missiles in the Kaliningrad region.” (see below.) The latter statement was likely included at Warsaw’s insistence.[66]

NATO’s 2009 summit was held in Strasbourg, France, and Kehl, Germany, in early April. The summit declaration “reaffirmed the conclusions of the Bucharest Summit about missile defence,” but noted that there was more work to be done. Specifically, it recommended that “missile threats should be addressed in a prioritised manner” that addresses “the level of imminence of the threat and the level of acceptable risk.” It tasked the Council in Permanent Session with studying and making recommendations on “architecture alternatives,” including usage of the ongoing Active Layered Theater Ballistic Missile Defense program, which is currently intended to protect deployed NATO forces.[67]

European opponents of the proposed U.S. plan also contend that statements by Russian officials are evidence that deployment of the U.S. system would damage Western relations with Russia. At a February 2007 security conference in Munich, former President Putin strongly criticized GMD, maintaining that it would lead to “an inevitable arms race.” Russia

63 NATO Summit Declaration. April 3, 20008 http://www.nato.int/docu/pr/2008/p08-049e.html.

64 NATO Backs U.S. Missile Shield. Los Angeles Times. April 4, 2008. NATO Endorses Europe Missile Shield. New York Times. April 4, 2008.

65 Opening Statement, Chairman Ellen O. Tauscher, Strategic Forces Subcommittee, Hearing on the FY2009 Budget Request for Missile Defense Programs, April 17, 2008.

66 Final communiqué. Meeting of the North Atlantic Council at the level of Foreign Ministers held at NATO Headquarters, Brussels. December 3, 2008. NATO website: http://www.nato.int/docu/pr/2008/p08-153e.html Poland Wants NATO To Declare Russian Placement Threat As Unacceptable – Sikorski. Poland Business Newswire. December 3, 2008.

has threatened to abrogate the 1987 Intermediate-Range Nuclear Forces (INF) Treaty, which eliminated this class of U.S. and then-Soviet missiles that were stationed in Europe. Putin also announced that Russia had suspended compliance with the Conventional Forces in Europe (CFE) Treaty,[68] and on another occasion indicated Russia might now target Poland and the Czech Republic and transfer medium- range ballistic missiles to the Russian exclave of Kaliningrad. Some U.S. and European officials dismissed Russia's alleged concerns and have noted that Moscow has known of this plan for years and has even been invited to participate.[69] GMD proponents maintain that the interceptors are intended to take out launched Iranian missiles aimed at European or American targets and could not possibly act as a deterrent against Russia, which has hundreds of missiles and thousands of warheads. The chief of the Czech general staff has noted that "by simple arithmetic, Russian generals can see that U.S. missile defenses cannot imperil Moscow's arsenal." Some Russians contend, however, that the modest GMD facilities planned for Eastern Europe are likely just the harbinger of a more ambitious program.

Russian officials have also argued that North Korean or Iranian missiles would not likely enter European airspace, and that the real reason for GMD is to emplace U.S. radar in eastern Europe to monitor Russian missile sites and naval operations. A Czech military officer dismissed the charge of electronic espionage as "absolute nonsense," arguing that "the radar monitors the already launched missiles, and it cannot monitor what is going on the ground"—a task that is already being performed by U.S. surveillance satellites.[70]

Some argue that Russia has other motives for raising alarms about the U.S. missile defense system: to foment discord among NATO member states, and to draw attention away from Russia's suppression of domestic dissent, its aggressive foreign policy actions, and its nuclear technology cooperation with Iran. Observers note that Russia blustered about NATO expansion, too, and argue that Russia's veiled threats may actually stiffen resolve in Prague and Warsaw. Some observers note, however, that Russian acceptance of NATO expansion was conditioned on a tacit understanding that NATO or U.S. military expansion into the new member states would not occur. The European GMD in this regard is seen as unacceptable to Russia.

On June 7, 2007, during the G-8 meeting in Germany, Putin offered to partner with the United States on missile defense, and suggested that a Soviet-era radar facility in Azerbaijan be used to help track and target hostile missiles that might be launched from the Middle East. President Bush responded by calling the proposal an "interesting suggestion," and welcomed the apparent policy shift. The following day, Putin suggested that GMD interceptors be "placed in the south, in U.S. NATO allies such as Turkey, or even Iraq ... [or] on sea platforms." Military and political representatives from both countries have met to discuss the proposal, but some experts point out that Azerbaijan is technically not the ideal place to locate the radar because it would be too close to potential Iranian launch sites; they also argue that the radar is outmoded.

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67 Strasbourg/Kehl Summit Declaration. April 4, 2009. NATO Web page. http://www.formin.fi/Public/Print.aspx?contentid=162749andnodeid=15145andculture=en-USandcontentlan=2

68 See CRS Report RL33865, *Arms Control and Nonproliferation: A Catalog of Treaties and Agreements*, by Amy F. Woolf, Paul K. Kerr, and Mary Beth Nikitin, section on Conventional Armed Forces in Europe Treaty. NATO "Very Concerned" At Russia Treaty Pullout. *Reuters*. July 16, 2007.

69 Russia Sees Threat From US Plan For Missiles In Eastern Europe. *AFP*. January 22, 2007. Poland Government Leaders Meet On U.S. Missile Defense Proposal. *Associated Press*. February 12, 2007.

70 U.S. Radar Not To Threaten Russia, China - Czech Chief Of Staff. *CTK Daily News*. January 25, 2007.

In the meantime, Putin urged the United States not to deploy elements of GMD until his offer had been examined. One week later, however, U.S. Defense Secretary Robert Gates stated that even if the United States were to accept Russia's offer to share use of the Azeri radar, that facility would be regarded as "an additional capability" to complement the proposed GMD sites planned for Europe.[71] In late July 2007, MDA Director Obering said the United States was looking at the proposal very seriously. He said the Azeri radar could be useful for early detection of missile launches, but that it does not have the tracking ability to guide an interceptor missile to a target— which the proposed Czech radar would be able to do.

At a July 1-2, 2007, meeting in Kennebunkport, ME, Putin expanded on his counterproposal by recommending that missile defense be coordinated through offices in Brussels and Moscow. He also suggested the possible use of radar in south Russia and said that cooperation could be expanded to other European countries through the use of the NATO-Russia council—eliminating, he added, the need for facilities in Poland and the Czech Republic. President Bush reportedly responded positively to Putin's new proposal, but insisted on the need for the Eastern European sites.[72]

Despite ongoing discussions over the issue, Russian criticism of the program has continued, edged, at times, with sarcasm. During an October 2007 visit to Moscow by Secretaries Gates and Rice, President Putin remarked "of course we can sometime in the future decide that some antimissile defense system should be established somewhere on the moon." Putin later likened the U.S. placement of the missile defense facilities in central Europe to the 1962 Cuban missile crisis—a comparison disputed by U.S. officials. In late November 2007, Russia rejected a written U.S. proposal on the project, arguing that it failed to include the points Secretary Gates had discussed a month earlier, including "joint assessment of threats, ... Russian experts' presence at missile shield's sites, [and] readiness to keep the system non-operational if there is no actual missile threat.... "[73] In December, the chief of Russia's army suggested that the launching of U.S. missile defense interceptors against Iranian missiles might inadvertently provoke a counter launch of Russian ICBMs aimed at the United States. However, critics assert that a Russian counterstrike could not be prompted so easily and mistakenly. In February 2008, Putin reiterated earlier warnings that, if construction commenced on the missile defense facilities, Russia would re-target ICBMs toward the missile sites.[74]

During President Bush's post-Bucharest meeting with Putin at the Russian resort of Sochi, the two leaders reportedly sought to find common ground on missile defense; they agreed to introduce greater transparency in the project, and to explore possible confidence-building measures. In the meantime, Russia remains opposed to the proposed European bases. The two sides agreed to "intensify" their dialogue on missile defense cooperation. After the

71 Putin Wants Quick Answer On Alternative Antimissile Site. RFE/RL Newsline. June 11, 2007. Putin Surprises Bush With Plan On Missile Shield. New York Times. June 8, 2007. US Says Russia Offer Cannot Replace Missile Shield. Reuters. June 14, 2007.

72 Putin Expands On His Missile Defense Plan. New York Times. July 3, 2007/ Putin Proposes Broader Cooperation On Missile Defense. Washington Post. July 3, 2007.

73 Putin Dismisses US Missile Shield Plan. Financial Times. October 12, 2007. Russia Dismisses US Offer On Missile Defence. AFP. November 23, 2007. Russia Alleges U.S. "Rollback" On Anti-Missile Plan. Washington Post. December 6, 2007.

meeting, however, Iran's ambassador to Poland warned that if the missile defense system is installed, "the United States will acquire supremacy over Russian nuclear forces."[75]

Following the signing of the U.S.-Poland agreement, Russia once more vociferously objected to the missile defense plan. On August 16, a highly placed Russian general officer stated that Poland's acceptance of the interceptors could make it a target for a nuclear attack. Later, newly inaugurated President Dmity Medvedev reiterated Russia's conviction that the interceptors constitute a threat, and added that Moscow "will have to respond to it in some way, naturally using military means." On August 20, it was also announced that the governments of Russia and Belarus had launched discussions on the establishment of a joint air defense system; the move was interpreted by ITAR-TASS as a "retaliatory measure" in response to the planned U.S. missile defense system.[76]

The day after the U.S. elections, in his State of the Federation speech, President Medvedev said that Russia would deploy short-range Iskander missiles to the Russian exclave of Kaliningrad, which borders Poland and Lithuania, if the U.S. GMD system is built. However, Medvedev later told a French newspaper that it the United States does not deploy the system, Russia would not transfer its missiles to Kaliningrad. Prime Minister Putin later reiterated that Russia would scrap its plans for the Iskanders if the United States cancelled its European GMD project.[77] Some observers believe that the announcement created more concern in central than in western Europe. Shortly thereafter, however, European Commission President Jose Manuel Barroso stated that "cold war rhetoric" was "stupid," and U.S. Defense Secretary Gates states that "such provocative remarks are unnecessary and misguided."[78]

In mid-November 2008, French President Nicolas Sarkozy recommended that the U.S. and Russian plans be discussed by NATO and the OSCE in the spring of 2009, and that, "until then we should not talk about missile or shield deployments which lead to nothing for security, which complicate things and rather make things go backwards." Czech Deputy Prime Minister Alexandr Vondra criticized Sarkozy's remarks as inappropriate, and Polish Prime Minister Tusk stated that GMD was a Polish-U.S. project, and that "I don't think that third countries, even such good friends as France, can have a particular right to express themselves on this issue." Sarkozy later appeared to backtrack somewhat, saying "every country is sovereign to decide whether it hosts an anti-missile shield or not."[79]

In late January 2009, the Russian media reported that Moscow had "suspended" plans to move short-range missiles to Kaliningrad because the Obama Administration was not "pushing ahead" with the European GMD deployment. The Obama Administration has

74 US Missile Could Trigger Russian Strike: Russian Army Chief. Agence Presse France. December 15, 2007. Putin Repeats Threat To Aim Russian Rockets At U.S. Missile Defenses. Associated Press Newswires. February 14, 20080.

75 Putin and Bush Narrow Some Differences. *Oxford Analytica*. April 7, 2008. U.S. To Gain Supremacy Over Russia With Central European Anti-missile Base—Iranian Ambassador. *Poland Business Newswire*. April 9, 2008. Fact Sheet: U.S.-Russia Strategic Framework Declaration. *News Press*. April 7, 2008.

76 Russian Says Shield Makes Poland Target. Washington Times. August 16, 2008. Medvedev Sees Military Response To U.S. Missile Shield. Reuters. August 26, 2008. Moscow, Minsk To Build Air Def In Response To Missiles In Europe. ITAR-TASS. August 20, 2008.

77 Putin Offers To End Stand-Off Over Missiles In Eastern Europe. DPA/Deutsche Welle. November 24, 2008.

78 Europe Split Over Russia's Tough Talk On Missiles. Washington Post. November 9, 2008. Gates and European officials Criticize the Russian President For His Bellicose Remarks. New York Times. November 14, 2008.

indicated that it is prepared to open talks with Teheran if it is willing to shelve its nuclear program and renounce support of terrorism. On February 7, at the 2009 Wehrkunde security conference in Munich, Vice President Biden stated that “we will continue to develop missile defenses to counter a growing Iranian capability.... We will do so in consultation with our NATO allies and Russia.”[80] During a February 10 visit to Prague, Secretary of State Hillary Clinton said that any change in U.S. policy on missile defense would depend upon Iran, but that “we are a long, long way from seeing such evidence of any behavior change” in Iran.[81]

In early March 2009, the media reported that President Obama had sent a letter to President Medvedev offering to stop the development of the missile defense program if Russia cooperated on policy that would help halt Iran’s nuclear weapons and missile programs. President Obama denied such a quid pro quo, stating that “what I said in the letter was that, obviously, to the extent that we are lessening Iran’s commitment to nuclear weapons, then that reduces the pressure for, or the need for a missile defense system. In no way does that in any—does that diminish my commitment to [the security of] Poland, the Czech Republic and other NATO members.”[82]

In a joint statement issued at their “get acquainted” meeting on April 1, 2009, Presidents Obama and Medvedev acknowledged that differences remained in their views toward the placement of U.S. missile defenses in Europe, but pledged to examine “new possibilities for mutual international cooperation in the field of missile defense.” Later that month, however, Russian Deputy Foreign Minister Sergei Ryabkov charged that “[U.S.] work in the missile defense has intensified, including in the NATO format.” Shortly thereafter, in a Russian media interview, Ryabkov was asked to comment on U.S.-Russia-NATO cooperation on missile defense through the use of Russian radar installations. He explained that the Russian offer is predicated upon the fulfillment of “certain preliminary stages,” including the U.S. cancellation of the Poland/Czech GMD facilities, followed by a threat assessment, and then by political and economic measures to eliminate the threat.[83]

Some observers believe that the ongoing dialog between Russia and the United States may help reduce tensions. Eventual Russian cooperation in missile defense could remove a significant impediment to the program and could dampen criticism by European and other leaders. It also may open the door to a more favorable attitude by NATO toward missile defense.

79 France urges Russia and US To End Missile Feud. Agence France Presse. November 14, 2008. Poles, Czechs Brush Aside Sarkozy Missile Plea. Agence France Presse. November 15, 2008. France “Overstepped Mandate” On Missile Shield. euobserver.com November 17, 2008.

80 Vice President Joseph Biden’s speech at the 45th Munich SecurityConference, http://www.securityconference .de/konferenzen /rede.php? menu_ 2009= andmenu_konferenzen =andsprache =enandid=238and

81 “Clinton Says Missile Shield Hinges in Part on Iran,” Reuters, February 10, 2009; “Obama Seen Unlikely to Hedge on Missile Defense,” Associated Press, February 13, 2009.

82 The White House. Office of the Press Secretary. Remarks By President Obama and British Prime Minister Gordon Brown After Meeting, March 3, 2009.

83 President Obama, Russian President Medvedev Commit To Reduce Nuclear Arms, Reset Relationship. US Fed News. April 11, 2009. Russia Warns U.S. Stepping Up Shield Plans – Agency. Reuters. April 21, 2009. An Interview With Deputy Foreign Minister Sergei Ryabkov. WPS: Defense and Security. April 24, 2009.

CONGRESSIONAL ACTIONS

Fiscal Year 2009

For FY2009, the Bush Administration requested $712 million for the European GMD Element. The reported cost of the European element is $4 billion (FY2008-FY2013), according to the Administration, which includes fielding and Operation and Support costs.

On May 14, 2008, the House Armed Services Committee approved its version of the FY2009 defense authorization bill (H.R. 5658). The committee provided $341 million for the proposed European GMD site, reducing the total by $371 million ($231 million in RandD funding and $140 million in Military Construction). The committee expressed concerns about the slower-thanexpected pace of the Iranian long-range missile program, the effectiveness of the GMD system based on program testing results, the ability to spend the proposed funds, and the lack of signed and ratified agreements with Poland and the Czech Republic.

On April 30, 2008, the Senate Armed Services Committee approved its version of the FY2009 defense authorization bill (S. 3001). The committee provided full funding for the European GMD Element, but noted that certain conditions have to be met before those funds could be expended: (1) military construction funds cannot be spent until the European governments give final approval (including parliamentary approval) of any deployment agreement, and 45 days have elapsed after Congress has received a required report that provides an independent analysis of the proposed European site and alternatives, and (2) acquisition and deployment funds, other than for long-lead procurement, cannot be expended until the Secretary of Defense (with input from the Dir., Operational Test and Operations) certifies to Congress that the proposed interceptor has demonstrated a high probability of accomplishing its mission in an operationally effective manner.

President Bush signed a continuing resolution into law on September 30, 2008 (P.L. 110-329), which incorporated defense appropriations and authorizing language for FY2009. According to a Press Release from the Senate Appropriations Committee dated September 24, 2008, Congress provided $467 million for the European BMD sites and development and testing of the two-stage interceptor. According to authorizing language,84 funding for the Czech radar and site will then be available only after the Czech Parliament has ratified the basing agreement reached with the United States and a status of forces agreement (SOFA) to allow for such deployment and stationing of U.S. troops is in place. Funding for the Polish interceptor site will only be available after both the Czech and Polish parliaments ratify the agreements reached with the United States, and a SOFA with Poland is also in place for the site. Additionally, deployment of operational GBIs is prohibited until after the Secretary of Defense (after receiving the views of the Director of Operational Test and Evaluation) submits to Congress a report certifying that the proposed interceptor to be deployed “has demonstrated, through successful, operationally realistic flight testing, a high probability of working in an operationally effective manner and the ability to accomplish the mission.”

84 Congressional Record – House, September 24, 2008, p. H9103.

Fiscal Year 2008

In its report on the FY2008 defense authorization bill, the House Armed Services Committee cited its concern from last year (FY2007) that investment in the European BMD site was premature.[85] In part, the Committee's concerns focus on the need to complete scheduled integrated end-to-end testing of the system now deployed in Alaska and California. Additionally, the Committee notes its reluctance to fund the European site without formal agreements with Poland and the Czech Republic and without knowing the terms under which the estimated $4 billion program costs would be expended. Therefore, the Committee recommended that no funds be approved for FY2008 for construction of the European GMD site.[86] The Committee did, however, recommend $42.7 million to continue procurement of ten additional GMD interceptors that could be deployed to the European site or for expanded inventory at the GMD site in Alaska (as noted in MDA budget documents). Also, the Committee expressed concern over the testing plan and risk reduction strategy for the proposed two-stage GMD interceptor for Europe. The Committee further directed that two studies be done: (1) the Secretary of Defense and the Secretary of State are to submit a report to Congress by January 31, 2008, to include how the Administration will obtain NATO's support for the European GMD proposal, and how other missile defense capabilities such as Aegis and THAAD (Terminal High Altitude Area Defense) could contribute to the missile defense protection of Europe; and (2) an independent assessment of European missile defense options should be done in a timely manner.

In the Senate defense authorization bill, the Armed Services Committee recommended limiting the availability of funding for the European GMD site until two conditions were met: (1) completion of bilateral agreements with Poland and the Czech Republic; and (2) 45 days have elapsed following the receipt by Congress of a report from an FFRDC (federally funded research and development center) to conduct an independent assessment of options for missile defense of Europe.[87] The Committee recommended a reduction of $85 million for site activation and construction activities for the proposed European GMD deployment. The Committee also limited FY2008 funding for acquisition or deployment of operational interceptor missiles for the European system until the Secretary of Defense certified to Congress that the proposed interceptor to be deployed had demonstrated, through successful, operationally realistic flight testing, that it had a high probability of working in an operationally effective manner. The Committee noted that the proposed 2-stage version of the interceptor has not been developed and was not scheduled to be tested until 2010.[88] Therefore, the Committee noted, it could be several years before it is known if the proposed interceptor will work in an operationally effective manner. The Committee indicated that it would not

85 National Defense Authorization Act for Fiscal Year 2008. Report of the House Armed Services Committee on H.R. 1585, May 11, 2007. House of Representatives. 1 10th Congress, 1st Session. H.Rept. 110-146, pp. 238-240.

86 To preserve the opportunity to move forward with the research and development components of the European interceptor and radar site, the Committee recommended that $150 million for FY2008 be available. Upon completion of bilateral agreements and if further engagement with NATO on the proposed site can be demonstrated, the Committee notes that the Department of Defense has the option of submitting a reprogramming request to Congress in FY2008 to fund site preparation activities.

87 National Defense Authorization Act for Fiscal Year 2008. Report of the Senate Armed Services Committee on S. 1547, June 5, 2007. Committee on Armed Services. U.S. Senate. 1 10th Congress, 1st Session. Report 110-77, pp. 140- 142.

88 See footnote 9.

limit site surveys, studies, analysis, planning and design for the proposed European GMD site, but that construction and deployment could not take place prior to ratification of formal bilateral agreements, which MDA estimates would not take place before 2009. Finally, the Committee notes there were a number of near-term missile defense options to provide defense of Europe against short-range, medium-range and future intermediate-range ballistic missiles, such as the Patriot PAC-3, the Aegis BMD system, and THAAD.

In floor debate, the Senate approved an amendment by Senator Sessions (90-5) to the defense authorization bill stating that the policy of the United States is to develop and deploy an effective defense system against the threat of an Iranian nuclear missile attack against the United States and its European allies. Further debate and passage of the defense authorization bill was postponed at the time by the Majority Leader until after debate over Iraq war funding.

On November 13, 2007, President Bush signed into law the FY2008 Defense Appropriations Bill (H.R. 3222; P.L. 110-114). This bill eliminated the proposed $85 million for FY2008 for the European missile defense site construction, but permitted $225 million for studies, analyses, etc. of the proposed European GMD element.

The House passed the FY2008 National Defense Authorization bill (H.R. 1585) on May 17, 2007. The Senate passed its version on October 1, 2007. House and Senate negotiators filed the defense authorization report on December 6, 2007. The House adopted the report on December 12, 2007. The Conference Report contained a number of provisions pertaining to the proposed European

GMD element. First, it cut the $85 million requested for site activation and construction activities. This left about $225 million to fund surveys, studies, analysis, etc. related to the European GMD element in FY2008. Second, the Conference Report required an independent assessment of the proposed deployment of long-range missile defense interceptors and associated radar in Europe and a second independent analysis of missile defense options in Europe before site construction and activation could begin. The conferees noted that if the Polish and Czech governments gave final approval to any successfully completed agreements during FY2008, the Department of Defense had the option of submitting a reprogramming request for those funds ($85 million) to begin site construction in Europe. Third, the conferees strongly supported the need to work closely and in coordination with NATO on missile defense issues. Finally, the defense authorization bill required that the Secretary of Defense certify that the proposed two- stage interceptor “has demonstrated, through successful, operationally realistic flight testing, a high probability of working in an operationally effective manner” before funds could be authorized for the acquisition or deployment of operational missiles for the European site.

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FRANCE: FACTORS SHAPING FOREIGN POLICY, AND ISSUES IN U.S.-FRENCH RELATIONS*

Paul Belkin [1]

ABSTRACT

The factors that shape French foreign policy have changed since the end of the Cold War. The perspectives of France and the United States have diverged in some cases. More core interests remain similar. Both countries' governments have embraced the opportunity to build stability in Europe through an expanded European Union and NATO. Each has recognized that terrorism and the proliferation of weapons of mass destruction are the most important threats to their security today.

Several factors shape French foreign policy. France has a self-identity that calls for efforts to spread French values and views, many rooted in democracy and human rights. France prefers to engage international issues in a multilateral framework, above all through the European Union. European efforts to form an EU security policy potentially independent of NATO emerged in this context. However, more recently, policymakers in France, Europe and the United States have come to view a stronger European defense arm as a complement to rather than a substitute for NATO.

From the September 11, 2001, attacks on the United States through the Iraq war of 2003 until today, France has pressed the United States to confront emerging crises within a multilateral framework. France normally wishes to "legitimize" actions ranging from economic sanctions to military action in the United Nations.

The election of Nicolas Sarkozy to the French presidency in May 2007 appears to have contributed to improved U.S.-French relations. Sarkozy has taken a more practical approach to issues in U.S.-French relations than his predecessor, Jacques Chirac. Perhaps most notably, in April 2009, Sarkozy announced France's full reintegration into NATO's military command structure, more than 40 years after former President Charles de Gaulle withdrew his country from the integrated command structure and ordered U.S. military personnel to leave the country.

Trade and investment ties between the United States and France are extensive, and provide each government a large stake in the vitality and openness of their respective economies. Through trade in goods and services, and, most importantly, through foreign direct investment, the economies of France and the United States have become increasingly integrated.

Other areas of complementarity include the fight against terrorism, the Middle East Peace process, peace operations in the Balkans, and the stabilization of Afghanistan and

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Lebanon—all challenges where France has played a central role. A major split occurred over Iraq, however, with many countries either supporting or independently sharing French ideas of greater international involvement.

Developments in the Middle East affect French foreign and domestic policy. France has a long history of involvement in the region, and a population of 5-6 million Muslims. Paris believes that resolution of the Arab-Israeli conflict is key to bringing peace to the region. Surges in violence in the Middle East have led to anti-Semitic acts in France, mostly undertaken by young Muslims.

This report will be updated as needed. See also its companion report, CRS Report RL32459, U.S.- French Commercial Ties, by Raymond J. Ahearn [Note: this report was written at the request of the co-chairs of the Congressional French Caucus.]

INTRODUCTION

The end of the Cold War altered the U.S.-French relationship. Before the collapse of the Soviet Union, the United States, France, and their NATO allies viewed the USSR as the principal threat to security. France was known for its independent streak in policy-making, both with its European counterparts and the United States, notably under President de Gaulle in the 1960s. Nonetheless, there was cohesion throughout the alliance at such moments as the Berlin crisis of 1961, the Cuban missile crisis the following year, and the debate over basing "Euromissiles" in the 1980s.

Several factors shape French foreign policy that may be of interest during the 111th Congress. After several years during which Jacques Chirac contested elements of Bush Administration policy, French President Nicolas Sarkozy has sought to improve bilateral relations. Sarkozy has pursued what he considers a more practical policy than his Gaullist predecessors, such as Chirac and President de Gaulle himself, who anchored elements of their nationalism by defining France as a country that selectively stood against U.S. influence in the world. By contrast, Sarkozy has expressed an acceptance of, and even admiration for, U.S. global leadership. He lauds American culture, has vacationed in the United States, and contends that European security must have a U.S. component.

Nonetheless, differences between the United States and France in the approach to foreign policy are likely to persist. France has a self-identity that calls for efforts to spread French values and views, many rooted in democracy and human rights. France prefers to engage most international issues in a multilateral framework, above all through the European Union (EU). France is also a highly secular society, a characteristic that influences views on the state's relation to religion.

Since the conclusion of the Cold War, the perspectives of France and the United States have diverged in some cases. Most core interests remain similar. Both countries' governments have embraced the opportunity to build stability in Europe through an expanded EU and NATO. Each has accepted the need to ensure that Russia remain constructively engaged in European affairs. Each has also recognized that terrorism and the proliferation of weapons of mass destruction are the most important threats today.

Post-Cold War developments have brought new challenges, which have affected the U.S.-French bilateral relationship. German unification and the entry of central European states into the EU and NATO may have shifted the continent's balance of political and economic power away from the French-German "engine" and towards central and eastern

Europe. While French-German initiatives remain of great importance in Europe, German perspectives are increasingly eastward; and, in some eyes, central European states feel closer strategically and politically to the United States than they do to France. Nonetheless, France remains a key player in European affairs and few initiatives can succeed without its support and participation.

The United States, a global superpower since the Second World War, has remained deeply involved in European affairs. In the view of some Europeans, however, by the mid-1990s, Washington appeared to be slowly disengaging from Europe, while wanting at the same time to maintain leadership on the continent.[2] French and German, and some would say British, efforts to form an EU security policy potentially independent of NATO and the United States emerged and evolved in this period. The Europeans based this policy in part on the belief that the United States had growing priorities beyond Europe, and in part because Americans and Europeans were choosing different means to protect their interests. The U.S. decision to go into Afghanistan in October 2001 with initially minimal allied assistance was one example of this trend; the U.S. war against Iraq, with overt opposition from France and several other allies, was another.

During the George W. Bush Administration, France, with other European allies, pressed the United States to confront emerging crises within a multilateral framework. Terrorism and proliferation are threats that cross borders, and often involve non-state actors. France, where possible, normally attempts to engage elements of the international community in responding to such threats, and to "legitimize" actions ranging from economic sanctions to political censure to military action at the United Nations. Past French Presidents have promoted a view of a "multipolar" world, with the EU and other institutions representing poles that encourage economic development, political stability, and policies at times at odds with the United States. While Jacques Chirac was president, Bush Administration officials reacted with hostility to such efforts, charging that "multipolar" is a euphemism for organizing opposition to U.S. initiatives. The election of President Obama was welcomed in France, and strong popular support for Obama suggests that many in France expect the Obama Administration to distance itself from the perceived unilateralism of the Bush Administration.

In the recent past, some U.S. observers characterized France as an antagonist. In 2004, the previous French ambassador reportedly charged that some U.S. officials deliberately spread "lies and disinformation" about French policies in order to undercut Paris.3 Occasional mutual antagonism was already evident during the first years of the Fifth Republic (1958-present), when President de Gaulle sometimes offered singular views on international affairs, often at odds with Washington and other allies, and in 1966 withdrew France from the military structures of NATO. In the 1960s, France began to develop its own nuclear deterrent force. As alluded to earlier, Sarkozy has made a concerted effort to draw France closer to the United States and distance himself and the country from past disputes with the United States. Most notably, in April 2009, Sarkozy announced France's full reintegration into NATO's military command structure as part of a broader realignment and modernization of French security and defense policy.

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2 Anand Menon, France, NATO and the Limits of Independence, 1981-1 997: The Politics of Ambivalence (New York, St. Martin's Press, 2000), p. 69-7 1.

3 "U.S. French 'Marriage' Edgy but Still There...," Rocky Mountain News, (interview with Ambassador Jean-David Levitte), April 15, 2004, p. 41A.

French assertiveness is generally seen in a different light in Europe. Other Europeans often credit French initiatives in the EU and in other institutions as fresh in perspective, or moving a discussion into a new realm; Paris played a major role, for example, in the conception and implementation of the EU's Economic Monetary Union (EMU). That said, some in Europe, most notably Germany's Chancellor Angela Merkel, have reportedly been frustrated by what they consider Sarkozy's tendency to pursue EU-wide initiatives without first consulting other European leaders.

Traditional French assertiveness accounts in some ways for France punching above its weight on the international scene. France is a country of medium size with relatively modest resources. Yet it has played a persistent role, for example, in establishing EMU, building a European Security and Defense Policy (ESDP), and in orchestrating opposition to the U.S.-led Iraq war. While U.S.- French relations have at times been contentious, there is also a complementarity and an intertwining of U.S. and French interests and actions. Nowhere is this more clear than in the realm of commercial interactions.

Trade and investment ties between the countries are extensive, providing each side a big stake in the vitality and openness of their respective economies. Through trade in goods and services, and, most importantly, through foreign direct investment, the economies of France and the United States have become increasingly integrated. Over $1 billion in commercial transactions take place every business day of the year between the two sides. This huge amount of business activity, in turn, is responsible for creating several million American and French jobs.[4]

Other areas of complementarity include the fight against terrorism, the Middle East Peace process, peace operations in the Balkans, and the stabilization of Afghanistan and Lebanon — all challenges where France has played a central role. A major split occurred over Iraq, however, with many countries either supporting or independently sharing French ideas of greater international involvement.

This report examines the key factors that shape French foreign policy. From that context, it analyzes some of the reasons for the tensions in and the accomplishments of U.S.-French relations. The report is illustrative, rather than exhaustive. Instead, the report reviews issues selected because they exemplify some of the essential features of the U.S.-French relationship. Some issues, such as the effort by the United States and the EU-3 (France, Britain, and Germany) to curb Iran's military nuclear program are analyzed more extensively elsewhere by CRS.[5]

FACTORS SHAPING FRENCH POLICY

A Global Perspective

France, like the United States, believes that it has a special role in the world. The core perceptions of France's role in the world stem from the Revolution that began in 1789. The

[4] For more information see CRS Report RL32459, *U.S.-French Commercial Ties*, by Raymond J. Ahearn

[5] See, for example, CRS Report RL32048, *Iran: U.S. Concerns and Policy Responses*, by Kenneth Katzman.

Revolution was an event of broad popular involvement: widespread bloodshed, expropriation of property, and execution of the king fed the notion that there could be no turning back to monarchical government. Not only was the monarchy overthrown and a powerful church structure forcibly dismantled, but French armies, and ultimately French administrators in their wake, transformed much of the continent into societies where more representative, democratic institutions and the rule of law could ultimately take root. The Revolution was therefore a central, formative element in modern European history, notably in Europe's evolution from monarchical to democratic institutions. The cultural achievements of France before and since the Revolution have added to French influence. French became the language of the élite in many European countries. By 1900, French political figures of the left and the right shared the opinion that France was and must continue to be a civilizing beacon for the rest of the world.[6]

The view that France has a "civilizing mission" (la mission civilisatrice) in the world endures today. For many years, the French government has emphasized the message of human rights and democracy, particularly in the developing world and in central Europe and Eurasia.

Many French officials, particularly Gaullists,[7] have been highly assertive in seeking to spread French values throughout the world. Dominique de Villepin, the last prime minister under Jacques Chirac, wrote that "at the heart of our national identity, there is a permanent search for values that might be shared by others." Gaullists have sought to embed French views in EU initiatives, sometimes in concert with Germany and sometimes alone. In the 1990s, one cabinet official called for an "inner circle" in the EU, defined as "a small number of states around France and Germany" that must move forward to secure EMU, a common foreign and security policy, and a military force able to protect the Union's interests. President Sarkozy also believes that France must play a leading role in shaping EU initiatives. France's rank and influence in the world are important to French policymakers. Membership on the U.N. Security Council, close relations with parts of the Arab world and former worldwide colonies, aspects of power such as nuclear weapons, and evocation of human rights are central to France's self-identity in international affairs.[8]

Others sometimes contest France's evocation of values. By the mid-20th century, some French colonies, such as Algeria and Morocco, sharply disputed whether actual French policy met the ideals of Paris's message. Algeria fought an eight-year war for independence—a brutal guerilla war of terrorism, counterinsurgency, and torture which left tens of thousands of French and hundreds of thousands of Algerians dead. Today, some Europeans praise the intellectual underpinnings of French "reason and good sense" that combat "prejudice and fanaticism." However, they see occasional contradictions in French policy, as when France sought to lift sanctions against Iraq when U.N. WMD inspections temporarily ended there in

6 In a vast literature, see John Weightman, "Fatal Attraction," New York Review of Books. February 11, 1993, p. 10; and François Furet, La Révolution de Turgot à Jules Ferry, 1770-1880 (Paris, 1988), p. 511-512, 516-517.

7 The term "Gaullist" originated during Charles de Gaulle's presidency (1958-1969). President Chirac was a founder of the Gaullist Party, once known as the Rally for the Republic. Gaullists have traditionally believed in a strong national voice and an independent foreign policy for France, and that France must play a central role in shaping Europe and in influencing world affairs. Gaullists are also normally fiscal conservatives who have supported a statist position in the economy.

8 De Villepin cited by Daniel Vernet, "Dominique de Villepin ou le gaullisme ressucité," *Le Monde,* December 11, 2003. Thierry Tardy, "France and the United States: The Inevitable clash?," *International Journal,* vol. LIX, no. 1, Winter 2003-2004.

1998, then only belatedly accepted a new inspections regime in 2002, even though French officials had privately been stating their belief that Iraqi WMD programs were likely continuing, or when France balks at what some view as more democratic power-sharing in the expanding European Union.[9]

The European Union

France was one of the founding members of the European Union (initially known as the European Coal and Steel Community, and then the European Community) in the 1950s. Improved trade and economic development were central objectives in a Europe still struggling from the dislocation caused by the Second World War, but overarching objectives from the beginning were political rapprochement between Germany and its former enemies, and political stability on the continent. The EU was conceived in this context, with strong U.S. support.

France has been a catalyst in achieving greater political unity and economic strength in the European Union. Jacques Chirac, the French president from 1995-May 2007, altered the traditional Gaullist view that France could act alone as a global power and be the Union's most important member. Rather, today, the Gaullists believe that France can best exert its power through the EU, acting in tandem with Germany and occasionally with Britain.

At the same time, the defeat of a referendum in spring 2005 endorsing an EU "constitution" meant to make EU decision-making more effective may be a sign of popular doubts about the direction and strength of the Union. The defeat of the "constitution" at least temporarily diminished France's leadership role in the Union.

Some European governments object to the view that France, Germany, and Britain can guide EU policies. They describe the claim for leadership of the three countries as a nascent "Directoire," or initiative to dominate the EU and push smaller member states to follow the three governments' lead. French officials dispute the idea of a "Directoire." In their view, initiatives in the Union should not be held back by governments that wish to proceed more slowly. Chirac described the efforts of France and Germany, and occasionally Britain, as those of a "pioneer group" that wishes "to go faster and further in European integration." Some French officials say that France "does not wish to be resigned to a Europe which would only be a space of internal peace." Rather, in their view the EU should become a force for positive, broad-reaching change in Europe and the world.[10]

French officials cite a range of examples where a "pioneer group" of EU countries has taken the lead in forging forward-looking policies. France, Germany, and other countries led the way in implementing the Schengen agreement (open borders for people) and EMU. In 2003 and 2004, France, Germany, and Britain played the key role in persuading Iran to accept International Atomic Energy Agency (IAEA) inspections of its nuclear energy sites for possible evidence of nuclear weapons production. French officials state that they want the EU to have a strong Commission and a strong President of the Commission, although the Council, where ministers from member states meet, must remain paramount in decision

[9] Christoph Bertram, in "La diplomatie Villepin jugée par les intellectuels," *Le Monde*, December 4, 2003, p. 16; interviews.

10 "Le Premier choix de Paris reste la relation avec Berlin," Le Monde, February 18, 2004, p. 2; "Après le fiasco de Bruxelles, Paris relance l'idée d'une Europe à la carte," Le Monde, December 16, 2003, p. 10.

making. France has supported initiatives to streamline voting in the EU, and to place more areas of decision making under "qualified majority voting (QMV)," to avoid a rule under which one government among the 27 member states may veto a decision.

France was broadly praised for its handling of the EU's rotating six-month presidency during the second half of 2008. The French presidency was distinguished by President Sarkozy's energetic and high-profile response to three unforeseen and challenging international crises: the June 2008 rejection by Irish voters of the Lisbon Treaty; the August 2008 conflict between Georgia and Russia; and the ongoing global financial crisis. Observers agree these events provided an opportunity for Sarkozy to boost his and the EU's international profile, but may have hindered his efforts to implement long hoped for internal European reforms.

French officials had hoped that ratification of the Lisbon reform treaty would provide impetus for its proposals to improve EU coordination in the fields of energy and climate change, immigration, and security and defense policy. The Treaty—which was conceived as a successor to the defeated "constitution"—would, among other things, create more streamlined decision-making structures and strengthen European foreign and security policy. The Treaty's future remains in doubt since it was rejected by Irish voters in June 2008. France did gain backing for the first stages of an EU immigration and asylum policy that would recruit high-skilled migrants, crack down on illegal immigration, strengthen border control, and harmonize national asylum policies. Modest gains were also made in France's efforts to advance a nascent security and defense policy (ESDP). France had hoped to launch a renewed "European Security Strategy" under which members would pledge to train their forces more assiduously and spend more on defense. However, challenges to enhancing collective capabilities through the pooling of national resources remain considerable.

President Sarkozy has also sought to advance a more vigorous EU policy toward the Mediterranean region. French officials acknowledge that the EU's "Barcelona Process," inaugurated in 1995 to enhance political and economic ties between the EU and Mediterranean littoral countries, has faltered. They hope that a new Union for the Mediterranean, launched in Paris in July 2008, will build on the admittedly modest gains of the Barcelona Process by: upgrading the political profile of the Barcelona Process through more frequent summits and more precise work-plans; increasing co-ownership of the initiative through a co-presidency and joint secretariat; and supporting more concrete and visible projects in partner states.[11] Despite the renewed impetus, however, most observers expect fundamental challenges to endure. Among other things, Israel's participation and lingering doubts about European motives are expected to reinforce skepticism in some Arab states. Sarkozy opposes Turkey's candidacy for EU membership, but has said that the door is open to eventual membership by Balkan countries, including Serbia.[12]

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11 See "Barcelona Process: Union for the Mediterranean," European Commission COM(2008) 319, May 5, 2008. Available at http://ec.europa.eu/external_ relations/euromed /index _en.htm.

12 "Le discours de politique étrangère de M. Sarkozy,"*Le Monde*, September 1, 2007; and "La Méditerranée," (editorial), *Le Monde*, April 14, 2007, p. 22.

MULTILATERALISM

Multilateralism is important to all U.S. allies and in particular to all 27 members of the European Union, which is itself a multilateral entity painstakingly put together over a fifty-year period. For Europeans, decision-making in international institutions can lend legitimacy to governmental policies. Member states of the EU share certain areas of sovereignty and pursue joint policies intended to provide political and economic stability, goals that the United States has supported since the 1950s. Globally, Europeans perceive the U.N. as the locus for decision-making that can provide an international imprimatur for member states' actions in international security. The U.N. carries special significance for European countries that experienced two world wars. Europeans see the EU and the U.N. as belonging to a civilizing evolution towards cooperation rather than confrontation in world affairs.

France is in a key position in the framework of multilateral institutions. It enjoys a permanent seat and holds a veto in the U.N. Security Council. Important EU policies are not possible without French support. French officials play central roles on the European Commission, in the European Central Bank, and the IMF, and are eligible to lead, and have led, each of these institutions.

France wishes to confront the greatest threats to its security through international institutions. French officials identify terrorism as the country's most important threat. France has considerable experience in combating terrorism and today is generally regarded as highly effective in that domain. At the same time, France believes that an anti-terror foreign policy must include a comprehensive multilateral effort to diminish the prevalence of poverty in the developing world and to encourage the spread of literacy, democracy, and human rights. While military action may also be a tool against terrorism for Paris, French leaders prefer to begin any effort to confront an international threat in a multilateral framework.

Sarkozy subscribes to this tradition that emphasizes multilateralism. Shortly after his victory in the presidential elections on May 6, 2007, he expressed his admiration for the United States, but added that the United States should reverse course and lead the effort to combat global climate change. Sarkozy has endorsed the Kyoto Treaty and the findings of scientists who believe that the global climate is becoming warmer. As discussed in more detail below, Sarkozy has also reaffirmed France's commitment to NATO by bringing the country back into the alliance's integrated military command structure.

THE USE OF FORCE AND THE UNITED NATIONS

For the French government, the conflict in Iraq in 2003 raised questions about the legitimate use of force. France, together with several other European governments, was critical of the Bush Administration's national security doctrine that endorsed "preemptive action" in the face of imminent danger. Sarkozy has said that the U.S. invasion of Iraq in 2003 was a significant mistake that has contributed to the destabilization of the Middle East.

Although the French government does not reject the use of force, it maintains that certain criteria must be met for military action to acquire legitimacy. In the words of de Villepin, fear of terrorism and other threats make "the use of force ... tempting. [Use of force] is justifiable if collective security or a humanitarian crisis requires it. But it should only be a last recourse, when all other solutions are exhausted and the international community, through the Security Council, decides upon the question." In a speech to the U.N. General Assembly in clear reference to the U.S. invasion of Iraq, Chirac said, "In today's world, no one can act alone in the name of all and no one can accept the anarchy of a society without rules. There is no alternative to the United Nations.... Multilateralism is essential.... It is the [U.N. Security Council] that must set the bounds for the use of force. No one can appropriate the right to use it unilaterally and preventively."[13]

For the most part, France's record over the past decade has been consistent in following the precept that the U.N. must endorse the use of force in a crisis. For example, France, along with other countries, since 1990 has obtained a U.N. resolution for the potential or actual use of force for interventions in the first Gulf War, Bosnia, Afghanistan, Congo, the Ivory Coast, and Haiti. One notable exception came in 1999, when France joined its NATO allies in going to war against Serbia in an effort to prevent ethnic cleansing in Kosovo. In that case, until the eleventh hour, the French government sought a U.N. resolution for NATO's use of force. At the same time, in the face of an increasingly likely Russian veto, French officials and counterparts from several other European allies began indicating that Serbian actions had reached a stage where using force to prevent a humanitarian catastrophe in Kosovo would be justifiable without a U.N. resolution.[14]

President Sarkozy has strongly supported the effort by the "EU-3" (France, Britain, and Germany) and the United States to curb or end Iran's illegal enrichment of uranium because it could lead to the development of Iranian nuclear weapons. Should the U.N. fail to agree upon further sanctions against Iran, Sarkozy has said that he supports U.S. and French sanctions and development of EU sanctions against Iran in the absence of a U.N. resolution.

RELIGION AND THE STATE: "LE FOULARD"

France has a long history of religious violence. Political factions went to war in the 16th century over religious differences and dynastic claims; the conflict left many thousands dead and the society badly divided. One cause of the Revolution was a desire by many to end the Catholic Church's grip on elements of society and dismantle a church hierarchy widely viewed as corrupt and poorly educated.

In the late 19th and early 20th centuries, the government sought to ensure that public schools did not become embroiled in religious controversies. Parliament passed a law in 1905 intended to ensure separation between religion and politics. The law enshrined laïcité as a principle of French life. Laïcité is not simply secularism, but rather an attempt to balance religious freedom and public order. The government protects freedom of religion, and there is no state church in France; at the same time, there is an effort to ensure that religious groups do not engage in political activism that would be disruptive of public life. [15]

[13] De Villepin, "Discours d'ouverture," Meeting of French ambassadors, Ministry of Foreign Affairs, Paris, August 28, 2003; and Jacques Chirac, Speech before the U.N. General Assembly, excerpted in *Le Monde*, September 24, 2003, p. 2.

[14] Interviews and discussions with U.S. and French officials, February-March 1999.

[15] For a discussion, see Justin Vaïsse, "Veiled Meaning: The French Law Banning Religious Symbols in Public Schools," Brookings Institution, March 2004. For the French government's view, see "Laïcité in France: Promoting Religious Freedom and Tolerance," supplied by the French embassy, March 2004.

One controversy in France has pitted elements of the Muslim community against the government. Approximately 36% of France's Muslim community describe themselves as "practicing."[16] Within this group are Muslims who seek to ensure that their children may pursue what they view as traditional Islamic practices in France's public school system. Some French Muslim families require their girls to wear head scarves ("le foulard") to school. French public schools are coeducational. Some Muslim families object to elements of co-education; for example, they do not want their female children to take physical education, nor do they want them to take biology classes where reproduction is discussed. Some families also do not want male doctors to treat their female children at public hospitals. The French government believes that such families are causing disruption in the public school system, especially in a period of increased tensions between Muslims and Jews in France, and a period of political tensions with the Muslim world over the issue of terrorism.

After an extended debate, the government presented a bill to Parliament to ban "conspicuous" religious symbols in schools through secondary-school level. The law prohibits the wearing of head scarves; it also bans religious symbols such as large crosses and the yarmulke. In the parliamentary debate over the bill, then Prime Minister Raffarin said that the purpose of the legislation is "to set limits" in the face of growing religious militancy. Some religious signs "take on a political sense and cannot be considered a religious sign," he said. "I say emphatically, religion must not be a political subject."[17] Some Muslim governments, such as that of Iran, sharply condemned the bill. Moderate Muslim groups in France supported it as a means to reduce tensions in the school system and in broader society.[18] The bill passed by a wide margin in March 2004, with government parties and elements of the left supporting it.

Some observers in France criticized the bill because they viewed it as essentially a negative instrument. In this view, the government should do more to integrate Muslims into French society. The debate evokes a familiar theme in recent French history. At the turn of the 20th century, for example, many opposed the large migration into France of Italians and Spaniards, ethnic groups viewed as coming from societies where political violence was rife. Yet these groups have become well assimilated into French society, their members commonly occupying senior positions in politics and the professions. In contrast, many observers in France believe that large elements of the Muslim population have not been assimilated. One observer, a member of the government-appointed commission to study the issue of head scarves in schools, opposed the law. In his view, France should seek a balance that embraces diversity yet preserves a degree of uniformity that sustains the French "identity." He believes that the law unfairly stigmatizes the Muslim population. [19]

Sporadic riots since late 2005 have troubled the suburbs surrounding Paris, Lyon, Toulouse, Lille, and other cities. For the most part, these are working class suburbs populated by North Africans; unemployment levels are high, and educational levels are low. In many ways, these suburbs are a society apart, their inhabitants cut off from most of the

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[16] Justin Vaïsse, "Veiled Meaning: The French Law Banning Religious Symbols in Public Schools," Brookings Institution, March 2004, p. 3.

[17] Cited in "French Premier Urges Approval of Scarf Ban," *International Herald Tribune*, February 4, 2004, p. 3.

18 Justin Vaïsse, "Veiled Meaning: The French Law Banning Religious Symbols in Public Schools," Brookings Institution, March 2004, p. 5.

19 Jean Baubérot, "Laïcité, le grand écart," (editorial), Le Monde, January 4-5, 2004, p. 1.

opportunities afforded French youth who are not Muslim. The rioting has largely taken the form of violence against property. The government declared a state of emergency and responded with curfews and with police, who cut off the neighborhoods from the nearby cities. [20]

Sarkozy has a difficult relationship with the Muslim community. As Interior Minister, he referred to the rioters in 2005 as "scum" who should be "washed away by a power hose." There was some violence in French cities the night of his election to the presidency, although not all of the disturbances were by Muslim youth. Some of those burning cars and destroying other property were young people from beyond the Muslim community apparently protesting his proposals to tighten labor laws. Sarkozy is also the first leading French official to propose "affirmative action" programs, such as job placement for youth, for Muslims.

Anti-Semitism in France

Between 2000 and 2004, there was a significant increase in anti-Semitic acts of violence in France. Incidents dropped dramatically in 2005 and have since wavered up and down. Most of the acts have occurred in the suburbs around Paris, and in southern cities such as Marseille and Montpellier. Molotov cocktails have been thrown at several synagogues and schools, rabbis have been assaulted, and, most notbaly, a Jewish phone salesman, Ilan Halimi, was brutally beaten and murdered in 2006.

France's Jewish population is the largest in Europe, estimated at 575,000 people, with some 300,000 to 350,000 living in the Paris metropolitan area and 80,000 in Marseille (France has a total population of 64 million).[21] According to a 2002 study by a French Jewish community organization, most French Jews today are white collar professionals, and are well integrated into French society. "Mixed" marriages with non-Jews have become increasingly common in the past two decades, but a strong community sense remains. In a 2002 poll, 42% of the Jewish population said that they keep kosher, while 29% said that they are non-observant. Since the increase in 2000 in anti-Semitic incidents, 6%, mostly young Jews in their teens and twenties, responded that they have thought about moving to Israel (the figure was 3% in a 1988 poll); at the same time 58% said that they had not thought of moving to Israel (an increase from 40% in 1988.)[22]

In France, there is broad agreement that most anti-Semitic acts have been committed by young North African Muslims. However, there is also concern that non-Muslims are increasingly engaged in anti-Semitic violence. Over the past decade, there has been a close correlation between surges in violence in the Middle East and increases in anti-Semitic acts in France. The Gulf War of 1991, the Palestinian Intifada since fall 2000, Israeli military action on the West Bank and in Gaza in spring 2002, and the Israeli war against Hezbollah in Lebanon in 2006 have all been followed by increases in anti-Semitic violence in France.[23]

20 CRS Report RL33 166, Muslims in Europe: Integration in Selected Countries, coordinated by Paul Gallis; see also Jonathan Laurence and Justin Vaisse, Integrating Islam: Political and Religious Challenges in Contemporary France (Washington, DC, 2006).

21 The Stephen Roth Institute for the Study of Antisemitism and Racism, France 2007, http://www.tau.ac.il/Anti-Semitism/asw2007/france.html.

22 "Qui sont les juifs de France?", Le Figaro, November 18, 2002.

23 "Les Juifs et les Arabes en France," Le Nouvel Observateur, January 24-30, 2002, p. 5; "Wave of Anti-Semitism Called Threat to France," International Herald Tribune, October 20, 2004, p. 3.

Most recently, a surge in anti- Semitic incidents in early 2009 was thought to be linked to the Israeli offensive into Gaza.

The history of Jews in France is replete with important political milestones and a strong measure of controversy. In 1791, during the Revolution, France was the first European country to extend citizenship to its Jewish population. There have been three Jewish prime ministers (Léon Blum in 1936-1937, Pierre Mendès-France in 1954-1955, and Laurent Fabius in 1984-1986). Blum was asked by General de Gaulle to head a post-war provisional government in 1946 (he declined due to ill health). French Jews hold senior positions in government, business, and academics.

Some American commentators have responded to the acts of anti-Semitic violence in France by charging that the country as a whole is anti-Semitic. They see a continuity among the Dreyfus trials of the 1 890s, in which a French Jewish military officer was wrongly convicted of espionage due to anti-Semitic sentiments in the government and the army, the Vichy regime of 1942-1944, which collaborated with the Nazis and sent French Jews to their deaths in concentration camps, and the anti-Semitic violence that increased after 2000. They describe the strong showing of Jean- Marie Le Pen (17.85%), in the past convicted of anti-Semitic crimes by French courts, in the 2002 presidential elections as evidence that the French population retains strong anti-Semitic sentiments.24 Israeli officials have charged that the French government's Middle East policies create an atmosphere where anti-Semitism can grow. One right-wing extremist Jewish group (Hérout) contends that the French government is "pro-Arab" and anti-Semitic. Some prominent French Jews intimate that the French government's criticism of Israel is a cloak for antiSemitism.[25]

Other views contest the assertion that France is an anti-Semitic country. Charles Haddad, the president of Marseille's Jewish Council, has said that "This is not anti-Semitic violence; it's the Middle East conflict that's playing out here." Most politically moderate Jewish groups, led by the Representative Council of French Jewish Organizations (CRIF), have stated that they do not regard the French population as anti-Semitic. They have also commended the French government for passing a strong law (the Lellouche Law) in December 2002 that cracks down on anti-Semitic violence and other racist crimes. Chirac and other members of his government vigorously condemned anti-Semitism, and held a number of public events criticizing such acts. David Harris, the executive director of the American Jewish Committee, has commended the French government for its efforts.[26] Sarkozy, while raised a Catholic, has Jewish ancestry on his father's side. He has also strongly condemned acts of anti-Semitism, and is a strong supporter of Israel.

24 See, for example, Charles Krauthammer, "Europe and 'Those People': Anti-Semitism Rises Again," Washington Post, April 26, 2002, p. A29. Most analysts believe that Le Pen's strong showing was due to his attacks on immigrants and crime, and not to his anti-Semitic views.

[25] "Les Juifs et les Arabes en France," *Le Nouvel Observateur*, January 24-30, 2002, p. 5; "Les Juifs de France et la France, une confiance à rétablir," editorial by several members of French Jewish community, *Le Monde*, December 30, 2003, p. 1.

[26] For Haddad, see "Attacks on Jews Leave Marseille Wondering about a Rupture," *New York Times*, April 8, 2002, p. 2; "Les clés d'une débâcle," *Libération*, April 24, 2002, p. 1; "Jacques Chirac remobilise le gouvernement contre l'antisémitisme," *Le Monde*, November 18, 2003; and [letter from David Harris], "Anti-Semitism in France," *International Herald Tribune*, January 7, 2003, p. 7.

ISSUES IN U.S.-FRENCH RELATIONS

European Security and Defense Policy (ESDP)

France has been at the forefront of efforts to build an EU security structure that could potentially act independently of NATO. In the 1990s, the EU began to implement a Common Foreign and Security Policy (CFSP) to express common goals and interests on selected issues and to strengthen its influence in world affairs. Since 1999, with France playing a key role, the EU has attempted to develop a defense identity outside NATO to provide military muscle to CFSP. The European Security and Defense Policy (ESDP) is the project that gives shape to this effort. Under ESDP, the EU has committed to creating what would ultimately become a rapid reaction force of 60,000 troops and to developing institutional links to NATO to prevent duplication of resources.[27] ESDP 's development has been increasingly driven by an emphasis on boosting civilian crisis management and police training capacity. Since January 2003, the EU has launched a total of over 20 civilian crisis management, police, and military peacekeeping operations in areas ranging from the Balkans, to the Congo and the coast of Somalia.

France and Germany, with some support from Britain, have sought to enhance EU decision- making bodies and a planning staff for EU military forces under ESDP. The United States initially opposed elements of this effort, particularly the proposal for a planning staff, as duplicative of NATO structures and a waste of resources. On December 12, 2003, NATO and the EU reached a compromise. There will be two planning staffs, with officers from EU states forming an EU planning cell at NATO's Supreme Headquarters Allied Command Europe (SHAPE) in Mons, Belgium, and NATO officers will be attached to a new, separate EU planning cell. The EU-NATO agreement reaffirmed elements of an existing arrangement (called "Berlin Plus"), under which the EU will consider undertaking operations only if NATO as a whole has decided not to be engaged. If NATO is engaged, then the EU will not seek to duplicate NATO's operational planning capabilities.[28] The arrangement is intended to meet the U.S. concern that there not be two existing, and potentially competing, plans for an operation.

EU defense ministers, under a plan offered by France, Britain, and Germany, agreed in April 2004 to create up to 13 "battle groups" of 1,500 troops each to act as "insertion forces" in the beginning stages of a crisis. Under this plan, the forces would also be available to NATO. If brought to fruition, the battle groups would be in action within 15 days of a decision to use them, and could sustain themselves for four months before a larger force replaces them.[29]

ESDP remains a work in progress. The EU includes several self-described "neutral" governments that do not have a strong interest in European defense structures. In addition, a number of governments, including several central European governments that joined the EU in May 2004, remain look first to the United States in defense matters and view NATO as

27 For a more detailed analysis, see CRS Report RL32342, NATO and the European Union, by Kristin Archick and Paul Gallis, "France in an Evolving NATO,"Defence nationale et sécurité collective, November 2006, p. 14.

28 Interviews, November 2003-December 2005; Statement of (then) NATO Secretary General Robertson, cited in *Atlantic News*, December 17, 2003.

29 Interviews, December 2003-December 2005; "Battle Group Plan Advances," *International Herald Tribune*, April 6, 2004, p. 3.

central to their strategic interests; for the foreseeable future, these governments are unlikely to follow any effort by an EU member to distance EU defense from NATO and Washington.[30]

At the same time, U.S. officials appear increasingly optimistic that these developments mean that ESDP will not undercut NATO. Some also believe that Sarkozy is more pragmatic on European security issues that Chirac.[31] Proposals by Sarkozy and Kouchner for an "autonomous military capacity" within the European Union were endorsed by U.S. officials. Kouchner believes that such a capacity is necessary for Europe to prevent conflicts, resolve crises, and undertake reconstruction projects, such as in Kosovo.[32]

President Sarkozy has strongly urged other EU members to increase their defense spending and build greater combat capability to undertake missions outside Europe. France's defense spending for 2008 will again be greater than 2% of GNP, a level that exceeds an unofficial NATO standard, and will be "around 2%" for the duration of President Sarkozy's first term, ending in 2012.[33]

NATO

At NATO's 60th anniversary summit in April 2009, France announced its full reintegration into NATO's integrated military command structure.[34] France is currently the fourth largest contributor of troops to alliance operations and a significant financial contributor to NATO.

However, it has had only very limited participation in the alliance's military decision-making structures since then-President de Gaulle withdrew the country from NATO's integrated command structure in 1966.[35] Despite domestic opposition from critics who fear that the move could limit French military independence, the French parliament approved Sarkozy's decision by a vote of 329-238 on March 17, 2009. U.S. officials have welcomed French reintegration as an important step toward improving alliance cohesion and strengthening the European role within NATO. [36] There appears to be a consensus that U.S.-French military relations are excellent, despite much publicized past differences between Washington and Paris on political issues.

Several factors in the 1990s contributed to renewed French doubts about NATO. Some French officials did not want the United States exercising strong leadership in the alliance when Washington appeared to be giving Europe diminished priority after the Cold War. U.S. positions on involvement in the Balkan conflicts of the early 1 990s led some French and

[30] Interviews, 2003-2005.
[31] Interview with Administration officials, March-May 2007.
[32] Kouchner, op. cit.
[33] "L'effort de défense devrait se maintenir 'autour de 2%' du PIB," *Le Monde*, March 22, 2008, p. 9.
[34] This section draws on CRS Report R40454, *NATO's 60th Anniversary Summit*, coordinated by Paul Belkin.
[35] France joined NATO as an original member in 1949. During the early years of the Fifth Republic, President de Gaulle had a number of disputes with the United States, in part over policies, in part over the small number of Europeans in senior allied command positions. President de Gaulle withdrew France from NATO's integrated command structure in 1966 and ordered U.S. military personnel to leave the country. However, France remained in NATO's political wing and maintained a seat on the North Atlantic Council (NAC), the alliance's political decision- making body. Since the mid-1990s France has participated more actively in NATO operations, and Paris has sent an observer to the alliance's Military Committee, where key military planning and operational decisions are made.
[36] See Vice President Biden's remarks at the 2009 Munich Security Conference, op. cit.

other European officials to question the alliance's efficacy, given that Europeans saw the Balkan wars as a major threat to security.[37] The United States eventually engaged its forces in the Balkans in several NATO operations, including in the Kosovo conflict in 1999. Some French officials believe that the Bush Administration distanced the United States from NATO in its efforts to create "coalitions of the willing," a practice that in their view undermines the principle of collective defense and allied unity, as well as the rationale behind enlarging the alliance to bring in a broad spectrum of new governments.[38]

French officials recognize that military self-sufficiency in an era of global threats is not possible, and that EU defense efforts may eventually have a regional but not world-wide reach. Put simply, France and the EU lack the military resources to resolve major crises on their own. For these reasons, France in the last several years has become more engaged in NATO operations. For many years, French governments had opposed proposals for NATO "out-of-area" operations, meaning military operations outside the Treaty area in Europe, as well as operations beyond Europe. The crises in the former Yugoslavia in the 1 990s, requiring a large military capacity to bring stability, and post-September 11 operations in Afghanistan, requiring a military force able to sustain combat operations in a distant theater, altered French thinking. Former President Chirac, reflecting on these developments, said, "You have to be realistic in a changing world. We have updated our vision, which once held that NATO had geographic limits. The idea of a regional NATO no longer exists, as the alliance's involvement in Afghanistan demonstrates."[39]

French officials hope that full reintegration into NATO will give France a level of influence in determining the strategic direction and planning decisions of the alliance that is proportional to its participation in alliance operations. Practically speaking, French four-star generals are expected to fill two NATO command posts—Allied Command Transformation (ACT) in Norfolk, Virginia and the Allied Joint Command regional headquarters in Lisbon, Portugal—and approximately 800 French officers will reportedly be integrated into command structures at NATO headquarters.[40]

What role France will play in determining the strategic direction of the alliance remains to be seen. However, some observers draw attention to France's past opposition to U.S. and UK calls for a more "global NATO" defined by enhanced partnerships with countries outside the core NATO area such as Australia and Japan. French officials have also argued that NATO should consult more closely with Russia before considering further enlargement and have indicated that NATO should concentrate on its core mission of defense and leave political and reconstruction activities to other international institutions (such as the EU and U.N.).[41] Other observers point to Sarkozy's willingness to break with tradition to argue that past policy positions could be of little consequence in France's future approach to the alliance.

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[37] For a thought-provoking discussion, see Anand Menon, *France, NATO and the Limits of Independence, 1981-1 997: The Politics of Ambivalence* (New York, St. Martin's Press, 2000).

[38] Interviews with French officials, 2006-2007.

[39] Jim Hoagland, "Chirac's Multipolar World," *Washington Post*, February 4, 2004, p.A22 (editorial based on an interview with Chirac).

[40] Today, France contributes two one-star flag officers to NATO headquarters and provides approximately one percent of NATO headquarters staffers. Interviews of European officials, March 2009; Steven Erlanger, "Sarkozy Embraces NATO, and Bigger Role for France," *New York Times*, March 8, 2009; Leo Michel, "Sarkozy's Next Big Battle," *Newsweek*, February 23, 2009.

Sarkozy has sought alliance and U.S. support for a strong European Security and Defense Policy (ESDP). France has argued that a robust and independent European defense capacity could reinforce and enhance NATO. After some reservation (outlined above), U.S. officials have welcomed French calls to develop Europe's security and defense capacity, which they view as a complement to, not a substitute for, NATO. As one U.S. supporter of French reintegration notes, "Every step taken by France to improve the cohesiveness and efficiency of NATO will sooner or later benefit European defense as well—in terms of capabilities, interoperability and operational performance."[42]

Some analysts believe France and Britain are the only two European allies with flexible, mobile forces that can sustain themselves long distances from their territories. In the 1990s, France began a multi-year effort to downsize and professionalize its military forces. Smaller, more flexible units were created. President Sarkozy has sought to build on these efforts by implementing a series of further reforms laid out in a 2007 "White Paper" on defense and national security. U.S. military officials say that French forces have improved substantially in the past decade, and have a highly educated and motivated officer corps. Former NATO Supreme Allied Commander Europe (SACEUR) and current National Security Advisor James Jones has said that "France probably has the military in Europe most able to deploy to distant theaters." At the same time, U.S. military officials also say that some problems persist in an overly centralized command structure, occasional poor equipment maintenance, and minimal depth in some units. French military officials concede that the Defense Ministry lacks the resources to train its forces in joint and other large-scale operations.[43]

AFGHANISTAN

NATO's most important mission is the stabilization of Afghanistan. The alliance's International Security Assistance Force (ISAF) is attempting to stabilize Afghanistan through combat operations against the Taliban and building the country's economy and political institutions. U.S. Administrations have consistently sought to persuade allies to contribute more forces to counter a growing Taliban insurgency. France is a leading troop contributor to ISAF. France's military is generally recognized as one of Europe's most effective and deployable, and U.S. and NATO officials consistently give French forces high marks for their ability and willingness to engage in combat. French officials have tended to view ISAF primarily as a combat force intended to buttress the efforts of the Afghan government to build legitimacy and governance. At the same time, they increasingly acknowledge the need to enhance efforts to train Afghan security forces and to boost the capacity of the police and judicial system.

France currently has 2,800 French military personnel deployed in Afghanistan, with an additional 600 supporting the mission from outside the country (in Tajikistan, Kyrgyzstan, and in the Indian Ocean as part of Operation Enduring Freedom). Almost all French forces

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[41] See, for example, Jamey Keaten, "U.S. Vision of 'global NATO' runs counter to role sought by France," Associated Press, March 18, 2009.

[42] Leo Michel, op. cit.

[43] Rupert Pengelley, "French Army Transforms To Meet Challenge of Multi-Role Future," *Jane's International Defence Review*, (June 2006), p. 45-46.

currently serve under ISAF (200 French Special Operations Forces participated in OEF in southern and eastern Afghanistan until February 2007). The French contribution to ISAF covers four areas: Regional Command Capital (RC-C), headquartered in Kabul; a joint task force battalion in RC-East; training of the Afghan security forces—primarily the Afghan National Army; and air support. Approximately 1,400 French troops, including an infantry battalion of about 800 and a logistics battalion of about 500 serve in RC-C, currently under the command of French General Stollsteiner. Since 2008, a battalion of 600 combat forces has been fighting alongside U.S. forces in the eastern province of Kapisa (RC-E), attempting to block Taliban infiltration into Kabul. The unit receives consistent praise from U.S. commanders in Afghanistan.

Terrorism

Many U.S. and French officials believe that bilateral cooperation between the United States and France in law-enforcement efforts to combat terrorism since September 11 has been strong, but at the same time a range of political factors is complicating the relationship.[44] France has long experience in combating terrorism, a tightly centralized system of law enforcement, and a far- reaching network that gathers information on extremist groups. Limits on resources and important social and political issues sometimes affect elements of France's anti-terrorism policies.

Unlike the United States, France uses its military as well as the police to ensure domestic order (however, France has no equivalent of the U.S. National Guard, which can be deployed in national crises). The French military is in the midst of an effort to modify its forces to be more effective in counter-terror efforts at home and abroad.

Terrorism has an extensive history in France. Since the 1960s, terrorists have repeatedly struck French targets. Since the late 1 970s, France has captured a number of members of the Basque terrorist group, the ETA, and extradited them to Spain. In recent years, a violent Corsican separatist group has carried out assassinations and bombings in France. In the past half century, France has created a number of intelligence agencies and specialized police forces to combat such groups, usually in a successful manner. In 1994, French police thwarted a hijacking at the Marseille airport; terrorists had reportedly intended to crash the plane into the Eiffel Tower. In a notable instance, in September 1995, an Algerian terrorist organization, the Armed Islamic Group (GIA), carried out bombings in the Paris subway that killed a number of French citizens. The reaction of the French government, according to U.S. and French officials, was swift, ruthless, and effective, and the bombings ceased.

Al Qaeda has carried out at least one successful attack against France. On May 6, 2002, Al Qaeda operatives exploded a car bomb in Karachi, Pakistan, that killed 11 French naval personnel. The French navy had sent men to Karachi as part of a contract to supply submarines to the Pakistani government.[45]

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44 This section is an abbreviated, updated version of the section on France in CRS Report RL3 1612, European Counterterrorist Efforts: Political Will and Diverse Responses in the First Year After September 11, by Paul Gallis. The study was originally prepared as a memorandum for Representative Doug Bereuter and the House Select Committee on Intelligence, and became a CRS report with Mr. Bereuter's permission.

45 "Face au terrorisme, M. Chirac prend seul la tête de l'executif," *Le Monde*, May 10, 2002, p. 2.

France has taken several steps to increase existing efforts to combat terrorism on its own soil. On September 12, 2001, France revived an existing law enforcement measure, Vigipirate, that enhances the ability of the government to ensure order. The government established Vigipirate in 1978; without legislative action, the government may activate the system. The system provides for greater surveillance of public places, government authority to cancel holidays or public gatherings that could be the target of terrorist attacks, the activation of elements of the military to secure infrastructure, and tighter security at airports, train stations, embassies, religious institutions, nuclear sites, and other locations that may come under threat. Upon activation of Vigipirate, the government called 35,000 personnel from the police and military to enforce such measures, including 4,000 personnel assigned to guard the Paris subway system. Vigipirate is still in force, although not at the highest level of alert.

Coordination has improved between the United States and France in counter-terror policy since September 11. As Interior Minister, Sarkozy was intimately involved in ensuring coordination. The two governments exchange selective intelligence information on terrorist movements and financing. In January 2002, the French and U.S. governments signed an agreement allowing the U.S. Customs Service to send inspectors to the major port of Le Havre. There, U.S. inspectors have joined their French counterparts in inspecting sea cargo containers for the possible presence of weapons of mass destruction intended for shipment to U.S. ports.[46]

The Middle East

France's long, intertwined history with the Middle East influences its debate on terrorism and its involvement in the region. While the French government supports key U.S. objectives in dismantling Al Qaeda, there is great political sensitivity in France to any issue that involves the Muslim world. A legacy of the French colonial empire is the presence of 5 to 6 million Muslims, mostly North Africans, living in France, a population that successive French governments have found difficult to integrate into society. There is tension in the French population between those of Caucasian background and those of North African origin. In 2005 and 2007, police pursuits ending in the deaths of teenagers triggered serious rioting in Parisian suburbs inhabited largely by people of North African descent.

France, along with the EU and all European countries bordering the Mediterranean, views the Middle East as a neighboring region whose political developments strongly affect European affairs. For this reason, France takes a strong interest in such issues as the Middle East peace process, terrorism, and Iraq. These issues often arouse a debate over sensitive social questions in France.

[46] "Terrorisme: Français et Américains se félicitent de leur coopération en matière de renseignement," *Le Monde*, December 31, 2003, p. 5; "Help from France Key in Covert Operations," *Washington Post*, July 3, 2005, p.A1; interviews.

The Israeli-Palestinian Conflict and the Middle East Peace Process

Under Jacques Chirac, French officials, and their counterparts in many EU states, were privately critical of a U.S. policy that, in their view, unduly favored Israel and supported an aggressive Israeli policy towards the Palestinians. Sarkozy—whose maternal grandfather was Jewish—has made a point of publicly reaffirming France's fundamental commitment to the state of Israel. In a June 2008 speech to the Israeli Knesset, the first by a French president in 26 years, Sarkozy pledged France's unmitigated support for Israel and announced his willingness to deploy French troops to support a peace agreement with the Palestinians.

French and EU policy continues to be driven by the conviction that Israel's long-term security depends on a peacefully negotiated, two-state solution to the Israeli-Palestinian conflict. France opposes Israel's settlement building, its demolition of Palestinian homes, and its construction of a separation barrier on the West Bank, and believes Jerusalem should be the capital of both Israel and a future Palestinian state. Publicly, France continues to support the EU's isolation of Hamas, which it considers a terrorist organization. However, in May 2008, France confirmed that it had been in contact with Hamas leaders to try to better understand its positions. French Foreign Minister Bernard Kouchner emphasized that the contacts should not be taken as evidence of ongoing negotiations or relations between the parties.[47]Some observers believe that French and European willingness to engage Hamas in the peace process could increase as more Europeans begin to view engagement as a better way to try to moderate the group and generate progress in the process.

The United States and France have cooperated closely in the effort to limit Syrian influence in Lebanon. France is a major participant in the U.N. stabilization force in southern Lebanon, in which the United States does not participate. For a century, France has had close relations with Lebanon and maintains an enduring commercial and cultural relationship with the country. French and U.S. officials have worked together to use the U.N. and other resources to diminish the Syrian presence and influence in the country. France and some other EU member states have resisted calls to designate Hezbollah as a terrorist organization, arguing that this would only serve to intensify Lebanon's turmoil at a time when Hezbollah's cooperation is needed to resolve the country's ongoing political crisis.

Relations between France and Syria are tense, largely due to Syrian interference in Lebanese affairs. However, France has increasingly favored diplomatic engagement as a means to gain more cooperation from Damascus. French officials, including President Sarkozy, have met several times with their Syrian counterparts, and France has advocated enhanced ties between the European Union and Syria.

Iran

France, with Britain and Germany, comprise the "EU-3" that has worked with the United States to curb Iran's possible nuclear military program. While French officials say that they were surprised by the U.S. Administration's December 2007 National Intelligence Estimate that stated that Iran does not have an active nuclear weapons program, they add that the EU-3

[47] Steven Erlanger, "France Admits Contacts with Hamas," *New York Times*, May 20, 2008

’s central purpose is to curb or end Teheran’s nuclear enrichment program, a precursor to any such weapons program. Sarkozy continues to support U.N.-endorsed sanctions against Iran, including reduction or elimination of Iran’s importation of gasoline. Sarkozy has also advocated bilateral EU sanctions in the event that the U.N. does not endorse new sanctions. In June 2008, EU states agreed to freeze the assets of Iran’s biggest bank, Bank Melli, among others, and to impose visa bans on a number of experts suspected of involvement in the Iranian nuclear program.

On January 15, 2008, Sarkozy announced that France and the United Arab Emirates (UAE) had reached agreement for a French military base in Abu Dhabi. The base will have 400-500 soldiers, a combination of air, ground, and naval personnel, and is intended as a signal to Iran that France will defend its allies and interests in the Persian Gulf. The base can accept a surge in French forces for exercises or a crisis, and is expected to become operational in 2009.[48]

Iraq

The French government did not contribute forces to the U.S.-led multinational force in Iraq. French officials say that Paris did not approve the conditions under which the United States launched the war and does not wish to be associated with the occupation of Iraq. At the NATO summit in June 2004, France and several other allies initially opposed sending a NATO force to Iraq. Chirac said that “any involvement of NATO in [the Middle East] seems to us to carry great risks, including the risk of confrontation of the Christian West against the Muslim East.” Ultimately, all allies agreed upon a training mission, but some countries do not wish to send their forces to Iraq to train Iraqi security forces. France was one of these countries, but offered to train Iraqi police in metropolitan France.[49] In 2003, France accepted a U.S.-German compromise plan negotiated in the context of the Paris Club to write off 80% of Iraq’s foreign debt.

Sarkozy has criticized as a “mistake” the U.S. invasion of Iraq in 2003, but added that France should have handled pre-war opposition to the conflict in a more diplomatic and less intrusive manner. “I am hostile to this war. ..there can only be a political solution,” he said in September 2007. He has called for a “clear horizon” for the withdrawal of U.S. troops.[50]

Trade[51]

U.S. commercial ties with France are extensive, mutually profitable, and growing. With over $1.35 billion in commercial transactions taking place between the two countries every day of the year, each country has an increasingly large stake in the health and openness of the other’s economy.

France is the eighth largest merchandise trading partner for the United States and the United States is France’s largest trading partner outside the European Union. More than half

48 “La France se doit être présente dans le Golfe, explique Morin,” Le Monde, January 16, 2007, p. 1.

49 Interviews of U.S. officials, July 2004; “Allies To Support Iraq with Troop Training,” NATO, Brussels, June 29, 2004; “Paris et Washington s’affrontent sur le rôle de l’OTAN en Irak,” Le Monde, June 26, 2004, p. 2.

50 “Discours de politique étrangère,” op. cit.

of bilateral trade occurs in major industries such as aerospace, pharmaceuticals, medical and scientific equipment, electrical machinery, and plastics where both countries export and import similar products.

The United States and France also have a large and growing trade in services such as tourism, education, finance, insurance and other professional services. In recent years, France has been the sixth largest market for U.S. exports of services.

Although trade in goods and services receive most of the attention in terms of the commercial relationship, foreign direct investment and the activities of foreign affiliates can be viewed as the backbone of the commercial relationship. The scale of sales of French-owned companies operating in the United States and U.S.-owned companies operating in France outweighs trade transactions by a factor of four and five, respectively.

In 2007, France was the thirteenth largest host country for U.S. foreign direct investment abroad and the United States, with investments valued at $68.5 billion, was the number one foreign investor in France. During that same year, French companies had direct investments in the United States totaling $169 billion (historical cost basis), making France the sixth largest investor in the United States. French-owned companies employed some 497,000 workers in the United States in 2006, compared to 651,500 employees of U.S. companies invested in France.

Most U.S. trade and investment transactions with France, dominated by multinational companies, are non-controversial. Nevertheless, three prominent issues—agriculture, government intervention in corporate activity, and the war in Iraq—have contributed periodically to increased bilateral tensions. The most pointed perhaps arose in early 2003 with reports of U.S. consumer boycotts of French goods and calls from some Members of Congress for trade retaliation against France (and Germany) due to foreign policy differences over the Iraq War.

Agriculture

Agricultural trade disputes historically have been the major sticking point in U.S.-France commercial relations. Although the agricultural sector accounts for a declining percentage of output and employment in both countries, it has produced a disproportionate amount of trade tensions between the two sides. As trade, as well as agriculture, is under the jurisdiction of the European Commission, the problems, of course, are not technically bilateral in nature.

From the U.S. perspective, the restrictive trade regime set up by the EU's Common Agricultural Policy (CAP) has been the main problem. It has been a longstanding U.S. contention that the CAP is the largest single distortion of global agricultural trade. American farmers and policymakers have complained over the years that U.S. sales and profits are adversely affected by (1) EU restrictions on market access that have protected the European market for European farmers; by (2) EU export subsidies that have deflated U.S. sales to third markets; and by (3) EU domestic income support programs that have kept non-competitive European farmers in business. From an EU and French perspective, the CAP has been substantially reformed in recent years and cannot be characterized as the largest source of distortions in agricultural trade. On the contrary, under this view there is ample evidence that

51 This section is drawn from CRS Report RL32459, U.S.-French Commercial Ties, by Raymond J. Ahearn.

EU (as well as Australian, New Zealand, and Canadian) farm exports have been hampered by U.S. food aid policies in some developing countries.

France’s agricultural sector, which in terms of output and land is the largest in Europe, has long been the biggest beneficiary of the CAP. Over the past several years, French farmers have received about 20 to 25% of CAP outlays that have averaged around $40 billion. Acting to continue benefits and subsidies for its farmers, the French position, which is shared by many other EU members, can determine the limits and parameters of the European Commission’s negotiating flexibility on a range of agricultural issues that are of keen interest to the United States. The most prominent and perhaps important example relates to current efforts to get the WTO Doha round of multilateral trade negotiations back on track by reducing agricultural subsidies and other barriers to market access. Other examples where the French position, backed by many other EU members, arguably has made settlement of disputes more difficult include expanded trademark protection for wines, cheeses, and other food products linked to specific regions, and a ban on the importation of beef treated with hormones.[52]

GOVERNMENT INTERVENTION IN CORPORATE ACTIVITY

Despite significant reform and privatization over the past 15 years, the French government continues to play a larger role in influencing corporate activity than does the U.S. government. This difference is manifested not only in the French government’s continuing direct control of key companies and its support of “national champions”, but also in its continuing proclivity to influence mergers involving French firms. President Sarkozy has continued to support this policy tradition in a number of ways. Nevertheless, although bilateral disputes may be more prone to occur because of the French government’s interventionist and regulatory tendencies, the dictates of EU laws as well as the urgent need to raise the revenues through privatization efforts and to enact market-oriented reforms, are weakening the French dirigiste tradition.

In 1997, the then-Socialist government restarted a process of privatization and opening of government-controlled firms to private investment that had begun in the 1980s, and the program was continued by the center-right government that took power in 2002. In 2003 and 2004, the government reduced its stakes in large companies such as Air France-KLM (to 44.6 from 54.0%), France Telecom (to 42.2 from 54.5%), Renault (to 15.6 from 26.0%), and Thomson (to 2.0 from 20.8%). The government still has stakes in Bull and Safran, and in 1,280 other firms. While the trend has been to privatize many large companies (fully or partially), the government still maintains a strong presence in sectors such as power, public transport, and defense. [53]

52 Trademark protection for geographic indications is also an issue of great importance for Italy (parma ham and parmesan cheese), Greece (feta cheese), Hungary (tokay wine), and Portugal (porto wine). Denmark, Italy, and Germany are other EU countries taking the lead on limits on research and use of GM crops and most all EU members strongly support the ban on the importation of beef treated with hormones. For further discussion of these disputes, see CRS Report RS2 1569, Geographical Indications and WTO Negotiations, by Charles E. Hanrahan, and CRS Report RS2 1556, Agricultural Biotechnology: The U.S.-EU Dispute, by Charles E. Hanrahan.

53 U.S. Department of Commerce, Country Commercial Guide-France, 2006.

Despite its ongoing privatization program, the French government continues to promote national champions and "economic patriotism," a concept that has been used to justify opposition to foreign takeovers of French firms. This tendency has been apparent in an effort by the government to strengthen a French takeover law and a parallel effort to scrutinize sensitive foreign investments more closely. In the summer of 2005, the government orchestrated a quick merger of two utilities, publicly traded Suez SA, a French utility, and state-controlled Gaz de France (GDF), to fend off a potential takeover by Enel of Italy. President Sarkozy is now exploring ways to create "national champions" in other industries such as nuclear power and defense. Such mergers would involve Areva, the state-owned nuclear group and other French companies, plus the huge defense/aerospace companies Thales and Safran.[54]

At the same time that Sarkozy is supporting interventionist policies designed to enhance France's economic and industrial strength, he is also promoting market-oriented domestic reforms on issues such as taxation and labor markets. During 2007-2008, the government implemented several important labor reforms, including a de facto extension of the 35-hour work week by allowing employees to work longer hours. While President Sarkozy may view increased competition as a way to get France's over-regulated economy on track for stronger growth, the government has delayed additional reform efforts due to the ongoing economic crisis.[55]

FOREIGN POLICY DISCORD AND THE IRAQ WAR

In the era of the Cold War, there was considerable concern that trade disputes between allies could undermine political and security ties. Deep differences over the Iraq war between the United States and many of its allies, particularly France and Germany, reversed this Cold War concern into whether foreign policy disputes can weaken or undermine strong commercial ties.

Specific concerns that divisions over Iraq could spill over into the trade arena arose in early 2003 with reports of U.S. consumer boycotts of French goods and calls from some U.S. lawmakers for trade retaliation against France (and Germany). The spike in bilateral tensions and hard feelings, however, appears not to have had much impact on sales of the products—such as wines, perfumes, handbags, and cheeses—most prone to being boycotted.[56] U.S. imports of all four of these French products increased in absolute terms from 2003 to 2008. Moreover, the French share of U.S. total imports of these products has increased for cheese and travel goods, stayed about the same for perfumes, and declined only for wines. But the decline in market share for wines (from 35% in 2003 to 31.4% in 2008) started well before the Iraq War.[57] It also should be pointed out that because the euro grew substantially weaker during this 2003-2007 time frame, U.S. demand for these products had to remain strong.

54 Financial Times, "National Champions: French Energy Mergers Test Europe's Free Market Puritans," September 27, 2007.

55 Hollinger, Peggy, Financial Times, "Sarkozy's Uneven First 100 Days," August 23, 2007.

56 This is an illustrative, not exhaustive, list of products that are likely to be targets of boycotts because they have a strong element of brand identification with France, and tend to be luxury items.

57 French wines have experienced a long-term declining share of total U.S. imports. In 1998 French wines accounted for 47.05% of total U.S. imports, in 2000 42.34% and in 2002 35. 12%.

Although there are few signs that goods and services clearly identified with France or the United States are being boycotted, some polls have found evidence of public support among some segments of the U.S. population for expressing opposition to foreign policy disagreements in the shopping malls. Nevertheless, a substantial economic backlash appears unlikely because of the high degree of economic integration. Effective boycotts would jeopardize thousands of jobs on both sides of the Atlantic.

ASSESSMENT

The United States and France retain a strong measure of economic and political interdependence. In economic terms, some $494 billion in annual commercial transactions, the vast majority due to sales by U.S. companies producing and selling in France and French companies producing and selling in the United States, serves as a strong form of economic glue that binds the two countries together. This deep and growing level of economic integration increases the stakes each country has in the vitality and openness of each other's economy, as well as works as a counterweight to the adoption of restrictive policies which could jeopardize hundreds of thousands of jobs in both countries. In political terms, France acknowledges that only U.S. forces can provide security on a global scale, evident in the conflict against terrorism and the post-September 11 campaign to overthrow the Taliban and weaken Al Qaeda. The United States also plays a key institutional role in a stable Europe, a measure of which is Washington's leadership in NATO.

Additionally, France does act to buttress U.S. international efforts and to lend legitimacy to Washington's foreign policy initiatives, measures that demonstrate a complementarity of interests and action that is still the norm, even if at times that norm appears to be diminishing. French forces fought in the Gulf War of 1991, and, with much greater ability, in the Kosovo conflict of 1999. France has followed important U.S. initiatives that seek to enhance global stability, as in NATO's eventual acceptance of the once controversial idea that NATO go "out of area," and act on a global scale. In the conflict against terrorism, France has supplied the United States with political contacts in countries, such as Algeria and Tunisia, that have proven valuable.[58] With other EU countries, France has worked closely with the United States in law enforcement efforts to combat terrorism.

Important divergences have emerged over the past decade. The belief in France that the United States at times acts "unilaterally" was already evident in the 1990s when the French government criticized Congress and the Clinton Administration for defeat of the Comprehensive Test Ban Treaty, sanctions against Cuba, and a program of national missile defense. [59] This belief sharpened during the current Bush Administration, due to its rejection of the Kyoto Treaty, its criticism of the International Criminal Court, and its Iraq policy. French public opinion grew increasingly critical of the United States during the course of the Bush Administration's two terms.[60] President Obama's popularity in France suggests that many French expect the new U.S. Administration to distance itself from the perceived

58 "Hubert Védrine effectue une tournée éclair au Maghreb," Le Monde, October 3, 2001. p. 9.

59 "Chirac's Attack on Congress Has a Bigger Target," International Herald Tribune, November 9, 1999, p. 2.

60 "French and German publics' trust in the U.S. falls to new lows," Office of Intelligence and Research, U.S. State Department, June 4, 2004, p. 1-2; "Image of U.S. Falls Again," International Herald Tribune, June 14, 2006, p. 1.

unilateralism of the Bush Administration. However, some observers caution that public expectations of the new President could be unreasonably high and note that policy differences between the two countries remain.

The French view of the United States is complex. While the French people view the United States as the sole superpower, the French media often describe the United States as having feet of clay. Hurricane Katrina fueled this sentiment. The French media was both puzzled by and critical of the U.S. government's seeming initial inability to assist Katrina's stream of refugees. Katrina also led to an outpouring of generous support from France, both in terms of the governmental emergency supplies and private and NGO giving.[61]

In France, there is a growing professional and academic interest in the United States. Universities now regularly offer courses in U.S. politics, culture, and foreign policy. Professional organizations, notably the Cercle Jefferson, encourage mutual U.S.-French understanding. The Cercle includes all the former French participants in the State Department's International Visitor program, and seeks to improve understanding and encourage dialogue with their American counterparts in government and the professions.[62]

France's belief in the importance of international institutions is deeply ingrained, a sentiment shared not only by such traditional U.S. allies as Germany and Britain, but learned and accepted as well by the democracies that have emerged from the Warsaw Pact. The United States is in part responsible for this belief. After the Second World War, Washington strongly urged acceptance of international institutions to resolve disputes and manage global financial and economic systems. Since the end of the Cold War, a centerpiece of the policy of three U.S. Administrations has been that central European governments should join NATO, the European Union, and other institutions as a means to ensure stability through closer consultation, joint decision-making, and development of interdependence. Many European governments have embraced these institutions as an antidote to the conflicts of the 20th and 21st centuries.

The controversy over Iraq during the Bush Administration illustrates the divergence between the United States and France over the use of international institutions and military force. Regarding the former, President Bush challenged the U.N. in fall 2002 to meet its responsibilities and enforce the U.N. prohibition on weapons of mass destruction in Iraq. He noted that the difficult tasks undertaken by the U.N., such as those involving the threat or use of military force and the consequent expending of resources, often fell to major governments, such as the United States. The French government, and other allies, were ultimately sympathetic to this argument, and backed a new effort to enforce inspections. When the Bush Administration began to criticize the inspections regime as insufficient several weeks after its inception, France, joined by Germany and several other allies, asked for time, and noted privately that it was Washington, after all, that was supplying much of the information to the U.N. for site inspections. They wished to allow the inspections to run their course. French officials also feared that war in Iraq could trigger unintended consequences, such as

61 "Les Américains consternés par la fragilité de leur puissance," *Le Monde*, September 3, 2005, p. 3; "Hurricane Katrina: French Assistance," doc. supplied by French embassy, September 2005.

62 http://www.cerclejefferson.org.

prolonged conflict or destabilization of neighboring regions, and an expansion of global terrorism.[63]

Differences over Iraq also threatened in early 2003 to disrupt commercial ties with reports of U.S. consumer boycotts of French goods. U.S. companies, too, worried that French and other European consumers might not buy their products as a way of expressing opposition to U.S. policy. Despite public opinion surveys indicating some support for using the marketplace to demonstrate political dissatisfaction, there is little evidence that sales so far have been adversely affected due to the foreign policy discord on either side of the Atlantic.

A complementarity of interests and action in many spheres is likely to continue. For those in Congress and in the executive branch who desire greater European burdensharing in the alliance, ESDP holds at least the possibility of greater military capability among continental allies, a capability that could be used by NATO for conflicts in the region, or in more distant theaters. For those who desire greater contributions by other countries in peacekeeping, or in international financial institutions, French influence and policy often buttress U.S. interests and diminish the need for greater expenditure of U.S. resources. And for those who desire to maintain an open world trading system, French support in the councils of the European Union and World Trade Organization is sometimes critical.

Finally, France and the United States, while sharing values inherent in most democratic societies, will likely continue to have different political perspectives, particularly over the role of international institutions and the use of force. In the past, some critics of France have interpreted instances of disagreement as a desire on the part of France to see the United States fail. However, President Sarkozy has emphatically emphasized his belief that failure of the United States in areas of foreign affairs would have direct implications for France and other European countries. In Iraq, failure of the U.S. effort to bring stability, for example, has potentially great negative consequences for all Europeans: disaffection with U.S. leadership of NATO; a renewal of radical Islam in the Middle East, with regimes hostile to western governments; and further exacerbation of tensions in the Middle East, with unwanted consequences on the European continent.

ACKNOWLEDGMENTS

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[63] Hans Blix, *Disarming Iraq*, New York: Pantheon Books, 2004, p. 156-157, 260-264; Report on "The Future of Transatlantic Security: New Challenges," French American Foundation conference of U.S., French, British, and German officials, December 2002.

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GERMAN FOREIGN AND SECURITY POLICY: TRENDS AND TRANSATLANTIC IMPLICATIONS*

Paul Belkin[1]

ABSTRACT

German Chancellor Angela Merkel took office in November 2005 promising a foreign policy anchored in a revitalized transatlantic partnership. Most observers agree that since reaching a low-point in the lead-up to the Iraq war in 2003, relations between the United States and Germany have improved. U.S. officials and many Members of Congress view Germany as a key U.S. ally, have welcomed German leadership in Europe, and voiced expectations for increased U.S.-German cooperation on the international stage.

German unification in 1990 and the end of the Cold War represented monumental shifts in the geopolitical realities that had defined German foreign policy. Germany was once again Europe's largest country, and the Soviet threat, which had served to unite West Germany with its pro- western neighbors and the United States, was no longer. Since the early 1 990s, German leaders have been challenged to exercise a foreign policy grounded in a long-standing commitment to multilateralism and an aversion to military force while simultaneously seeking to assume the more proactive global role many argue is necessary to confront emerging security threats. Until 1994, Germany was constitutionally barred from deploying its armed forces abroad. Today, approximately 7,400 German troops are deployed in peacekeeping, stabilization, and reconstruction missions worldwide. However, as Germany's foreign and security policy continues to evolve, some experts perceive a widening gap between the global ambitions of Germany's political class, and a consistently skeptical German public.

Since the end of the Cold War, Germany's relations with the United States have been shaped by several key factors. These include Germany's growing support for a stronger, more capable European Union, and its continued allegiance to NATO as the primary guarantor of European security; Germany's ability and willingness to undertake the defense reforms many argue are necessary for it to meet its commitments within NATO and a burgeoning European Security and Defense Policy; and German popular opinion, especially the influence of strong public opposition to U.S. foreign policies during the George W. Bush Administration on German leaders.

President Obama's popularity in Germany suggests that many Germans expect the new U.S. Administration to distance itself from the perceived unilateralism of the Bush Administration. However, some observers caution that public expectations of the new

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* This is an edited, reformatted and augmented version of CRS report RL34199, dated May 20 2009.

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President could be unreasonably high and note that policy differences between the two countries remain. For example, in the face of the global economic slowdown, German leaders on both sides of the political spectrum have resisted calls from the Obama Administration to stimulate economic growth through larger domestic spending measures. In the foreign policy domain, while German officials have welcomed the Obama Administration's strategic review of Afghanistan/Pakistan policy, they have essentially ruled out sending more combat troops or relaxing constraints on those troops currently serving in Afghanistan before German federal elections scheduled for September 2009.

INTRODUCTION

German Chancellor Angela Merkel took office in November 2005 promising a foreign policy anchored in a revitalized transatlantic partnership. Since reaching a low point in the lead-up to the Iraq war in 2003, diplomatic relations between the United States and Germany have improved substantially and the bilateral relationship remains strong. Merkel has distinguished herself as an advocate for strong U.S.-European relations and as a respected leader within Europe and internationally. Despite continuing areas of divergence, successive U.S. Administrations and many Members of Congress have welcomed German leadership in Europe and have voiced expectations for increased German-U.S. cooperation on the international stage.

Merkel is seeking to establish Germany as a U.S. partner on the forefront of multilateral efforts to address global security threats. She has made a concerted effort to improve the tone of U.S.- German diplomacy, emphasizing shared values, and the need for broad U.S.-German, and U.SEuropean cooperation in the face of common security challenges. The Merkel government has sought to increase transatlantic cooperation in areas ranging from economic and trade relations, climate change policy, counterterrorism, and non-proliferation policy, to peacekeeping, reconstruction and stabilization in Afghanistan, the Middle East, Africa, and the Balkans.

Although U.S. and German officials agree that cooperation has increased, some fundamental differences remain. During the Administration of former President George W. Bush disagreement tended to stem from what many Germans perceived as a U.S. indifference to multilateral diplomacy and standards of international law and what some in the United States considered a German, and broader European, inability or unwillingness to take the necessary steps to counter emerging threats. Widespread belief that U.S. policy in Iraq has failed and even exacerbated global security threats appears to have fueled persistently negative German public opinion of U.S. foreign policy and corresponding skepticism of the exercise of military power. That said, strong popular support for President Obama in Germany suggests that many Germans expect the United States to distance itself from the policy agenda of Obama's unpopular predecessor. Observers caution however, that policy differences will remain, and that Berlin could continue to react skeptically to U.S. foreign policy actions it perceives as unilateral and lacking international legitimacy.

CURRENT DOMESTIC CONTEXT

Merkel has led a "grand coalition" government of Germany's two largest political factions, Merkel's Christian Democratic/Christian Social Union (CDU/CSU) and the Social Democratic Party (SPD), since November 2005. This is only the second time in post-war history that the traditionally opposing parties have ruled together.[2] After setting an electoral goal of 40% for September 2005 federal elections, Merkel and the CDU won 35.2% of the vote—barely one percentage point more than the SPD, and three percentage points less than in the 2002 elections. The disappointing electoral showing fueled criticism of Merkel within the CDU. However, publicopinion polls suggest that Merkel has since gained favor with the German public and that the CDU has maintained steady support while the SPD has dropped in popularity.[3]

Observers attribute Merkel's initial and somewhat unexpected popularity to her leadership in foreign policy and to the relatively strong performance of the German economy during the first three years of her term. Merkel gained high marks from her peers within Europe and beyond during Germany's six-month presidency of the EU in the first half of 2007 and its corresponding year-long presidency of the G8 group of industrialized economies. In addition, a rise in GDP growth from just under 1% in 2005 to about 2.5% in 2007 helped bring unemployment down from almost 12% in the first quarter of 2005 to 7.5% in October 2008. More recently, however, the Merkel government has struggled to address a sharp decline in economic growth that began in late 2008 in the context of the global financial crisis. In March 2009, the government revised its January economic forecast for 2009 to predict a 6% contraction in GDP growth for the year (it had announced an expected 2.5% decline in January). Unemployment—at 8.1% in March—is expected to continue rising steadily through 2009. [4]

The rapid decline in German economic performance is the key issue confronting Germany's governing coalition ahead of federal elections scheduled for September 2009. Although most observers expect Merkel's governing "grand coalition" to hold through the election, SPD leaders appear poised to increasingly seek to block CDU policy initiatives in an effort to distinguish the party from its coalition partners. At the same time, Merkel could face calls from within the CDU to take a stronger stand on domestic economic and other policy issues. As one German commentator has lamented, "Neither side can impose its will on the other, resulting in gridlock and crippling Germany's influence in the world."[5]

There is also some indication that the SPD may increasingly challenge aspects of Merkel's foreign policy which have heretofore enjoyed broad bipartisan support. Germany's Foreign Minister and Merkel's opponent in the upcoming elections, Frank-Walter Steinmeier of the SPD, has consistently pursued foreign policy initiatives in unison with Merkel's positions. Nonetheless, differences between the respective parties have emerged on issues such as Turkish membership in the EU, German policy in the Middle East, and more

2 Germany's first grand-coalition government, from 1966-1969, was widely viewed as ineffectual, and many observers have voiced similar expectations for the current government.

3 A May 2009 poll conducted by research institute Forsa indicates a 36% approval rating for the CDU and 26% approval for the SPD. Spiegelonline, die Sonntagsfrage. URL: http://www.spiegel.de/flash/0,5532,17440,00.html

4 "Country Report: Germany," Economist Intelligence Unit, May, 2009.

5 Beste, 'A Recipe for Foreign Policy Impotence," Spiegelonline, May 15, 2008.

drastically, on German policy toward Russia and the United States. With respect to Russia, both coalition parties advocate a "strategic partnership." However, Merkel appears to favor a harder line than the SPD, and has openly criticized Moscow for its treatment of non-governmental organizations and political opponents, and for an increasingly confrontational energy and foreign policy. The SPD is thought to favor a more conciliatory approach to Russia marked by enhanced political and economic engagement.

FOUNDATIONS OF GERMAN FOREIGN POLICY

Much of the criticism in Germany of U.S. foreign policy during the George W. Bush Administration was grounded in perceived U.S. disregard for multilateral diplomacy and standards of international law—both fundamental tenets of German foreign policy. Since the end of the Second World War, German foreign policy has been driven by a strong commitment to multilateral institutions and a deep-rooted skepticism of military power. In the war's aftermath, the leaders of the newly established Federal Republic of Germany (West Germany) embraced integration into multilateral structures as a crucial step toward fulfilling two of the country's primary interests: to reconcile with wartime enemies; and to gain acceptance as a legitimate actor on the international stage. To this end, foreign policy was identified almost exclusively with the Cold War aims of NATO and the European integration project, and a related quest for German unification.

German unification in 1990 and the end of the Cold War represented monumental shifts in the geopolitical realities that had defined German foreign policy. Germany was once again Europe's largest country and the Soviet threat, which had served to unite West Germany with its pro- western neighbors and the United States, was no longer. In the face of these radical changes, and conscious of Germany's newly found weight within Europe and lingering European and German anxiety toward a larger and potentially more powerful Germany, German leaders reaffirmed their commitment to the multilateral process and aversion to military force. The EU, NATO, and the U.N. remain the central forums for Berlin's foreign, security, and defense policy. Despite the deployment of approximately 7,400 German troops in internationally-sanctioned peacekeeping, reconstruction, and stabilization missions worldwide, German armed forces operate under what many consider stringent constraints designed to avoid combat situations.

Since the end of the Cold War, German leaders have been increasingly challenged to reconcile their commitment to continuity in foreign policy with a desire to pursue the more proactive global role many argue is necessary both to maintain Germany's credibility as an ally within a network of redefined multilateral institutions, and to address the foreign and security policy challenges of the post-Cold War, and post-September 11, 2001 era. As one scholar notes, "the tensions, even contradictions, between [Germany's] traditional 'grand strategy'—or foreign policy role concept as a 'civilian power'—and a Germany, a Europe, a world of international relations so radically different from what they had been before 1990 have become increasingly apparent."[6] These tensions are especially apparent in an evolving domestic debate over German national interests.

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[6] Hanns W. Maull, ed. *Germany's Uncertain Power: Foreign Policy of the Berlin Republic*. New York: Palgrave MacMillan, 2006, p. 1.

MULTILATERALISM AS NATIONAL INTEREST

During the Cold War, West German leaders were reluctant to formulate or pursue national interests that could be perceived as undermining a fundamental commitment to the multilateral framework as embodied by the Atlantic Alliance, European Community, and United Nations. West Germany avoided assuming a leading role within these institutions, preferring a low international profile, and seeking to establish a reputation as an "honest broker" with limited interests beyond supporting the multilateral process itself. [7] West German governments did pursue distinct foreign policy goals, chief among them a quest for German unification, but sought to frame these objectives as part of the broader East-West Cold War struggle, rather than as unilateral German interests.[8]

Since unification, German governments have continued to exercise a multilateralist foreign policy. To this end, they have sought to reform and strengthen the EU, NATO, and the United Nations in an effort to improve multilateral responses to emerging security challenges and threats. Through these institutions, Germany pursues a "networked" foreign and security policy focused on intra- and inter-state conflict prevention and settlement, crisis intervention and stabilization, the struggle against international terrorism, and mitigating the proliferation of weapons of mass destruction (WMD). These goals are to be pursued in strict accordance with international law, and with respect for human rights.[9] German politicians and the German public generally express strong opposition to international action that is not sanctioned by a United Nations mandate, or that appears to violate human rights standards and/or international law. German law forbids unilateral deployment of German troops, and requires parliamentary approval for all troop deployments. Although German leaders have traditionally treated energy considerations as distinct from foreign and security policy, energy security goals are playing an increasingly important role in German foreign policy, particularly toward Russia and within the European Union.

GERMANY IN THE EU AND NATO—THE "MIDDLE PATH"

The EU and NATO are the focal points of German foreign and security policy. Since unification, Germany has asserted itself as a driving force behind the EU's enlargement eastward, deeper European integration, increased European foreign policy coordination, and the development of a European Security and Defense Policy (ESDP). As Germany's role within the European Union evolves, its foreign policy is marked by a desire to balance its support for a stronger, more capable Europe, with a traditional allegiance to NATO as the foundation for European security. Chancellor Merkel argues that a more cohesive European foreign, security, and defense policy apparatus will in fact enable Germany and Europe to be

[7] See August Pradetto, "The Polity of German Foreign Policy: Changes since Unification," in Hanns W. Maull, ed., op. cit.

8 West German foreign policy, particularly toward the Soviet Union, at times diverged from the United States and other partners, but never to a degree that it threatened the country's broader commitment to U.S. and NATO policies. In instances of divergence, West German leaders generally sought to quietly influence policy within multilateral institutions rather than openly confront Western allies.

9 See White Paper 2006, op. cit.; and Coalition Agreement CDU, CSU, SPD, November 11, 2005, http://www.bundesregierung.de

more effective transatlantic partners to the United States. Germany consistently supports policies aimed at advancing EU-NATO cooperation. Berlin's dual commitment to the EU and NATO suggests that it is unlikely to advocate what might be perceived as too strong or independent a role for either organization in the foreseeable future, instead seeking what could be called a middle path of cooperation between the two institutions.

GERMANY IN THE UNITED NATIONS

Since joining the United Nations as a full member in 1973, Germany has supported its development as a cornerstone of a German foreign policy grounded in a commitment to international legitimacy. Today, Germany contributes just under nine percent of the regular U.N. budget, making it the third-largest financial contributor to the U.N. after the United States and Japan.[10] For Germany, the U.N. offers a vital framework to determine and implement international law, and a necessary mechanism through which to sanction international peacekeeping and peacemaking efforts, and efforts to reduce world hunger and poverty, and increase sustainable development.

German governments since the end of the Cold War have supported reform efforts aimed at improving the U.N. 's ability to provide timely and robust peacekeeping missions, avert humanitarian disasters, combat terrorist threats, and protect human rights. Many of these efforts have been resisted by some U.N. members, and the consequentially slow pace of U.N. reform has provoked much criticism, including from leaders in the United States.[11] However, Germany continues to view the U.N. as the only organization capable of providing the international legitimacy it seeks in the conduct of its foreign policy.

An early indication of Germany's post-Cold War aspirations to assume greater global responsibilities has been its quest for permanent representation on the United Nations Security Council. Former Chancellor Helmut Kohl first articulated Germany's desire for a permanent U.N. Security Council seat in 1992, and received the backing of the Clinton Administration. Kohl's successor, Gerhard Schröder, intensified calls for a permanent German seat, but failed to gain international support. In what some consider an indication of the Merkel government's decision to soften its tone on the international stage, German officials have ceased publicly calling for a permanent German seat. Nonetheless, German government documents state that "Germany remains prepared to accept greater responsibility, also by assuming a permanent seat on the Security Council," and September 2007 press reports indicated that Merkel asked former- President Bush to support a German bid for permanent Security Council representation.[12]

10 "German Policy in the United Nations," German Federal Foreign Office, March 2004, http://www.auswaertiges-amt.de/diplo/en.

11 For more information on U.N. reform efforts, see CRS Report RL33848, United Nations Reform: U.S. Policy and International Perspectives, by Luisa Blanchfield.

12 White Paper 2006, op. cit. p. 45.; "German chancellor reportedly to lobby Bush for permanent UNSC seat," BBC News, September 27, 2007.

EVOLVING DOMESTIC DEBATE

As global security threats have evolved, particularly since the terrorist attacks against the United States on September 11, 2001, German leaders have pursued a more proactive foreign policy. As recently as the early 1 990s, German forces were understood to be constitutionally barred from operating outside of NATO territory, and the German foreign policy establishment was cautiously beginning to chart a post-Cold War course for the country. Today, approximately 7,400 German troops are deployed worldwide (largely in Afghanistan and the Balkans), and Germany plays a leading role in diplomatic initiatives from the Balkans to the Middle East. However, what some consider too rapid a shift in German security and defense policy has led to a growing debate over German national interests and the most appropriate means to realize them.

German politicians have tended to justify increasing troop deployments and a more assertive foreign and security policy by appealing to a long-standing desire both to be considered a credible global partner, and maintain alliance solidarity. [13] Some argue, however, that a foreign policy built largely on the need to assume a “fair share” of the multilateral burden, and on notions of international legitimacy and credibility, has obscured a lack of domestic consensus on more precisely defined national interests. This has become more apparent as German troops are deployed in riskier missions with less clear limits and mandates, such as in Afghanistan or Lebanon. Increasingly, Germans are questioning whether stated goals of alliance solidarity and credibility are worth the risks associated with military deployment; or, indeed, whether such deployments run counter to other German interests such as a commitment to pacifism. In response, calls for “exit strategies” and a more comprehensive accounting of the goals of German foreign policy have grown.

Some analysts and politicians—primarily in conservative political circles—argue that German leaders should be more willing to justify diplomatic and military engagement as satisfying national interests beyond those defined in the multilateral sphere. Others are skeptical, emphasizing what they see as a continued post-World War II obligation to surrender a degree of German sovereignty to such multilateral institutions, and to avoid any action seen as satisfying unilaterally determined German interests. Germany’s grand coalition government includes proponents on all sides of the debate on national interests. The evolving discussion is likely to increasingly influence German policy within the European Union, the Atlantic Alliance, and the United Nations.[14]

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13 For example, Schröder, in arguing for German engagement in Afghanistan, and Merkel, in arguing for German participation in EU and U.N. missions in Congo and Lebanon, both emphasized Germany’s historic obligation to join efforts sanctioned by NATO, the EU, and U.N. Text of parliamentary debates on these missions available in German at http://www.bundestag.de; see also Kerry Anne Longhurst, Germany and the Use of Force. Manchester: Manchester University Press, 2004.

14 For a more comprehensive assessment of the evolving debate on national interests see Marco Overhaus, “Conceptual Evolution and Domestic Confusion: Germany’s Security and Defense Policy from the Schröder to the Merkel Government.” World Security Institute, Brussels. Policy Briefing number 1, February 2007; and Hanns Maul, ed., op. cit.

GERMANY IN THE EU

Germany's post-World War II and Cold War commitment to the European integration project was grounded in a desire to reconcile with former enemies and spur economic and political development. Since the end of the Cold War, German leaders have used the EU as the primary forum through which to forge a more proactive role for Germany on the international stage. German foreign policy in the early- to mid-1990s was almost singly focused on fostering deeper European integration and EU enlargement to the east. This focus, strongly supported by former President George H.W. Bush, was widely understood as based in a desire to quell fear of a resurgent Germany, and to replicate the benefits of West Germany's post-World War II integration in central and eastern Europe. [15] Europe's inability and/or unwillingness to intervene to stem conflicts in the Balkans in the early- to mid-1990s fueled calls within Germany and other European countries for a collective European foreign, security, and defense policy.

To some analysts, Merkel's predecessor, Gerhard Schröder, embodied a growing German desire to pursue German interests within the EU more assertively. Merkel has continued this trend, also demonstrating a willingness to forge a more proactive role for Germany within Europe. This growing assertiveness has at times put Germany at odds with other EU member states, causing some to question Germany's long-standing commitment to European unity.

As is the case in several other EU member states, German EU policy under Merkel reflects a much tempered enthusiasm for EU enlargement and skepticism of several aspects of European market integration. On the other hand, Germany advocates deeper European integration in areas ranging from climate change policy to police and judicial cooperation, and has assumed an increasingly significant role in Europe's Common Foreign and Security Policy (CFSP) and European Security and Defense Policy (ESDP). Germany was a strong proponent of the proposed EU constitutional treaty rejected by French and Dutch voters in 2005, and Merkel used Germany's EU presidency in the first half of 2007 to forge agreement on the outlines of a new reform treaty aimed at enabling a larger EU to operate more effectively.[16] Finally, some analysts point to personal differences between Merkel and her French counterpart, Nicolas Sarkozy, and to what some perceive as their more pragmatic approaches to EU affairs as evidence of a weakening of the Franco-German partnership long considered the engine of European integration.

15 At the time of German unification, former French President Francois Mitterrand is said to have remarked to U.S. President George H. W. Bush, "I like Germany so much, I think there should be two of them." Former U.K. Prime Minister Margaret Thatcher is also said to have expressed concerns about German unification. See Bush speech at the German Embassy, Washington, DC, October 3, 2006, http://www.germany.info/relaunch /politics/speeches/ 1003 06_Bush.html; see also Ulrike Guerot, "Germany and Europe: new Deal or Deja Vu?" Notre Europe, Studies and Research No. 55, November 2006, http://www.notre-europe.eu

16 For more information on the EU's proposed "constitutional reforms" see CRS Report RS21618, *The European Union's Reform Process: The Lisbon Treaty*, by Kristin Archick.

EU ENLARGEMENT

Germany was an early and strong supporter of the EU's eastern enlargement after the Cold War.[17] This support was based largely on the belief that European integration offered an unparalleled mechanism to spread democratic governance and associated values to Germany's immediate neighbors. While analysts agree that the EU's eastward enlargement satisfied pressing German interests by bringing stability and democracy to its new eastern borders, the benefits of further enlargement are not so clear to many Germans. An ongoing debate on the EU's "absorption capacity" highlights possible German concern both about its potentially decreasing decision- and policy-making power within the Union, and growing public pressure to better define Europe's borders and to reform EU institutions. Calls for curbing further EU enlargement, particularly to Turkey, are especially strong within Merkel's CDU/CSU political group.

Merkel and others in her party have been careful not to explicitly rule out future EU expansion, particularly to the Western Balkans. However, Merkel has advocated more stringent requirements for new membership, and has advanced proposals for alternatives to full EU membership, especially for Turkey, which she argues could help bring some of the desired political and economic stability to non-EU member states within the European "neighborhood."

Germany's position on Turkey's EU accession process highlights the broader domestic debate on enlargement. According to a 2008 survey, 13% of Germans see Turkish accession to the Union as "a good thing."[18] Despite the Schröder government's support of a 2005 EU decision to officially open accession negotiations with Turkey, and despite strong U.S. support for Turkish membership, Merkel and other CDU/CSU members are said to oppose Turkey's entry to the EU.[19] Merkel does not explicitly voice such opposition; but she is viewed as at best skeptical, and has advocated imposing relatively vigilant benchmarks and timetables for Turkey's accession process. Merkel and others in her party have also proposed offering Turkey a "privileged partnership" with the EU as an alternative to full membership. Despite a persistently skeptical public, the SPD supports Turkey's efforts to accede to the EU, and continues to view further EU enlargement favorably.[20]

Disagreement within the governing coalition on Turkey's EU membership suggests that neither party will seek decisive action before the September 2009 elections. Nonetheless, public opinion in Germany and across Europe indicates that any and all future proposed enlargements would be the subject of intense scrutiny and debate.

[17] The Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia joined the EU in May 2004; Bulgaria and Romania in January 2007. For more information on EU enlargement see CRS Report RS2 1344, European Union Enlargement, by Kristin Archick.

[18] "Transatlantic Trends Topline Data 2008," The German Marshall Fund, September 2008, http://www.transatlantictrends.org/trends/index.cfm?id=126

[19] See "Merkel visit to Turkey complicates life at home," *International Herald Tribune*, October 4, 2006; "Merkel presses Turkey over Cyprus," *BBC News*, October 5, 2006.

[20] A May 2007 *Eurobarometer* survey reports that 34% of Germans favor further EU *enlargement. This is 8% less than in 2005. See Eurobarometer 67, June 2007, http://ec.europa.eu/public_opinion /index_en.htm.*

COMMON FOREIGN AND SECURITY POLICY (CFSP) AND RELATIONS WITH RUSSIA

German leaders have supported and increasingly sought to influence the development of the Union's evolving Common Foreign and Security Policy (CFSP). In some areas, for example Middle East policy, Germany's growing role has been welcomed both within Europe and by the United States. In others, such as relations with Russia, Germany's position has elucidated and even inflamed disagreements within the Union. Although it continues to emphasize the importance of EU-wide consensus on foreign policy issues, Berlin has exhibited what some consider a growing willingness to pursue independently defined foreign policy interests both within and outside the EU framework, even at the expense of European or transatlantic unity.

Germany's pursuit of close bilateral relations with Russia has prompted some analysts to question Berlin's commitment to fostering European unity in foreign and security policy matters. Close German-Russian relations have their modern roots in the 1960s and 1970s when German leaders increased diplomatic and economic engagement with the Soviet Union and other Eastern Bloc countries in an effort to improve relations with and conditions in East Germany. Since the end of the Cold War, Germany has consistently sought to ensure that Russia not feel threatened by EU and NATO enlargement. Germany continues to prioritize relations with Russia. Today, Germany is Russia's largest trading partner, and relies on Russia for close to 40% of its natural gas and 30% of its crude oil needs.[21]

Some argue that Germany's dependence on Russian energy resources and its pursuit of bilateral agreements to secure future energy supplies has threatened broader European energy security and undermined the EU's ability to reach consensus on energy matters. The EU's newer member states in central and eastern Europe have been especially critical. Polish, Lithuanian, and other leaders take particular aim at a German-Russian gas pipeline agreement negotiated by former Chancellor Schröder, and point to Russia's subsequent manipulation of gas and oil supplies flowing to Europe in early 2006, 2007, and 2009 as evidence of Russia's ability to use its energy wealth to divide Europe.[22]

Since taking office, Merkel has made a concerted effort to improve ties with Germany's eastern neighbors, seeking, among other things, to reassure them that Germany's close bilateral relations with Russia should not be viewed as a threat to European unity or security. While most have welcomed Merkel's efforts, German-Polish relations have been marked by disagreement on a variety of issues, including Germany's close ties to Russia.[23] Merkel advocates a "strategic partnership" with Russia—both for Germany and the EU—based on mutual trust and cooperation. Negotiating a new EU-Russia Partnership and Cooperation Agreement was one of Germany's primary goals during its EU presidency in early 2007. However, Merkel allowed negotiations to collapse in May 2007 when faced with strong Polish opposition, and apparent Russian intransigence. Some observers and eastern European

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[21] On average, EU member states import about 30% of their natural gas and 25% of their oil from Russia.

[22] Within three months of leaving office in 2005, Schröder accepted a position with Russian energy concern Gazprom as board chairman of Nord Stream AG, the German-Russian gas pipeline project he negotiated while in office. For more information see, "Schröder joins Gazprom pipeline group," *Financial Times*, December 9, 2005; and "Schröder's New Gig Causes Trouble at Home," *Stratfor*, March 30, 2006.

[23] For more information on Poland see CRS Report RS228 11, *Poland's New Government: Background and Issues for the United States*, by Carl Ek.

leaders took this as an important affirmation of Merkel's commitment to European unity in foreign policy.[24]

As noted earlier, Merkel is seen by some as taking a harder line on Russia than her predecessor Schröder, a position attributed at least in part to her East German background. Nonetheless, divisions within Germany's governing coalition over how to engage Russia, and the strong historical, economic, and energy ties between the two countries lead analysts to suggest that Germany is likely to continue to seek what could become an increasingly tenuous middle path between Russia and some of the EU's newer member states.[25]

German leaders on both sides of the governing coalition continue to affirm their commitment to a strong CFSP. Germany has played a leading role in forging a common EU approach to a range of international issues, including the question of Kosovo's future status, the Israeli-Palestinian conflict, the Iranian nuclear program, and policy in Africa and central Asia. In advocating common EU positions on these and other issues, Germany emphasizes the importance of EUwide consensus, at times demonstrating a willingness to alter national goals for the sake of European unity. However, Germany's pursuit of bilateral energy agreements with Russia signals what could be considered both growing assertiveness within Europe in certain areas, and frustration with what many consider a cumbersome EU foreign policy-making apparatus.

European Security and Defense Policy (ESDP)

Germany has become a strong supporter of a European Security and Defense Policy (ESDP) as a means for EU member states to pool defense resources and work collectively to counter emerging security threats. German and European backing for ESDP arose during the mid-1990s as Europeans proved unable and/or unwilling to respond militarily to conflicts in the Balkans. German support has grown since the terrorist attacks of September 11, 2001, and is increasingly driven by an emphasis on boosting civilian crisis management and police training capacity. Germany contributes military and civilian personnel to ESDP missions in Bosnia, Kosovo, the coast of Somalia, and Afghanistan, four of 12 civilian crisis management, police, and military operations currently overseen by the EU.[26] Germany has also committed troop support for four of the EU's 13 new rapid-response Battlegroups, each made up of roughly 1,500 soldiers ready for deployment within 10 days of an EU decision to launch operations.[27]

Merkel is particularly careful to cast ESDP as a complement to, not substitute for, NATO. To this end, Germany has advocated formal agreements between NATO and the EU

[24] "Europe and Russia: the Divorce?" *Spiegelonline*, May 18, 2007; "German rebuke sets up tense EU-Russia summit," *EU Observer*, October 5, 2007; "Estonia urges EU to defend small countries against Russia," *EU Business*, July 11, 2007.

25 Ibid.; Mitchell, op. cit. "Talking with Russia—or Not," Spiegelonline, May 21, 2007.

26 EU police training and border crossing missions in the Palestinian territories, and a police training mission in Iraq each consist of fewer than 100 personnel. The police training mission launched in Afghanistan under German leadership in June 2007 is to consist of up to 200 police trainers. For more information on ESDP and ESDP missions, see http://www.consilium.eu.int/cms3_fo/showPage.asp?id=268andlang=EN.

[27] As of January 2007, the EU has the capacity to conduct two concurrent Battlegroup operations. For more information see "Factsheet: EU Battlegroups," EU Council Secretariat, February 2007, http://www.c onsilium.europa.eu/cms3_fo/ showPage.asp?id= 261andlang=en.

aimed at preventing the duplication of NATO structures, such as the so-called “Berlin Plus” agreement, which allows the EU to use NATO assets and capabilities for EU-led operations in which, “the alliance as a whole is not engaged.”[28] Nevertheless, some U.S. critics (including some Members of Congress) remain concerned that ESDP could ultimately usurp NATO’s role and weaken U.S. influence in Europe.

EUROPEAN LEADERSHIP AND FRANCO-GERMAN RELATIONS

A historically strong Franco-German partnership has widely been considered the driving force behind European integration. As two of the EU’s largest and most prosperous member states, Germany and France continue to work closely to advance joint interests within the EU. However, the EU’s eastward expansion over recent years has both diminished collective Franco-German decision-making power within the Union and compelled Merkel to shift diplomatic focus to managing relations with Germany’s eastern neighbors. In directing German EU policy eastward, Merkel reportedly hopes to improve Germany’s relations with newer member states. Many analysts believe that Schröder’s and former French President Jacques Chirac’s pursuit of stronger relations with Russia, and their criticism of those EU member states that supported the 2003 U.S.- led invasion of Iraq, fueled harmful divisions between what former Secretary of Defense Donald Rumsfeld once famously dubbed “old” and “new” Europe.[29]

Merkel and French President Sarkozy espouse what many consider a highly pragmatic approach to EU policy. As German policy within the EU has become more focused on its eastern borders, France has sought to invigorate EU policy in the Mediterranean. While both appear eager to implement economic reforms aimed at increasing Europe’s global competitiveness, each has also displayed a willingness to protect national interests and industries, especially in the energy sector. Merkel and others in her government have expressed particular concern about Sarkozy’s reported desire to increase political governance of EU economic policy, and of his plans to introduce domestic tax cuts, which would likely prevent France from meeting EU-wide deficit-reduction targets.[30] Merkel and Sarkozy’s efforts to forge a common European response to the global financial crisis and the related economic downturn have had mixed results. While both continue to pursue tailored national responses to the crisis, they have united to advocate enhanced international regulation of global financial markets.

Analysts and European diplomats cite these policy differences as evidence of the decreasing influence a Franco-German partnership will have within an EU of 27 or more member states. Others note that Merkel and Sarkozy’s more pragmatic approach to the Union and their emphasis on increasing the EU’s economic competitiveness, and fostering a more outward-looking EU could present an opportunity for improved relations with the United Kingdom (U.K), and its leader Gordon Brown. Brown, Merkel, and Sarkozy are often touted as a new generation of European leaders with the potential to reinvigorate the EU politically

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28 For more information on ESDP and EU-NATO links see CRS Report RL32342, NATO and the European Union, by Kristin Archick and Paul Gallis.

29 Guerot, op. cit.

30 “Sarkozy ist von Merkel genervt,” Spiegelonline, September 11, 2007; “Sarkozy faces clash with EU partners over economic policy,” EU Business, July 7, 2007.

and economically. However, while they appear to share an enthusiasm for a more dynamic Union, differences on specific policy issues, including enlargement, economic liberalization, and constitutional reform could ensure that long-standing divisions between Germany and France and the traditionally more Euroskeptic U.K. persist.

EVOLVING SECURITY AND DEFENSE POLICY

Perhaps the most profound change in German foreign and security policy since the end of the Cold War is Germany's deployment of troops outside NATO territory for the first time since World War II.

Since a 1994 Constitutional Court ruling enabled German leaders to deploy troops abroad, Germany has participated in a number of U.N.- and NATO-sanctioned combat, peacekeeping, reconstruction and stabilization missions, and today, approximately 7,400 German soldiers are deployed in missions ranging from NATO's stabilization force in Afghanistan (ISAF) to the U.N. Mission in Lebanon (UNIFIL). However, Germans are increasingly questioning the grounds for what many believe has been too rapid a shift in German defense policy. One German security policy expert categorizes the evolving defense policy debate as evidence of "a widening gap between Germany's institutional commitments and official defense posture, and the country's readiness to deal with the practical military consequences of these developments."[31] Some observers point out that while German politicians have consistently voiced support for more robust collective European and NATO defense capabilities, budget allocations in the foreign and defense policy sectors have decreased by about 40% in real terms since their peak in the late 1980s.[32]

In the early 1 990s, public opposition and constitutional constraints prevented Germany from offering more than financial support to multilateral combat and peacekeeping efforts in the Persian Gulf and in the Balkans. Germany's inability to deploy troops to missions supported by many of its leaders led to the landmark 1994 Constitutional Court ruling, which determined that German troops could be deployed abroad, but only under a U.N. mandate and with the prior approval of the German parliament. This paved the way for Germany's participation in its first combat mission since the Second World War—NATO's 1999 air campaign to prevent ethnic cleansing in Kosovo.[33] Considerable domestic opposition to German participation in the Kosovo mission was based largely on the contention that Germany's history obligated it to refrain from all military intervention. In response, then German Foreign Minister Joschka Fischer, a member of the traditionally pacifist Green Party, successfully argued that German history, in fact, obligated Germany *to* intervene—militarily, when necessary—to stop atrocities similar to those perpetrated by Germany during the Second World War. Fischer's argument set the precedent for Germany's growing participation in so-called humanitarian interventions, mostly in the form of U.N. and NATO peacekeeping and reconstruction and stabilization missions, worldwide.

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[31] Overhaus, op. cit.

[32] See Hanns Maull, in Hanns Maull ed. op. cit., p. 4; and Michael Zuern, "Edel, hilfreich—nicht gut," *Die Zeit*, January 4, 2007.

[33] That NATO's 1999 air campaign against Serbia lacked a U.N. mandate caused considerable dispute as to the legal basis for Germany's involvement. The U.N.'s subsequent endorsement of NATO's peacekeeping mission, KFOR, resolved remaining challenges.

Current German Troop Deployments*

Afghanistan/ Uzbekistan (NATO - ISAF)	3,730 soldiers
Coast of Somalia – anti-piracy (EU – NAVFOR – ATALANTA)	840
Kosovo (NATO - KFOR)	2,210 soldiers
Lebanon (U.N. - UNIFIL)	220 soldiers
Bosnia Herzegovina (EU - EUFOR)	130 soldiers
Djibouti/Horn of Africa (*Operation Enduring Freedom*)	110 soldiers
Sudan (U.N. - UNMIS)	34 soldiers
Mediterranean (NATO - Active Endeavor)	30 soldiers
Georgia (U.N. - UNOMIG)	12 soldiers
TOTAL	7,316
* As of April 30, 2009	

Source: German Ministry of Defense.

Today, Germany's global threat assessments mirror those of many of its EU and NATO partners, including the United States. The government identifies terrorism, proliferation of weapons of mass destruction (WMD), regional conflicts and failed states, transnational crime, energy security, migration, and epidemics and pandemics as the primary security threats facing Germany and its EU and NATO allies. However, Germany's approach to countering these threats has at times been perceived to be at odds with U.S. policy. Germany highlights the importance of a multilateral approach within the confines of a strengthened system of international law. Germany's 2006 *White Paper* on security policy emphasizes the importance of non-military means to combat threats to security, arguing for a strong civilian role in all aspects of defense policy. While Germany views terrorism as a primary threat, it has never referred to a war on terrorism, and underscores the need to address root causes of terrorism through development and other policies. The government does not completely rule out military engagement to combat terrorism, but does downplay this option.

GERMANY IN NATO

The Merkel government's 2006 White Paper on security policy asserts that "the transatlantic alliance remains the bedrock of common security for Germany and Europe. It is the backbone of the North Atlantic Alliance, which in turn is the cornerstone of German security and defense policy."[34] Along with the United States, Germany was one of the first proponents of NATO expansion as an initial step in the Alliance's post-Cold War transformation. Since then, Germany has backed efforts to transform the Alliance to respond to post-Cold War and post-September 11, 2001 global security threats and engage in "out-of-area" missions. German policy within NATO and its relations with its NATO allies are influenced by several factors which have caused, and may continue to cause, tension within the Alliance. One factor concerns U.S. leadership within NATO, and the degree to which the United States, Germany, and other European allies continue to share a strategic and operational vision for the Alliance. A second factor concerns Germany's ability to undertake the security and defense policy reforms many, particularly in the United States, believe are necessary for Germany to meet its commitments to an evolving alliance that is expected to increasingly engage in "out-of-area" missions.

Approximately 3,500 German troops are deployed to NATO's International Security Assistance Force (ISAF) in Afghanistan, and about 2,200 soldiers serve in NATO missions in Kosovo and the Mediterranean Sea. German participation in ISAF—NATO's largest and most significant mission—has sparked considerable domestic debate over national defense policy, and has fueled tension between Germany and some of its NATO allies. German forces in Afghanistan are engaged almost exclusively in stability operations in the northern part of the country. Germany is the lead nation for Regional Command North (RC-N), commands a forward support base in Mazar-E-Sharif, and leads two PRTs, one in Kunduz and one in Feyzabad. Since July 2008, Germany has also staffed RC-N's 200-man Quick Reaction Force, intended to provide reinforcement in emergency combat situations. Since 2007, six German Tornado aircraft have been used for country-wide surveillance operations. In April 2009, Germany announced plans to send a temporary deployment of an additional 600 troops to northern Afghanistan in preparation for August 2009 elections (the current parliamentary mandate governing Germany's engagement in Afghanistan authorizes a maximum troop deployment of 4,500).

Despite having the third largest troop contingent in Afghanistan, Germany has faced pointed criticism, particularly from the United States, for "national caveats" which prevent its soldiers from being deployed to Afghanistan's more dangerous southern region.[35] German forces are authorized to engage in combat operations as part of their defense of the northern sector but they have reportedly been reluctant to conduct combined combat operations with their Afghan partners. The German response is generally twofold. First, German officials claim that strong public opposition to military engagement and to U.S. policies in Afghanistan leave legislators no other choice but to impose operational caveats on their forces. Second, German officials increasingly claim that NATO is overly focused on military action and must devote more resources to civilian reconstruction.[36]

To this end, German officials have welcomed the Obama's Administration's renewed focus on Afghanistan and are particularly encouraged by the Administration's regional approach – especially its emphasis on Pakistan and its apparent willingness to engage Iran in discussions of the mission – and by its emphasis on improving civilian capacity- and

34 White Paper 2006, op. cit.

35 For more information on "national caveats," and NATO in Afghanistan, see CRS Report RL33627, *NATO in Afghanistan: A Test of the Transatlantic Alliance*, op. cit.

36 "Berlin Mulls Limits to Afghanistan Mandate," *Spiegelonline*, July 2, 2007; "Tornados in Afghanistan, Political Twisters in Germany," *Spiegelonline*, July 4, 2007.

institution-building efforts, and economic development in Afghanistan. On the other hand, there is some concern in Germany that significant U.S. troop increases and a continued reluctance in many allied countries to increase troop contributions to ISAF could lead to an "Americanization" of the mission that may limit allied influence in decision-making (for more information on German engagement in Afghanistan, see Appendix A).[37]

Some in Germany argue that U.S. policy in Afghanistan indicates a broader U.S. reluctance to view NATO as a credible collective security mechanism. In particular, critics cite the U.S. decision to lead an initial "coalition of the willing" in Afghanistan in 2001—despite the invocation of NATO's Article 5 collective defense clause—as evidence that the United States prefers to use NATO as a tool box through which to realize independently defined U.S. interests, rather than as a legitimate multilateral forum to define interests collectively.[38] Some analysts and U.S. officials counter that the United States has essentially been forced to rely on "coalitions of the willing" because many of its NATO allies, including Germany, lack the military capacity to justify NATO- rather than U.S.-led missions.

Germany has backed NATO efforts to reassess the Alliance's collective defense strategy and to develop the capacity to more effectively respond to emerging threats. In signing on to the Alliance's 1999 Defense Capabilities Initiative (DCI) and 2002 Prague Capabilities Commitment (PCC), Germany committed to focus national defense procurement practices on specifically defined areas, including strategic air and sea lift. Most agree that meeting these commitments will require Germany and other allies to increase overall defense spending, modernize procurement priorities and procedures, and reduce personnel costs. However, German defense spending has declined steadily since 1991, and by most accounts, Germany has been slow to realign its spending priorities to reflect its NATO commitments. NATO's agreed-upon defense spending target for Alliance members is 2% of GDP. While the NATO average is about 2.2%, German defense spending in 2006 represented about 1.4% of GDP.[39]

FORCE TRANSFORMATION AND *BUNDESWEHR* REFORM

The changing security environment of the post-Cold War and post-September 11, 2001 era has fueled calls for military modernization and structural defense reform. As a condition of the 1990 "Two plus Four Treaty" between the post-World War II occupying powers (France, Great Britain, the Soviet Union, and the United States) and West and East Germany, which restored Germany's full sovereignty over security matters, Germany agreed to reduce its total troop numbers from 500,000 to under 370,000. Since then, Germany has sought to transform its defense forces in order to meet NATO and ESDP targets—specifically, to be

37 Interviews of European officials, December 2008 – March 2009.

38 On September 12, 2001, Germany joined its NATO allies in moving to invoke NATO's Article 5 collective defense clause; in November, 2001 German Chancellor Schröder received parliamentary approval to make up to 3,900 German troops available to the U.S.-led Operation Enduring Freedom. Opposition to the U.S. decision to lead a "coalition of the willing" outside the NATO framework compelled Schröder to tie the parliamentary vote to a vote of confidence in his government. See Longhurst, op. cit. pp. 82-90; interviews of NATO and German officials, December 2006, and May 2007.

39 Overhaus, Op. Cit; Stephen Szabo, "The German Defense White Paper," American Institute for Contemporary German Studies (AICGS), December 2006; "Redefining German Security: Prospects for Bundeswehr Reform," American Institute for Contemporary German Studies (AICGS), September 2001; Proceedings of

able to contribute to the NATO Response Force (NRF) and EU Battlegroups.[40] To meet these goals, Germany aims to reform its force structure to include 35,000 troops for high intensity, short duration crisis intervention operations; 70,000 for longer duration crisis stabilization operations; and support forces of 147,500. According to the 2006 White Paper on security policy, such a restructuring could enable Germany to expand its current deployment capabilities to simultaneously deploy 14,000 troops in two larger scale or five smaller scale operations. As mentioned above, about 7,400 troops are currently deployed worldwide.

Observers generally commend Germany's stated intention to transform its military to meet EU, NATO and U.N. commitments, but point to substantial gaps between stated goals and actions taken. Other than to say "there is no room for further reductions in spending," Germany's 2006 White Paper does not address funding mechanisms. German government officials have long appeared skeptical about the prospects for meaningful increases in defense spending. Some express confidence, however, that a realignment of spending priorities and increased EU-wide cooperation could bring the country closer to realizing its defense priorities.[41]

In addition to stagnant defense spending, many security policy experts, including members of a 2000 high-level commission on Bundeswehr reform, argue that Germany's continued adherence to mandatory military service, or conscription, represents a significant impediment to meaningful reform. These critics call for a voluntary, fully professional force, arguing that the constraints placed on conscripts—they can only be deployed abroad on a volunteer basis—lead to significant operational deficiencies in the armed services. While conscription is suited for defense of national territory, they argue, it impedes Germany's ability to meet its peacekeeping and stabilization obligations abroad by wasting scarce financial resources to fulfill outdated security goals. In 2000, the government reduced the number of conscripts from 130,000 to about 70,000. However, support for conscription remains strong among members of the CDU and some in the SPD.

Strong CDU support, based largely in a historically-rooted anxiety about the dangerous potential of a professional army like Hitler's Wehrmacht, indicates that reforms are unlikely during the remainder of Merkel's term. However, the SPD has joined Germany's opposition parties in calling for at least a partial end to conscription.[42]

TRANSATLANTIC IMPLICATIONS

For some, the end of the Cold War, Germany's growing assertiveness within the European Union and corresponding enthusiasm for European integration, and more recently, German opposition to the 2003 U.S.-led war with Iraq, all symbolize increasing divergence in U.S.-German relations. However, the countries continue to cooperate in pursuit of common foreign and security policy goals, and share robust bilateral investment and trade relations.

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the AICGS conference, "German Security Policy: Assessing the 2006 White Paper on German Security Policy and the Future of the Bundeswehr." Washington, DC, July 10, 2007. Available at http://www.aicgs.org.

40 The NRF is a rapid response force of up to 25,000 NATO troops able to deploy to Article 5 (collective defense) or non-Article 5 crisis response operations within five days' notice. It was created as the result of a 2002 proposal by former U.S. Secretary of Defense Rumsfeld. For more information, see http://www.nato.int/issues/nrf/index.html.

41 Interviews of German government officials, November 2006 - May 2007.

Under Merkel's leadership, Germany seeks to bolster U.S.-German and U.S.-EU trade and investment ties, and works closely with the United States on counterterrorism policy, and on a range of foreign policy issues. U.S. Administration officials and many Members of Congress have welcomed the Merkel government's commitment to a foreign and security policy anchored in NATO and the transatlantic relationship, and have expressed confidence in Merkel's ability to improve U.S.- German and U.S.-European cooperation on the world stage. U.S.-German bilateral relations remain strong, anchored not only by deep economic ties, but by a shared commitment to democratic values. Germany, the European Union, and the United States share similar global security threat assessments, and cooperate closely to mitigate these threats, whether in the struggle against international terrorism, through NATO efforts to combat the Taliban and strengthen the Afghan government, or in pursuit of a two-state solution to the Israeli-Palestinian conflict.

Looking forward, several overarching features of Germany's evolving foreign and security policy stand to shape U.S.-German relations. These include Germany's commitment to international institutions, international law, and the multilateral framework; its deep-rooted aversion to the exercise of military force; and a potentially widening gap between the foreign policy ambitions of some in Germany's political class and the German public. In addition, ongoing domestic debate over approaches to German national interests and what many consider too rapid a shift in defense policy could increasingly influence German foreign and security policy decisions.

German politicians have questioned, and at times openly opposed, aspects of U.S. foreign and security policy they view as lacking multilateral legitimacy, and/or as being overly dependent on the exercise of military force. On Middle East policy, for example, Merkel urged former President George W. Bush to diplomatically engage the leaders of Syria and Iran in order to initiate a region-wide effort to address the Israeli-Palestinian dispute and the future status of Iraq.

Germany's strong commitment to a unified international front in dealing with Iran suggests it is more willing to accept compromises in exchange for Security Council unanimity than to support unilateral measures in the face of Chinese or Russian opposition. As U.S., German, and European leaders consider increased cooperation to stem global security threats and to promote stability, democracy, and human rights in regions from Africa to central Asia, Germany will likely continue to uphold its commitment to the multilateral process. Germany has called on U.S. leaders to enhance U.S. multilateral engagement and has consistently urged U.S. Administrations to join the International Criminal Court and U.N.-sanctioned climate change treaties such as the Kyoto Protocol. German officials appear encouraged by the Obama Administration's apparent willingness to boost U.S. multilateral engagement and to reconsider the U.S. position on some multilateral treaties and agreements.

Recent developments suggest that German leaders will remain both reluctant and hard-pressed to justify increased German military engagement abroad to a persistently skeptical public, even within a NATO or EU framework.[43] Germany's 2006 White Paper on national security indicates that Germany could increasingly emphasize the importance of civilian components to multilateral peacekeeping, stabilization and reconstruction missions, and that it

42 Hugh Williamson, "Berlin moves to scrap conscription," Financial Times, August 20, 2007.

43 The German Marshall Fund of the United States' 2008 Transatlantic Trends survey reports that 20% of Germans agree that "under some conditions, war is necessary to obtain justice." Transatlantic Trends Topline Report, September 2008, http://www.transatlantictrends.org.

will work within NATO and the EU to bolster such capacities. At the same time, trends in German defense spending, and the relatively slow pace of German defense reform highlight what many consider a notable discrepancy between articulated foreign policy goals and action taken to realize these goals.

Germany's ongoing debate on military participation in Afghanistan has exposed a lack of domestic consensus on the goals and limits of German foreign and security policy. Specifically, Germans appear wary of linking reconstruction and development efforts with combat operations. Until now, Merkel and the Bundestag have argued that German participation in Afghanistan be focused on reconstruction and stabilization efforts. However, as the distinction between development work and combat operations becomes increasingly unclear, especially under unstable security conditions, Germans have begun to re-examine the nature and effect of German military engagement both in Afghanistan and elsewhere. Ensuing calls for a reassessment of the grounds for and rules of military engagement stand to further shape Germany's ability to partner with its allies in multilateral missions worldwide.

Germany appears poised to continue to seek a "middle path" between NATO and the EU, promoting the development of an independent European foreign and defense policy as a complement, rather than counterweight to NATO. Successive U.S. Administrations have supported ESDP as a means to enhance European defense capability and interoperability, but Washington has also insisted that EU defense policy be tied to NATO. To this end, U.S. leaders have welcomed Merkel's renewed emphasis on NATO-EU links. While Germany remains committed to NATO as the pillar for European security, some Germans have questioned the U.S. commitment to NATO, and a perceived U.S. preference to pursue independently defined national interests within the Alliance rather than to define and pursue the collective interests of the Alliance.

Domestic political considerations and German public opinion could continue to play a key role in shaping U.S.-German relations, especially ahead of Germany's scheduled federal elections in 2009. President Obama's popularity in Germany suggests that many Germans expect the new U.S. Administration to distance itself from the perceived unilateralism of the unpopular George W. Bush Administration. However, some observers caution that public expectations of the new President could be unreasonably high and note that policy differences between the two countries remain, particularly in areas where public opposition is high. For example, in the face of the global economic slowdown, German leaders on both sides of the political spectrum have resisted calls from the Obama Administration to stimulate economic growth through larger domestic spending measures. In the foreign policy domain, while German officials have welcomed the Obama Administration's strategic review of Afghanistan/Pakistan policy, they have essentially ruled out sending more combat troops or relaxing constraints on those troops currently serving in Afghanistan before the fall elections.

Appendix A. Selected Issues in U.S.-German Relations—Current Status

Economic Ties

Germany's export-based economy is the world's third largest and Europe's largest.[44] The United States is Germany's second largest trading partner with two-way trade in goods totaling $144 billion in 2007. U.S. exports to Germany in 2007 were worth about $50 billion, consisting primarily of aircraft, and electrical and telecommunications equipment. German exports to the United States—primarily motor vehicles, machinery, chemicals, and heavy electrical equipment—totaled about $94.5 billion in 2007. The United States is the number-one destination for German foreign direct investment (FDI); 11.5% of all U.S. FDI is in Germany. U.S. firms operating in Germany employ approximately 800,000 Germans, and an estimated 670,000 Americans work for German firms in the United States.

Like the United States, Germany is experiencing a relatively sharp decline in economic growth. Germany's export-based economy is expected to contract 6% in 2009, and unemployment has been slowly but steadily rising since the end of 2008. However, although U.S.-German economic and trade ties remain strong, the global financial crisis and ensuing economic downturn have exposed U.S.-German differences on the cause of and the appropriate response to the crisis. U.S. officials and some observers have argued that Germany was late in recognizing the degree to which the German economy would be affected by the global financial crisis, and that it has not moved aggressively enough to spur domestic economic growth since acknowledging the domestic effects of the crisis. German officials counter that they have taken substantial action to stimulate their economy—measures which they value at upwards of $100 billion for 2009 and 2010, including the effect of so-called "automatic stabilizers" guaranteed by Germany's social welfare programs. Moreover, they have argued that such domestic spending measures will do little to address the root of the problem, which they tend to view as inadequate regulation of global financial markets.

Counterterrorism Cooperation

Most observers consider U.S.-German cooperation in the fight against terrorism to be close and effective. Since discovering that three of the hijackers involved in the September 11, 2001 attacks on the United States lived and plotted in Germany, the German government has worked closely with U.S. and EU authorities to share intelligence. Germany has identified radical Islamic terrorism as a primary threat to its national security, and has passed a number of laws aimed at limiting the ability of terrorists to live and raise money in Germany.[45] In June 2007, Germany's Interior Minister Wolfgang Schäuble (CDU) proposed a series of domestic counterterrorism initiatives including for increased computer surveillance, and domestic military deployment in the event of a terrorist attack. Schäuble's proposals have

[44] Information in this paragraph from U.S. Department of State, "Background Note: Germany," December 2008.

45 See CRS Report RL33573 , European Approaches to Homeland Security and Counterterrorism, by Kristin Archick et al.

sparked considerable debate in Germany, where personal privacy and individual civil liberties are strictly guarded, and where domestic military deployment is barred by the constitution.

Domestic support for Schäuble's proposals appears to have increased following the September 2007 arrest of two German citizens and a Turkish resident in Germany accused of plotting what German investigators say could have been one of the deadliest attacks in European postwar history. According to German and U.S. intelligence officials, the suspected terrorists planned to target the Frankfurt airport and other locations frequented by U.S. citizens. German authorities are reported to have collaborated closely with U.S. intelligence agencies in foiling the plot, with then-Homeland Security Secretary Michael Chertoff saying that intelligence cooperation between the two countries is "the closest it's ever been."[46] Discovery of the September 2007 terrorist plot has elevated concern in Germany about the possibility of future attacks, with some predicting greater support for antiterrorism measures as proposed by Merkel and Schäuble. At the same time, others see the planned attack as designed to raise pressure for a pullout of German troops from Afghanistan, and expect calls for an end to German engagement in that country to increase.[47]

German officials are encouraged by the Obama Administration's reported shift away from the designation "Global War on Terror." Germany has never considered its counterterrorism policies part of a war effort and refer rather to a "struggle against international terrorism." German officials stress the importance of multilateral cooperation and adherence to international law in combating terrorism. Like the United States, Germany advocates a comprehensive U.N. antiterrorism convention. Germany has welcomed President Obama's decision to close the U.S. prison for terrorist suspects at Guantanamo Bay, Cuba, which it views as violating rights guaranteed to "prisoners of war" under the Geneva Conventions. However, a reported May 2009 request from the Obama Administration asking Germany to house nine detainees – reportedly all Uighurs originally from central and western China – scheduled to be released from Guantanamo Bay appears to be causing concern within the German government. According to press reports, some German officials are reluctant to accept the detainees for fear of inciting a diplomatic dispute with the Chinese government, while others fear that the individuals could pose security risks.[48] On the other hand, German politicians have indicated their desire to assist the Obama Administration with an effort they have long advocated.

German and European parliamentary investigations into alleged CIA "renditions" of German nationals suspected of membership in terrorist organizations have sparked calls in Germany for a re-examination of U.S.-German counterterrorism cooperation. In January 2007, the District Attorney's office in Munich issued arrest warrants for 13 suspected CIA operatives alleged to have abducted German citizen Khaled al-Masri in Macedonia in 2003, and to have subsequently imprisoned and tortured him in Afghanistan.49 German officials claim to have been unaware of the Al-Masri abduction. However, related investigations

46 See Simone Kaiser, Marcel Rosenbach, and Holger Stark, "How the CIA Helped Germany Foil Terror Plot," Spiegelonline, September 10, 2007.

47 Judy Dempsey, "Plot seen as pressure to pull out of Afghanistan," International Herald Tribune, September 7, 2007.

48 "A Worrying List from Washington," Spiegel Online, May 12, 2009.

49 The German government has since decided not to pursue the arrest warrants, announcing in September 2007 that it will not seek extradition of the American suspects.

suggest that high-level German officials were aware of the alleged post-September 11, 2001 CIA abduction and subsequent imprisonment of German citizen Mohammed Haydar Zammar and German-born Turkish citizen Murat Kurnaz.[50]

THE MIDDLE EAST[51]

Germany, along with other European countries, believes the Israeli-Palestinian conflict lies at the root of many of the challenges in the Middle East. Merkel has promoted continuity in a German Middle East policy based on a commitment to protect Israel's right to exist; support for a two- state solution to the Israeli-Palestinian conflict; a commitment to a single EU-wide framework for peace; and a belief that U.S. engagement in the region is essential. Germany has been active in international negotiations aimed at curbing Iran's nuclear ambitions and, despite continuing to rule out a German troop deployment to Iraq, Berlin has provided funded some Iraqi reconstruction efforts and participated in efforts to train Iraqi security forces.

RELATIONS WITH ISRAEL AND THE ISRAELI-PALESTINIAN CONFLICT

Germany, along with the United States is widely considered one of Israel's closest allies. Germany is Israel's second largest trading partner and long-standing defense and scientific cooperation, people-to-people exchanges and cultural ties between the countries continue to grow. While distinguishing itself as a strong supporter of Israel within the EU, Germany has also maintained the trust of Palestinians and other groups in the region traditionally opposed to Israeli objectives. Germany has been one of the largest country donors to the Palestinian Authority (PA), and in June 2008, hosted an international conference to raise funds to bolster PA President Mahmoud Abbas' emergency government in the West Bank. At the request of the Israeli government, German intelligence officers used their contacts with Lebanese-based militia Hezbollah to negotiate a prisoner exchange between Hezbollah and Israel in July 2008.[52]

Like other EU member states, Germany views a sustainable, two-state solution to the Israeli- Palestinian conflict as key to ensuring Israel's long-term security, and to fostering durable stability in the Middle East. German officials have urged the Obama Administration to play a leading role in negotiations for a peace agreement. Germany remains firm in its support for EU and U.S. efforts to isolate Hamas since its victory in 2006 parliamentary elections and subsequent 2007 takeover of the Gaza strip. However, some experts argue that U.S.-EU efforts to isolate Hamas have not worked, and some in Germany and Europe view

50 "In Another CIA Abduction, Germany Has an Uneasy Role," Washington Post, February 5, 2007; "Kurnaz Case Continues to Trouble German Foreign Minister," Spiegel Online, January 31, 2007.

51 For more information see CRS Report RL33 808, Germany's Relations with Israel: Background and Implications for German Middle East Policy, by Paul Belkin.

52 David Byers, "Hezbollah Confirms Prisoner-Swap with Israel," TimesOnline, July 2, 2008.

engagement as a better way to try to moderate the group and generate progress in the peace process.

Iran

As a member of the so-called EU-3 (France, Germany and the United Kingdom), Germany has been at the forefront of EU and U.N. efforts to prevent Iran from developing nuclear weapons and continues to seek international consensus on more stringent economic sanctions against Iran. Of the EU-3, Germany has reportedly been the most reluctant to endorse autonomous EU sanctions against Iran without an accompanying U.N. Security Council resolution, and has consequently emphasized the importance of winning Chinese and Russian support for stricter sanctions. The Merkel government remains strongly opposed to a military response to the situation.

In a sign that Berlin's stance toward Iran may be hardening, in June 2008, Germany backed an EU decision to freeze the assets of Iran's biggest bank, Bank Melli, among others, and to impose visa bans on a number of individuals suspected of involvement in the Iranian nuclear program. Despite the recent sanctions, the EU has not withdrawn an offer of incentives to Iran in exchange for discontinuing its uranium enrichment program. These include providing technology to develop a nuclear program solely for energy generation and a range of economic incentives. German and European officials have welcomed the prospect of full U.S. participation in ongoing nuclear talks with Iran being led by the EU. European leaders also appear united in their support for bilateral talks between the United States and Tehran. At the same time, they emphasize that U.S. engagement with Iran should be closely coordinated within the existing multilateral framework consisting of the EU3, China, Russia, and the United States (the so-called P5+1).

Berlin has faced pressure from the United States and others to limit civilian commercial ties with Iran and to curb the substantial export credit guarantees it offers companies doing business in the country. Along with Italy and China, Germany remains one of Iran's most important trading partners. However, German-Iranian commercial ties have cooled significantly since 2005. German exports to Iran reportedly dropped 25% between 2005 and 2007, from $6.4 billion (4.3 billion euros) to $4.8 billion (3.2 billion euros), and Germany's two largest banks, Deutsche Bank and Commerzbank AG, say they have withdrawn from the Iranian market. In addition, new export credit guarantees to companies doing business in Iran fell by more than half from 2006 to 2007, dropping from $1.74 billion (1.16 billion euros) to $731.84 million (503.4 million euros).[53] While some interpret weakening German-Iranian economic ties as a sign that Berlin is intent on increasing economic pressure on Tehran, others argue that German-Iranian trade remains robust and that politicians in Berlin are unlikely to seek further cuts in commercial ties. They view German officials' emphasis on unanimity with, for example, Russia and China, as evidence that Berlin is unwilling to take bolder action against Iran.[54]

53 See "German Economy Ministry Reports Lower Exports to Iran," Associated Press, February 13, 2008; and "Berlin Hardens Stance with Iran," Financial Times, February 11, 2008.

54 See, for example, "Berlin's Ambiguous Relationship with Israel," Jerusalem Post, February 11, 2008.

Afghanistan

Germany is the third-largest troop contributor to ISAF and the fourth largest donor of bilateral aid for reconstruction and development.[55] However, perhaps more than any other ally, Germany has been criticized for a reluctance to engage in combat. U.S. officials have praised Germany for its continued efforts, but have urged its leaders to ease the operational restrictions which prevent most German forces from engaging in combat. The Merkel government has resisted calls to lift these caveats and to send combat troops to Afghanistan's southern regions. Low public support for the Afghan mission and national elections scheduled for October of this year lead most observers to rule out the possibility of significant troop increases in the coming year.

German officials have long advocated a shift in NATO's Afghanistan strategy toward a more "comprehensive approach," reflected in NATO's 2008 strategic vision for Afghanistan, that emphasizes civilian reconstruction and development projects, army and police training activities, and enhanced political engagement with Afghanistan's neighbors. To this end, the Merkel government has welcomed President Obama's renewed strategy for Afghanistan and Pakistan. Germany has appointed a special representative for Afghanistan and Pakistan, Bernd Muetzelburg, who has emphasized the need to enhance coordination among major donor countries, NATO, and the UN.

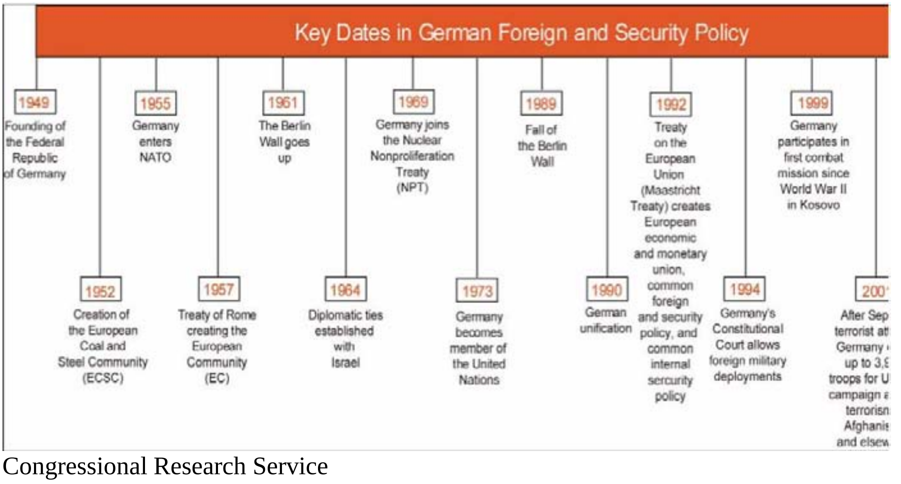
Germany currently has approximately 3,500 troops in ISAF engaged almost exclusively in stability operations in the northern part of the country. In April, it announced plans to send a temporary deployment of an additional 600 troops to northern Afghanistan in preparation for August elections (the current parliamentary mandate governing Germany's engagement in Afghanistan authorizes a maximum troop deployment of 4,500). Germany is the lead nation for Regional Command North (RC-N), commands a forward support base in Mazar-E-Sharif, and leads two PRTs, one in Kunduz and one in Feyzabad. Since July 2008, Germany has also staffed RC-N's 200-man Quick Reaction Force, intended to provide reinforcement in emergency combat situations. German officials report that Germany provides almost 50% of ISAF's fixed wing air transport as well as other country-wide air support. Since 2007, six German Tornado aircraft have been used for country-wide surveillance operations. German forces are authorized to engage in combat operations as part of their defense of the northern sector but they have reportedly been reluctant to conduct combined combat operations with their Afghan partners. Some NATO and allied government officials have criticized the existing restrictions on German forces, saying that German troops and civilians rarely venture beyond the perimeter of their PRTs and Forward Operating bases due to concern that they might arouse suspicion or come into contact with armed elements.

German officials indicate a willingness to take on a greater role in training the Afghan National Army and Afghan National Police. Germany currently provides seven OMLTs and expects to add an additional OMLT in 2010. In April 2009, Germany committed EUR 50 million (about $65 million) to the newly established Afghan National Army Trust Fund. About 55 German police officials—mostly retirees—contribute to a nascent EU police-training mission (EUPOL) of 225 that is expected to eventually include up to 450 trainers. However, the EU mission, initially approved in May 2007, has reportedly suffered from personnel problems and a lack of EU-NATO coordination. Prior to the EU mission, Germany

[55] Information in this section provided by the German Embassy, Washington, D.C., April 2009.

shared responsibility for police training with the United States. Some criticized German training efforts, carried out by about 50 police trainers in Kabul, for having too narrow an impact and for being overly bureaucratic.

APPENDIX B. KEY DATES



Source: Congressional Research Service

Figure B- 1. Key Dates in German Foreign and Security Policy.

Germany has sought to boost its police training efforts over the past year. In addition to the 55 officers contributing to EUPOL, 86 police instructors participate in other U.S.-led training efforts under CSTC-A . In January 2009, German trainers began participating in the Focused District Development Programme (FDD), through which Police Mentoring Teams of up to 10 civil and military police personnel train and accompany Afghan units in the field. The effort remains focused in the north and will include the construction of a training center in Kunduz (a training center has already been constructed in Mazar-E-Sharif). In 2009, Germany expects to spend an estimated EUR 35.7 million (about $46.4 million) on infrastructure and equipment for the Afghan police force, including the construction of training centers in Kabul and elsewhere.

Germany emphasizes the need to enhance civil reconstruction efforts in Afghanistan. Since 2007, its annual bilateral aid to Afghanistan has increased from EUR 80 million (about $104) to EUR 170 million (about $221 million) for 2009, for a total of EUR 1.2 billion (about $1.56 billion) between 2002 and 2010. Germany seeks to fund a mix of long-term development projects as well as short-term, "quick-impact" measures that can provide immediate and tangible benefits to the local population. Projects cover a variety of sectors including: energy and water supply; security sector reform; justice sector capacity building; secondary education and vocational training; mine clearance; and cultural reconstruction.

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THE EUROPEAN UNION: QUESTIONS AND ANSWERS*

Kristin Archick[1] and Derek E. Mix[2]

ABSTRACT

The European Union (EU) is a unique economic and political partnership in which 27 countries share sovereignty over an extensive range of policy areas. With strong U.S. support and encouragement, a group of European statesmen began this process of integration after World War II with the hope of ensuring peace on the continent. Over the years, additional economic and political rationale have emerged to support further integration.

Although some issues require unanimous consensus among member countries, EU decision- making is supranational on most economic and social issues. The three main institutions of the EU are the European Commission (essentially the EU's executive), the Council of the European Union (representing the national governments), and the European Parliament (representing the citizens of the EU). The yet-to-be-ratified Lisbon Treaty is the EU's latest attempt to reform its institutional arrangements and decision-making procedures. Enlargements in 2004 and 2007 increased the number of member countries in the EU from 15 to 27.

The EU has a strong common trade policy, and a developing Common Foreign and Security Policy (CFSP) for a more united voice in global affairs. It has also been developing a European Security and Defense Policy (ESDP) in order to improve its military capabilities and capacity to act independently. Although some shortcomings exist in EU-NATO relations, the two institutions continue to seek a more cooperative and complementary relationship.

The United States and the EU share a large, mutually beneficial trade and investment relationship. The global financial crisis and recession has challenged both sides to forge a common response. The United States and EU have a number of lingering trade disputes, but have led the push to liberalize world trade, and have sought to reduce non-tariff and regulatory barriers in the transatlantic marketplace. With compatible worldviews on most global issues, the United States and the EU also have a well-developed and cooperative political relationship.

This report provides a summary overview of these issues, many of which may be of interest to the 111th Congress. It will be updated as events warrant.

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What is the European Union?

The European Union (EU) is an economic and political partnership that is unique in history. Built upon a series of treaties and embodied in a set of governing institutions, the EU represents a voluntary pooling of sovereignty among 27 countries.[3] These countries have committed to a process of integration by harmonizing laws and adopting common policies on an extensive range of issues. Notable areas of shared sovereignty include a customs union; a common trade policy; a single market in which goods, people, and capital move freely; a common currency (the euro) that is used by 16 member states;[4] and many aspects of social and environmental policy. EU member states have also taken significant steps in the development of a Common Foreign and Security Policy (CFSP) and closer police and judicial cooperation.

Why Integration?

In the 1950s, a group of European leaders hoped that by creating communities of shared sovereignty and interdependence, another war in Europe would be made unthinkable. At first, Belgium, France, Germany, Italy, Luxembourg, and the Netherlands agreed to jointly manage their coal and steel industries. These six then began working toward increasing economic integration and developing a common market, and also agreed to cooperate on atomic energy. Over the ensuing decades, as integration helped underpin Europe's post-war economic success, peace and prosperity became the mutually reinforcing, fundamental rationale for deepening (increasing the degree of integration) and widening (adding new countries). More recently, additional reasons have grown in importance: proponents of integration argue that in addition to economic challenges, problems such as terrorism, immigration, and the environment can no longer be dealt with effectively at a national level alone. Many also believe that a united voice in foreign policy and security matters is increasingly essential for European influence in world affairs.

How Does the EU Work?

EU policy areas are conceptually divided into three "pillars." Pillar One includes a wide range of economic (e.g., trade, agriculture, customs union, single market,) and social (e.g., health, research, education, immigration, environment, consumer protection) policies. Integration in these areas is the most developed and far-reaching. Pillar One decision-making is supranational— EU institutions hold executive authority and can impose binding decisions on national governments. Pillar Two is the EU Common Foreign and Security Policy, and Pillar Three is police and judicial cooperation in criminal matters. Decision-making in Pillar

3 The member countries of the EU are Austria, Belgium, Bulgaria, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and the United Kingdom.

4 The members of the Eurozone are Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.

Two and Pillar Three is intergovernmental—agreement between member state governments must be unanimous and any one may veto a decision.

How is the EU Governed?

Three institutions are central to EU decision- and policy-making. They do not correspond exactly to the traditional branches of government or division of power in representative democracies.

The European Commission upholds the common interest of the EU as a whole. The Commission is essentially the EU's executive: it implements and manages Council decisions and common policies, ensuring that member states adopt and abide by the provisions of EU treaties, regulations, and directives. The Commission is the EU's primary administrative entity. In most cases, the Commission has the sole right of legislative initiative and proposes legislation to the Council. The 27 commissioners, one from each country, are appointed by member state consensus to five-year terms. One is selected to lead and represent the Commission as the Commission President. The others hold a distinct portfolio (e.g., agriculture, energy, external relations), with five double-hatted as Vice Presidents in addition to their portfolio. On many issues, the Commission represents the EU internationally and handles negotiations with outside countries.

The Council of the European Union (also called the Council of Ministers) represents the national governments. The main decision-making body of the EU, the Council enacts legislation, usually based on proposals put forward by the Commission. A minister from each country takes part in Council meetings, with participation configured according to the subject under consideration (e.g., foreign ministers would meet to discuss the Middle East, agriculture ministers to discuss farm subsidies). Most decisions are made by qualified majority vote, but some areas—such as foreign and defense policy, taxation, amending EU treaties, or accepting new members—require unanimity.[5] Council decisions are generally taken in consultation or "co-decision" with the European Parliament. The Presidency of the Council rotates among the member states, changing every six months. The presidency country sets agenda priorities and organizes the work of the Council.

The European Parliament represents the citizens of the EU. The Parliament consists of 785 members (reduced to 736 as of June 2009) who are directly elected in each member state for five-year terms. Each member state holds a number of seats proportional to the size of its population. Members of the European Parliament (MEP) caucus according to trans-national groups based on political affiliation, rather than by country.[6] The Parliament cannot initiate legislation, but it has numerous important powers of oversight and supervision. It shares "co-

5 In qualified majority voting, countries are allotted a number of votes in rough proportion to their population size. Passage of a measure requires a double majority: at least half of the member states (two-thirds if not a Commission initiative) and 255 out of the 345 total votes. Votes must also represent at least 62% of the total EU population.

6 There are currently 7 political groups in the European Parliament: the Group of the European People's Party (Christian Democrats) and European Democrats (288 MEPs); the Socialist Group in the European Parliament (216); the Group of the Alliance of Liberals and Democrats for Europe (99); the Union of Europe for the Nations Group (44); the Group of the Greens/European Free Alliance (43); the Confederal Group of the European United Left-Nordic Green Left (41); and the Independence/Democracy Group (21). There are also 30 non-attached MEPs.

decision" power with the Council of Ministers in many areas, can amend and reject the EU's budget, and can vote to dismiss the Commission.

A number of other institutions also play important roles in the EU. The European Council is composed of the Heads of State or Government of the member states plus the Commission President. Meeting at least twice a year (in what are often termed "EU Summits"), the European Council acts principally as a strategic guide for EU policy. The Court of Justice interprets EU laws and rules on compliance; a Court of Auditors monitors financial management; the European Central Bank manages the euro and monetary policy; and advisory committees represent economic, social, and regional interests.

WHAT IS THE LISBON TREATY?

In December 2007, EU leaders approved the Lisbon Treaty, seeking to amend existing EU treaties with a number of significant reforms. In order to come into force, the treaty must be ratified by all 27 member states. Leaders had initially hoped that ratification would be complete in the first half of 2009, but Ireland's rejection of the treaty in a June 2008 national referendum threw the timetable for adoption into disarray. Three other countries have not completed formal ratification, but Ireland is the only country to decide ratification of the Lisbon Treaty by referendum. Ireland plans to try again with a second vote, possibly in October 2009.

The major aims of the Lisbon Treaty are to streamline institutional decision-making, to give the EU a stronger and more coherent global voice and identity, and to increase democracy and transparency within the EU. Supporters argue that these reforms are needed for an EU of 27 members to function—the most recent update, the Nice Treaty, was designed for an EU of 15 members. The treaty would create a new position, President of the European Council, that would replace the six-month rotating presidency system with an individual elected to a two-and-a-half year term. Another new position would make a single representative for EU foreign and security policy, combining the duties of the Council's High Representative for CFSP and the Commissioner for External Relations. The Lisbon Treaty would increase the number of areas decided by qualified majority voting—although issues such as CFSP and taxation would still be subject to unanimous intergovernmental consensus. The treaty would also increase the power of the European Parliament by expanding use of the co-decision procedure, give national parliaments more of a role in EU policy-making, and allow for new proposals based on citizen initiatives. The Lisbon Treaty would do away with the "pillar" structure and give the EU a single legal personality.

The Lisbon Treaty follows the failure of the EU constitutional treaty, a major reform effort that was shelved after its rejection in referendums held in France and the Netherlands in 2005. Legally speaking, the constitutional treaty would have wholly replaced, rather than amended, existing EU treaties; however, analysts have noted that the Lisbon Treaty preserves over 90% of the substance of the constitutional treaty.

How Do European Countries View the EU?

All member states hold that the EU brings them important political and economic benefits. Nevertheless, tensions have long existed within the EU between those seeking an “ever closer union” through greater integration and those that prefer a more intergovernmental footing. Concerns about the impingement of the EU on national sovereignty have played out in decisions to “opt out” of certain aspects of integration, such as passport- and visa-free travel within the EU (UK and Ireland), the euro (UK, Denmark, and Sweden), Justice and Home Affairs issues (UK, Ireland, and Denmark), and the common defense policy (Denmark). Another classic divide in the EU falls along big versus small state lines—small states are often cautious of initiatives that they fear could allow a few large states to dominate decision-making. In addition, the newer member states of central and eastern Europe have recent histories of Communism and Soviet domination, which impact their view on issues such as relations with Russia, EU treaties and decision-making arrangements, and even climate change policy. At times, such differences have caused frictions with western European member states and slowed EU decision-making.

The prevailing view among European citizens is likewise favorable toward the EU, and many assert a general perception that the EU benefits them in important ways. Some observers have noted that, owing largely to the EU, many of the continent’s citizens describe a European identity layered on top of national, regional, and local identities. However, there is also a certain amount of “Euro-skepticism” among a significant portion of Europe’s citizens. Concerns over the loss of national sovereignty are one central element of this sentiment. Some citizens assert that there is a “democratic deficit”—a feeling that one has no say over decisions taken in far away Brussels. Others view the EU as a giant bureaucracy that delivers few concrete benefits. Some observers suggest that the benefits and founding ideals of the EU—peace and prosperity—may not ring as loudly among younger generations with no experience of war or economic hardship.

Why and How is the EU Enlarging?

Many observers have regarded EU enlargement as crucial to expanding stability and prosperity across Europe. In order to be eligible for membership, countries must first meet criteria for democracy, rule of law, and economic policy. Observers have noted that the prospect of membership can act as an incentive for countries to adopt beneficial reforms in order to qualify. Once a country becomes an official candidate, accession negotiations are a long and complex process in which the applicant must adopt and implement a massive body of EU laws, treaties, and regulations that now cover 35 “chapters” (subject areas).

In 1973, Denmark, Ireland, and the United Kingdom joined the six pioneer countries (Belgium, France, Germany, Italy, Luxembourg, and the Netherlands). Greece joined in 1981, Spain and Portugal in 1986, and Austria, Finland, and Sweden in 1995. In 2004, the EU welcomed eight formerly communist countries of central and eastern Europe—the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia—plus Cyprus and Malta. Bulgaria and Romania joined in 2007. Following these latest rounds, some Europeans have spoken of “enlargement fatigue” and advocated pausing enlargement pending the enactment of internal reforms that allow an EU of 27-plus members to function more smoothly.

Further enlargement is likely to focus on the Balkans—Croatia and Macedonia are officially considered candidates for accession, and Albania, Bosnia-Herzegovina, Kosovo, Montenegro, and Serbia are potential candidates down the road. There are indications that Iceland may apply for membership, an effort that would likely receive quick approval. Turkey has also had a longstanding bid for EU membership. Whether owing to its demographic, geographic, economic, or cultural characteristics, many Europeans are opposed to the idea of Turkish EU membership. Many analysts believe that the final outcome of EU accession negotiations with Turkey is uncertain. The status of Turkey's application is a frequent source of tension between Turkey and the EU.

DOES THE EU HAVE A FOREIGN POLICY?

The EU has a Common Foreign and Security Policy (CFSP) in which member states agree to adopt shared positions, undertake joint actions, and pursue coordinated strategies. Since CFSP decision-making is intergovernmental and requires unanimity, all 27 members must agree that a common EU stance is the most desirable and effective approach to a given issue, and all 27 members must agree on the terms of that stance. CFSP does not preclude individual member states pursuing their own national foreign policies or conducting their own national diplomacy.

Proponents of expanding CFSP assert that the EU must increasingly speak with one voice in foreign and security policy if its global weight and influence are to match its economic clout. Skeptics argue, however, that the reach and credibility of CFSP too often suffers from an inability to reach consensus. While EU countries do often have similar worldviews and international goals, some differences in viewpoint are inevitable among 27 countries that still retain different approaches, cultures, histories, and relationships—and often different national interests—when it comes to foreign policy.

Currently, two major positions represent the EU externally. The High Representative for CFSP (Javier Solana) represents the Council of the EU in CFSP matters, such as negotiations with Iran, EU military missions, counterterrorism policy, sanctions, and a wide range of other issues on which CFSP declarations have been agreed. The Commissioner for External Relations (Benita Ferrero-Waldner) represents the EU in general dialogue and cooperation with outside countries, including aid and development support and European Neighborhood Policy, in which the EU seeks to build close partnerships with its southern and eastern neighbors. The Lisbon Treaty, if approved, would combine these posts into a single position—High Representative for Foreign Affairs and Security Policy/Vice President of the Commission. The treaty would also create an EU diplomatic corps (European External Action Service) to support the High Representative.

DOES THE EU HAVE A DEFENSE POLICY?

The EU has been developing its European Security and Defense Policy (ESDP), which was formally launched in 1999. The main purpose of ESDP is twofold: to help build up European military capabilities, and to give the EU a capacity for separate action in cases where NATO is not engaged. Through a series of "Headline Goals," the EU has set targets for the development of forces and capabilities. Forces under development include a rapid reaction force and multinational "battlegroups." ESDP operations focus largely on tasks such as peacekeeping, crisis management, and humanitarian assistance. ESDP does not mean a standing "EU army," but rather a catalogue of forces that member countries could make available for EU missions. The EU is currently engaged in some 12 ESDP missions in the Balkans, Africa, Caucasus, and the Middle East, and has completed an additional 10 missions in previous years. However, improving military capabilities has been difficult, especially given flat or declining European defense budgets. Serious capability gaps continue to exist in areas such as strategic airlift and sealift, and a relatively low percentage of European forces are deployable for expeditionary operations. Some analysts have suggested asset pooling and a greater focus on national niche capabilities as a way forward for European defense. Reflecting such thinking, the EU created the European Defense Agency in 2004 in order to help coordinate defense-industrial and procurement policy.

WHAT IS THE RELATIONSHIP OF THE EU TO NATO?

Despite overlapping membership and interests, NATO and the European Union have struggled to establish a cooperative and complementary relationship. [7] In the United States and some other NATO countries such as the UK, support for ESDP as a means for Europe to develop security capabilities has mostly overcome initial concerns that ESDP would mean decoupling/delinking (from NATO strategy and decision making), duplication (of NATO structures and resources), and discrimination (against non-EU members of NATO). The 2003 Berlin Plus agreement, allowing EU-led missions access to NATO assets and planning capabilities, remains the biggest step forward to date and the cornerstone of EU-NATO relations. Berlin Plus reflects a pragmatic conclusion that NATO and the EU need not be competitors, but are better served as partners sharing a pool of resources and offering each other an array of complementary capabilities.

While EU-NATO cooperation exists at the tactical level, procedural blockage related to EUTurkey tensions and the issue of divided Cyprus prevents the two institutions from sharing sensitive intelligence information, thereby hindering their ability to cooperate on matters of strategic importance. Some analysts argue that this impasse needs to be resolved to allow greater EU-NATO cooperation. An enhanced EU-NATO relationship might include joint planning in areas such as crisis management, defense policy, and procurement, as well as more formal coordination of complementary capabilities for expeditionary missions, stabilization and reconstruction operations, and security sector reform programs.

7 21 countries belong to both NATO and the EU. There are six non-NATO members of the EU (Austria, Cyprus, Finland, Ireland, Malta, and Sweden) and seven non-EU members of NATO (Albania, Canada, Croatia, Iceland, Norway, Turkey, and the United States).

DOES THE EU HAVE A TRADE POLICY?

Yes. EU member states have a common external trade policy in which the European Commission negotiates trade deals with outside countries and trading blocs on behalf of the Union as a whole. The EU's trade policy is one of its most well-developed and integrated policies. It evolved along with the common market, which provides for the free movement of goods within the EU—preventing one member state from importing foreign goods at cheaper prices due to lower tariffs and then re-exporting the items to another member with higher tariffs. The scope of the common trade policy has been extended to include negotiations on services and intellectual property in some cases. The Council of Ministers has the power to establish objectives for trade negotiations and can approve or reject agreements reached by the Commission. EU rules allow the Council to make trade decisions with qualified majority voting, but in practice the Council tends to employ consensus. The Commission and the Council work together to set the common customs tariff, guide export policy, and decide on trade protection or retaliation measures where necessary. The EU also plays a leading role in the World Trade Organization (WTO).

DOES THE UNITED STATES HAVE A FORMAL RELATIONSHIP WITH THE EU?

Yes. For decades, the United States and the EU (and its progenitors) have maintained diplomatic and economic ties. Washington has strongly supported European integration, and U.S.-EU trade and investment relations are extensive. The 1990 U.S.-EU Transatlantic Declaration set out principles for greater consultation, and established regular summit and ministerial meetings. In 1995, the New Transatlantic Agenda (NTA) and the EU-U.S. Joint Action Plan provided a framework for promoting stability and democracy together, responding to global changes, and expanding world trade. The NTA also sought to strengthen individual ties across the Atlantic, and launched a number of dialogues, including for business leaders and legislators. The Transatlantic Legislators' Dialogue (TLD) has been the formal mechanism for engagement and exchange between the U.S. House of Representatives and the European Parliament since 1972.

The United States also maintains strong bilateral ties with individual EU member states. Some observers call for a further strengthening of the U.S.-EU relationship, arguing that U.S. engagement at the EU level—rather than bilaterally with individual capitals—is the most relevant and effective approach in a large and growing number of issues.

WHO ARE U.S. OFFICIALS' COUNTERPARTS IN THE EU?

U.S.-EU Summits occur at least once a year, with the U.S. president meeting with the president of the European Commission and the Head of State or Government of the country holding the rotating Council presidency. The U.S. Secretary of State's most frequent interlocutors in the EU context are the High Representative for CFSP, the External Relations Commissioner, and the foreign minister of the EU presidency country. The U.S. Trade

Representative's key interlocutor is the European Commissioner for Trade, who directs the EU's common external trade policy. Other U.S. cabinet-level officials interact with Commission counterparts or member state ministers in the Council of Ministers context as issues arise. Many working-level relationships between U.S. and EU officials also exist. A Delegation in Washington, DC represents the European Commission in its dealings with the U.S. government, while the U.S. Mission to the European Union represents Washington's interests in Brussels.

HOW ARE U.S.-EU ECONOMIC RELATIONS DOING?

Comprising nearly 60% of global gross domestic product (GDP), the U.S.-EU trade and investment relationship is the largest and most influential in the world. In 2007, the value of the two-way transatlantic flow of goods, services, and income receipts from investment totaled more than $1.6 trillion. U.S. and European companies are also the biggest investors in each other's markets: total stock of two-way direct investment exceeded $2.6 trillion by the end of 2007.

The global financial crisis and recession have posed difficult challenges to both sides and raised concerns about the adoption of protectionist policies. While leaders have pursued a coordinated response through the G-20, different preferences have emerged in the process. At the April 2009 G-20 Summit in London, European leaders resisted U.S. calls for further stimulus spending, focusing instead on efforts to reform regulation of the global financial system. Leaders agreed to a package worth around $1 trillion in extra resources for the International Monetary Fund and financing for global trade.

Although an inability to reach a transatlantic agreement on agricultural subsidies has contributed to stalling the Doha Round of trade negotiations, U.S.-EU cooperation has been the key driving force behind efforts to liberalize world trade. Transatlantic trade disputes persist over poultry, subsidies to Boeing and Airbus, hormone-treated beef, and bio-engineered food products. The United States and the EU have made a number of attempts to reduce remaining non-tariff and regulatory barriers to trade and investment. The Transatlantic Economic Council (TEC) was created at the 2007 U.S.-EU summit and tasked with advancing the process of regulatory cooperation and barrier reduction. Many analysts note that resolving U.S.-EU trade disputes has become increasingly difficult, perhaps partly because both sides are of roughly equal economic strength and neither has the ability to impose concessions on the other. Another factor may be that many disputes involve differences in regulatory frameworks, political priorities, and domestic values and preferences.

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THE U.S.-UK SPECIAL RELATIONSHIP IN HISTORICAL CONTEXT: LESSONS OF THE PAST

Ray Raymond

Winston Churchill once wrote, "Learn all you can from history, for how else can one even make a guess what is going to happen in the future ... in history lie all the secrets of statecraft." Churchill was right, and his advice is especially appropriate to the study of the special relationship. Properly understood, the lessons of the past not only help us keep the problems of the present in perspective, but also point to one central conclusion: some kind of intimate and unbreakable link does exist between the United States and Britain, and its roots are very deep.

Throughout the deliberations of the two conferences that form the basis of this book, I was struck that so many of my fellow participants knew so little of the history of the Anglo-American relationship. Stereotypes abounded, particularly in the British delegation. Many of these participants appeared eager to deny the existence of a shared heritage so critical in helping us resolve disputes past and present. This chapter attempts to explain what the special relationship is and to provide a more balanced view of its value.

KEEPING THE PRESENT IN PERSPECTIVE

To begin, the lessons of the past put our current problems in perspective. Anti-Americanism is one example. Throughout the Carlisle and Shrivenham conferences, many participants expressed serious concern about the extent, intensity, and nature of anti-Americanism in the United Kingdom. They were right to do so. The current level of anti-Americanism is indeed disturbing and, in my judgment, poses the biggest single threat to the special relationship. But anti-Americanism in Britain is nothing new. It has been a prominent feature of the ideology of the left and right wings of British politics ever since 1945. Yet, over the past 60 years, the special relationship has not only survived but prospered, making a vital contribution to international security.

The years immediately following World War II offer a very good example. The war had marked a substantial shift in economic power—and hence political and military power—from Britain to the United States. This was a terrible shock to a proud nation accustomed to controlling the destiny of much of the world. The psychological repercussions of this transfer of power were clearly identifiable in a strongly anti-American mood intensified by moral unease over the dropping of the atomic bombs on Japan, resentment at the abrupt termination of Lend Lease, and fear that the rapid demobilization and withdrawal of U.S. forces from Europe would leave a weakened Britain unable to deter Soviet aggression. In August 1948, U.S. Ambasador Lew Douglas reported to Washington that “there is an undercurrent of feeling here against the U.S., both in and out of government ... at times their attitude towards the U.S. borders on the pathological.” But this intense anti-Americanism did not prevent Britain and the United States from collaborating closely to ensure the success of the Marshall Plan in 1947, nor did it impede the Anglo- American diplomacy that led to the foundation of the North Atlantic Treaty Organization (NATO) in 1949.

History also reminds us that vigorous arguments between London and Washington are nothing new. There was never a golden age of Anglo-American relations free from acrimony. Franklin D. Roosevelt and Churchill had profound disagreements on the desirability of the continuation of the British Empire in Africa, Asia, and the Middle East, and of the continued existence of British imperial trade preferences in the postwar era. These disagreements were compounded by difficulties over the detailed arrangements for Lend Lease, over British sterling and dollar balances, and over access by U.S. companies to protected markets within the Empire and Commonwealth. On military strategy and tactics, Churchill—the incorrigible worshiper of the periphery—had ferocious arguments with Dwight Eisenhower and George Marshall, who remained wedded to a cross-channel attack on the core of Nazi power.

The true essence of the special relationship was captured in a lunchtime conversation in Washington in the late 1980s when Lord Franks, who had been British Ambassador during the Harry Truman administration, asked the then current Ambassador Sir Oliver Wright, “How are things?” Sir Oliver replied, “Oh, just fine. I have got about six rows going on with the administration and Congress at present.” Lord Franks replied, “Oh, good ... sounds normal to me.” The point is that, over the decades, there have been frequent strong disagreements between London and Washington, but they have never prevented us from working effectively together to achieve shared objectives so long as the disagreements were conducted in private like family squabbles. Picking fights in public with the United States is utterly counterproductive.

History also shows that the other grave threat to the special relationship is the continued miniaturization of the British armed forces. As Lord Renwick, one of our greatest Ambassadors in Washington, has shrewdly observed: “Britain has influence on American policy to the extent that it still has some power and influence itself in various parts of the world ... the price of consultation is presence and participation.” In other words, sound, unvarnished advice and diplomatic support—though welcome—will not be enough. The more and the more relevant military capability we have, the greater will be our influence in Washington. The reduction of the British armed forces must stop.

THE LONG-TERM ROOTS OF THE SPECIAL RELATIONSHIP

Some years ago, the elder President George Bush described the special relationship as “the rock upon which all dictators this century have perished.” He was referring to the importance of the special relationship in combating fascism and communism in the 20th century. In the 21st century, the special relationship has confounded the skeptics by emerging with renewed vigor. President George W. Bush, for example, frequently describes Britain as America's most important global ally in the war on terror. British Prime Minister Tony Blair commands the stage in Washington and the admiration of the American public as no other British leader since Churchill.

Among the cynical British chattering classes, it has long been fashionable to dismiss the special relationship as mere "rhetorical nonsense, sometimes majestic and often moving, yet nevertheless nonsense." And yet even the most hardened cynics have been forced to admit that some kind of intimate connection does exist between the United States and Britain. But defining it is not easy. The special relationship is not like a sentence that you can parse or a treaty that you can analyze. The most intriguing clue I have found is in a speech given in London by John Hay in the early 1890s when he was U.S. Ambassador to the Court of St. James. Describing the Anglo- American relationship, John Hay said that Britain and the United States "are bound by a tie we did not forge and which we cannot break; we are joint ministers of the same sacred mission of liberty." Hay's insightful phrase suggests to me that to unravel the mystery of the special relationship we need a longer historical perspective; that we need to understand the American Revolution in its full complexity as well as the three pillars of the relationship—the shared common law heritage, the mutual economic investments, and the diplomatic and security ties.

What I am suggesting, contrary to conventional wisdom, is that this relationship does have the "patina of antiquity," and that the usual view of Anglo-American relations—warm and close since 1941, cold and distant before—is mistaken. Instead, I want to offer a provocative working hypothesis: that the solution to the mystery, the real reason the special relationship is special, is that so much of the basic DNA of the infrastructure of the American political, legal, and economic system is British. And I will go further: the basic assumption of Roosevelt's security policy in World War II—the idea that the United States and Britain shared a common strategic interest in preventing a single hostile power from dominating the European continent—can be traced back to the Federalists' foreign policy of the 1790s. In a very real sense, therefore, the United States, however foreign it may sometimes appear to many modern-day Britons, is—to borrow David Hacket Fisher's memorable phrase — "Albion's seed."

Therefore, let's linger a moment on the American Revolution, a subject on which the latest British and American scholarship offers some fascinating insights. To begin with, this scholarship suggests that the secession of the American colonies and the birth of the American Republic were not inevitable. Until well into the 1770s, whatever differences the colonies may have had with London or with each other, few questioned their common allegiance to the crown or their intense pride in their common British identity. Some—including the illustrious Benjamin Franklin—thought the center of gravity of the British Empire and perhaps even its capital eventually must shift to the United States.

The Founders of the British Empire in America envisaged a loose maritime commercial empire cemented by the 17th-century Puritan concept of liberty which was rooted in resistance to the idea of an Absolutist Monarch. This concept of liberty meant parliamentary consent to taxation, representative government, habeas corpus, trial by jury, and protection of the individual citizen from arbitrary arrest and from a corrupt government. As Simon Schama has written, this concept of liberty also included,

> the constant reiteration of its historical epics—Magna Carta, the Petition of Right, and most recently, and therefore most hallowed, the Bill of Rights of 1689 and its heroes and martyrs: John Hampden, John Milton, and Algernon Sidney (ironically, the same heroes and martyrs beloved by John Adams, Thomas Jefferson, and Benjamin Franklin) ... . The British Empire was supposed to satisfy itself with just enough power, and just enough regulation, to make the interlocking parts of its economic machinery work with well-oiled smoothness.

Those American colonists who had taken these professions of freedom seriously felt betrayed. In the end, they rebelled not because of excessive taxation—the was merely a convenient rallying cry—but because they were concerned that the most sacred principles of British freedom were at stake; that they were the custodians of the true British Constitution which had been abandoned by a corrupt oligarchy in London. I believe they were right. The government of Lord North, in order to protect short-term economic interests, abandoned Pitt the Elder's concept of an empire of liberty based on mutual consent and respect. It was a disastrous mistake. The underlying issue was one of constitutional principle: the difficulty was the failure of the British government to adhere to its own professed ideals of liberty, coupled with the failure of both the American colonists and the British government to agree to a constitutional relationship that clearly defined the rights of the colonial assemblies and the authority of the Westminster Parliament. The American War of Independence, therefore, can be seen as a legitimate rebellion rooted in the English common law. The colonists were not trying to reject their treasured British heritage, but rather to reaffirm and reclaim it from a foolish King and a corrupt political cadre.

The American War of Independence can also be seen as a tragic British civil war in that it divided social classes, towns, villages, and families both in Britain and in the 13 colonies. At least one-third of the colonists—including Benjamin Franklin's son and John Jay's brother—remained loyal to the crown. In Britain, large numbers of Puritans and other religious dissenters strongly supported the American cause because of a shared religion, shared values, and a heartfelt community of friendship. They were joined by English republicans and other radicals whose grandparents had supported Cromwell and the Parliamentary cause against the Stuart Kings: the skilled craftsmen, shopkeepers, and owners of taverns and coffee houses in London, in East Anglia, and in the industrial towns of central England. Opposition to the war also included many elements of the press, as well as members of the Whig opposition in the House of Commons and Lords and many senior officers in the British army and Royal Navy who were especially reluctant to take up arms against their kith and kin in America. This was not, therefore, the case of a united American nation fighting British imperialists determined to subjugate it by force, but rather of one transatlantic "Anglosphere" divided against itself.

Pillar I: Common Law

The first pillar of the special relationship is, of course, the shared heritage that was and is our great common law tradition. The central point here is that America's Founding Fathers enthusiastically embraced the profoundly British concept of a law-based state shaped by centuries of British political philosophy, jurisprudence, and practice dating back to the Magna Carta. As a result, our shared conception of individual freedom, of a law-based state, and of the pragmatic common law approach to justice rooted in custom, experience, and precedent is now firmly embedded in the American legal system. America's founding documents—the Declaration of Independence, the U.S. Constitution, and the Bill of Rights— do not divide us. They unite us. As Winston Churchill once said, "The Declaration of Independence and the U.S. Constitution are not only American documents. They follow on the Magna Carta and the English Bill of Rights as the great title deeds in which the liberties of the English-speaking peoples are founded." As leading colonial American historians have demonstrated, this was not mere Churchillian romanticism, fuelled by several after-dinner brandies. The political and legal structures created by the colonists were deeply rooted in British constitutional history, political philosophy, and jurisprudence

In its form and content, the Declaration of Independence, for example, is a profoundly British document and part of a centuries- old British tradition. Pauline Maier has shown that, in both England and Scotland, declarations were important political and legal instruments. Politically, declarations were issued to explain and justify the removal of a king. For the Founding Fathers, the most important declaration was the English Declaration of Rights of 1689. It ended the reign of King James II and began that of William and Mary. For the Founding Fathers, the English Declaration became a key source of inspiration: a document which set out certain fundamental political and legal truths to inspire and shape the political and legal structures of the new American republic, as well as to proclaim the end of an old regime.

Jefferson used the English Declaration of Rights as his model when writing the preamble of his constitution for Virginia, one of the two texts we know he had with him in his lodgings in Philadelphia that hot summer of 1776. The other was George Mason's Declaration of Rights for Virginia which was even more closely modeled on the English Declaration of Rights. So Jefferson, the assiduous student of British law and history, was acting as so many Britons had acted before him: drawing up a declaration to explain and justify bringing the reign of George III to an end in his American colonies.

And it is not just a matter of form, but of content. Jefferson relied heavily on two of the leading thinkers of the 18th-century Scottish Enlightenment—David Hume and Francis Hutcheson—for many of his ideas. Hutcheson, for example, wrote that human rights included the right of a people to oppose tyranny and the right of colonies to secede if their mother country treated them unjustly. English philosopher John Locke argued that sovereignty derived from the people, who have a right to remove an unjust monarch. This argument clearly shaped Jefferson's thinking. Indeed, much of the language in the opening paragraphs of the Declaration of Independence closely resembles passages from Locke's Two Treatises of Government. As Dick Howard has written, the English Bill of Rights not only "anticipates the American document of a century later, but also some of the American bill's specific provisions—for example, the Eighth Amendment's ban on excessive bail and fines and on cruel and unusual punishment."

That leads me to a central point as best expressed by the distinguished colonial American historian Gordon Wood:

> The English had worked out a respect for the law and a semblance of popular self-government, however flawed by modern standards, long before the Americans. Whatever innovations Americans made to their English heritage, and they were undeniably considerable, their ultimate success in governing themselves and protecting individual freedom owed

> more to their English heritage than in did to their constitutional inventions in 1787. From decades of experience they had acquired an instinctive knowledge of English liberty and the English Common Law, and this inherited and inherent knowledge, this long experience with English political culture, was what ultimately enabled them to succeed as well as they did in establishing new governments.

Pillar II: Mutual Investment

The second pillar of the Anglo-American relationship is the extraordinary interpenetration of our two economies. Today, Britain and America invest over $250 billion in each other's economies, more than any two other countries, and they lead in cross-border mergers and acquisitions. This relationship did not begin yesterday. For over 300 years, the prosperity of Britain and America has always been closely linked. Indeed, the great paradox of the American Revolution is that those rebelling against the Crown in the 1770s were its wealthiest subjects, to a large degree the beneficiaries of British investment and trade.

The foundation of the modern investment relationship can be traced to Alexander Hamilton's tenure as the first U.S. Treasury Secretary. The American War of Independence left financial chaos in its wake: the 13 states suffered Weimar-levels of inflation because they had printed unsecured paper with reckless abandon. And it took all of Alexander Hamilton's financial genius, his knowledge of British best practice, and British investment to bring order out of chaos and lay the foundations for modern American capitalism. As Treasury Secretary, Hamilton created the first Bank of the United States, modeled closely on the Bank of England. To achieve the financial stability necessary to attract the British investment that was in turn essential to help pay off the American debt, Hamilton once again turned to the British model of monetizing the national debt by issuing long-term bonds that could be traded on the open market. And as Hamilton studied the British financial system in 1789, he also borrowed William Pitt's idea of the sinking fund—earmarking a portion of annual tax revenues to pay off the national debt. This helped tame rampant inflation resulting from the War of Independence and restored investor confidence. Building on the investor confidence established by Hamilton, British capital financed the construction of the American railroads—which knitted a continent into a country— and also financed much else of the American Industrial Revolution.

Pillar III: Diplomatic and Security Partnership

The third and final pillar is the unique diplomatic and security partnership formed by the two countries. Since World War II, there has been a unique collaboration in defense and national security between Britain and the United States and in the closeness of our consultation and action about most world crises.

FDR and Churchill invented this unique defense and intelligence relationship, of course. They not only gave it its unique flavor, but also helped create the vast network of institutions and consultative arrangements to sustain the partnership. It would be absurd to suggest that a special relationship of this kind existed before 1941. But the theme of confronting the common adversary was not new to Anglo-American relations. It had existed since the 18th century as a shared assumption of common interest even when bilateral relations between Washington and London were strained. There are two striking examples of this. The first can be found in the foreign policy of the Federalists in the 1780s and the 1790s; the second even more striking example can be found in the foreign policy of Theodore Roosevelt and Lord Salisbury when there was a Falklands in reverse.

As John Lamberton Harper has argued, in the late 1780s and 1790s, John Jay, Alexander Hamilton, and George Washington created and implemented a prudent, realistic foreign policy of strength through peace. It was a foreign policy anchored in the belief that America's best interests lay in an alliance with Britain based on common interests. Like their counterparts in the British government, Hamilton, Jay, and Washington saw it as an irreducible interest of the United States, as well as Britain, to prevent the domination of the European continent by any single power. They saw British financial and naval power as America's first line of defense against French and Spanish ambitions to control the Mississippi Valley, thereby threatening the territorial integrity of the United States.

This policy found expression in Jay's Treaty in 1794, which represented the culmination of their earlier efforts to foster reconciliation based on reciprocity and shared interests and a common desire to heal the wounds of the Revolutionary War. Jay's Treaty not only repudiated the Franco-American alliance of 1778, but also marked the birth of a common Anglo-American strategic outlook and the hesitant beginnings of a mutual understanding. It also linked American and British security policy because it recognized that the Royal Navy was America's first line of defense against potential aggressors like France and Spain.

This said, it must be admitted that the 19th century was a difficult period for Anglo-American relations. Despite the best efforts of John Jay and Alexander Hamilton to heal the wounds of the Revolutionary War, this tragic conflict left a bitter legacy of mistrust. The War of 1812, another unnecessary war, made it worse. But in the decades before the Civil War, Anglo-American relations improved because Britain and the United States supported Latin American independence and opposed French and Spanish attempts to reconquer their former colonies.

The main source of friction arose out of the American Civil War and Britain's ambivalent response to it. While some British leaders, including then Prime Minister Lord Palmerston, hoped that the Civil War might lead to the breakup of the Union, the overwhelming majority wanted to keep out of the war. The ambivalence of British policy had deeper roots, however. On the one hand, the British anti-slavery movement (which had helped finance the American "underground-railroad" enabling slaves to escape to the North) had convinced almost all Britons that slavery must be abolished, and it lobbied successfully against recognition of the Confederacy. On the other, the powerful British textile industry needed continued access to cheap raw cotton, and the bankers of the City of London had to protect their loans to the big cotton plantation owners. Add to that the pressure from the large British shipbuilders eager to accommodate Confederate orders for warships, and one gets an idea of how difficult it was for the British government to formulate a consistent and balanced policy that did not offend either side in the Civil War.

But the British policy of nonrecognition was compromised by its decision to allow the Confederates to order warships from British shipyards. One such ship, the *Alabama*, built in the Cammell Laird shipyard on Merseyside, reached Confederate hands and sank nearly 60 Union vessels in 2 years. Afterwards, the victorious North was understandably angry that the British government had allowed the building of the *Alabama* and two other warships. What was important was not the dispute, but how it was resolved through a Joint High Commission. The Commission, whose actions personified the shared pragmatic Anglo-American common law tradition, agreed on suitable compensation for the damage caused by the *Alabama* and resolved the other outstanding grievances. Once again, the common law heritage helped ensure a joint approach and a successful resolution of a difficult, divisive problem.

Throughout the later part of the 19th century, despite the frictions caused by embittered Irish-Americans, Anglo-American relations grew much closer. There were three reasons for this. First, the passage of time and deft British diplomacy combined to soften Britain's image as the colonial oppressor and enemy of American independence. Second, America's remarkable economic growth after the Civil War created new opportunities for British investors, which they eagerly snapped up, thereby strengthening the Anglo- American business relationship. Third, the arrival of steam-powered transatlantic liners, combined with changes in British and American social structure, facilitated closer social relationships between the elites of both countries. America's new Gilded Age millionaires wanted the social prestige of links to the British aristocracy, which needed an infusion of American dollars to meet the ever-increasing costs of maintaining their vast country mansions. Between 1895 and 1903, the daughters of more than 70 American millionaires married prominent British aristocrats, many of them in key positions in government. The great Anglo-American rapprochement did indeed build on the these closer links, but it was driven primarily by a common strategic outlook: both governments agreed on the "Open Door" policy in China, and were deeply concerned about the emergence of an aggressive militaristic Germany in Europe and in the Pacific. Both governments saw each other as key allies in containing German power. U.S. Ambassador and later Secretary of State John Hay spoke for both governments when he wrote, "There is in the German mind something monstrous in the thought that a war should take place anywhere and they not profit by it." Lord Salisbury saw the Spanish-American War in 1898 as an excellent opportunity for a show of solidarity with the United States. Just after the outbreak of hostilities, Lord Salisbury's government not only declared its political support for the United States, but also gave the U.S. Navy the use of British bases in the Caribbean. The Royal Navy also gave Admiral Dewey every possible assistance in Hong Kong as he prepared to attack the Spanish fleet in the Philippines. It was truly a Falklands in reverse. So as the 20th century began and America stepped forcefully onto the world stage for the first time, she did so with Britain's full diplomatic, intelligence, and military support. The impact on U.S. leaders was profound. President Theodore Roosevelt (TR) wrote to his closest British friend, Cecil Spring Rice, "I am greatly mistaken if we ever slide back into the old conditions of bickering and angry mistrust." TR was right. We never have.

CONCLUSION

I hope I have provided a clue to unraveling the mystery of the special relationship. Before 1941, there was, of course, bickering and hostility, but underlying geopolitics and a common heritage continue to be inescapable. Both countries were always wary of expansionism on or from the European continent, so the implied partnership was always there. But it took the Nazi threat and the leadership of FDR and Churchill to make it explicit. They succeeded in building so well and so fast because the foundations were already there, strong and deeply rooted. Then and now, we are indeed “bound by a tie we did not forge and which we cannot break.” Or, as Margaret Thatcher put it in an address to the Joint Houses of Congress on February 20, 1985,

> Our two countries have a common heritage as well as a common language. It is no mere figure of speech to say that many of your most enduring traditions—representative government, Habeas Corpus, trial by jury, a system of constitutional checks and balances—stem from our own small islands. But they are as much your lawful inheritance as ours. You did not borrow these traditions: you took them with you, because they were already your own.

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THE SPECIAL RELATIONSHIP — ECONOMIC AND BUSINESS ASPECTS: AMERICAN PERSPECTIVE*

Michael Calingaert

What constitutes a "special relationship"? And, particularly, what is "special"? Is it "distinctive"? "Unusual" or "unique"? Does it make a value judgment, connoting a relationship that is more important than other bilateral relationships? If so, how does one define or measure the scale of importance? Is it a relationship between governments, between peoples, or both? Is it a relationship that is distinguished by being privileged or preferential in some sense? If so, how? Or is the United States' relationship with every country "special"—perhaps some simply more "special" than others?

These are questions that underlie the assessment one is asked to make about the nature of a U.S.-UK relationship characterized as being "special." Viewed from the economic/business perspective, the relationship is, in many respects, distinctive and, in some respects, unique. On the other hand, many aspects of the relationship fit the pattern of U.S. relations with other countries of the developed world.

A related issue is American and British attitudes toward the existence of such a special relationship. To what extent does promoting the existence of and drawing attention to this special relationship promote national interests? What advantages are gained from doing so? While any such relationship is necessarily complex, and thus generalization can be misleading, the United Kingdom, as the smaller of the two partners, must compete for U.S. attention to enhance its influence over U.S. economic policies, particularly foreign economic policy, and promote its trade and investment objectives. Thus, there are clear advantages to the United Kingdom in propagating the idea that a special relationship exists, which is presumably why special relationship rhetoric is more prevalent there than in the United States. Of course, it is also important for the United States to obtain support for its foreign economic policies and to achieve its trade and investment goals. However, the United Kingdom plays a less important role relatively for the United States than the other way around. In any event, there is a downside for the United States in touting a special relationship—for it implies that other bilateral relationships are less "special."

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CONTEXT OF THE RELATIONSHIP

Two essential constituents distinguish economic interaction between the United States and United Kingdom. In one respect, the economic relationship is distinctive and important to both sides, while in the other, it is less so.

The key of the U.S.-UK economic special relationship is the shared belief in and practice of what is often called the "Anglo-Saxon economic model" (while one can debate the appropriateness of this term, the intended distinction is between it and the more regulated form of capitalism prevailing in much of continental Europe). It refers to a web of laws, practices, and attitudes that reflect acceptance of a business culture and system that facilitate entrepreneurial activity (and permits failure), encourages wealth accumulation, promotes competition, and provides flexibility in the use of labor and other inputs.

The "model" contains many elements. One is a relatively reduced role of government as a participant in and, especially, regulator of the economy. Another is the preponderant role played by the stock and bond markets as a source for investment capital—compared to the Continent, where the banking system is more heavily involved—and, related to that, the high percentage of shareholding by the general public, which thus has a direct stake in the economy. A third is the similarities of the two countries' legal and accounting systems. Fourth is the strength of the financial services sector, consisting of a vast array of market participants ranging from financial intermediaries and accountants to insurance and pension funds. And, finally, the economies operate in a relatively transparent manner. This is perhaps more so in the United States than the United Kingdom in regard to the government and, increasingly, the private sector, as corporate governance issues assume ever greater prominence.

For the United States, these elements represent an essentially continuous pattern of policy and practice, whereas in the United Kingdom, they are the result of a significant measure of policies promoted by and adopted under the prime ministership of Margaret Thatcher in the 1980s, and, after their success became apparent, continued by the Labour government under Tony Blair. The net result of the mutual embrace of this economic model is a strong tendency to look at economic issues—domestic and international— from a similar point of view.

However—and this is the second constituent—this similarity of system and outlook is to some extent counterbalanced by UK membership in the European Union (EU). The United Kingdom is thus not a free agent in terms of economic policies and actions. EU economic integration has progressed to a remarkable degree. The EU single market, while clearly deficient in many areas, is nonetheless a reality over a wide range of economic activities. The EU has competence in major areas, notably competition policy and trade policy. Thus, the United Kingdom is but one of 25 member states making an input to those policies. Similarly, the voluminous corpus of EU law and regulation, the *acquis communautaire*, covers economic subjects, and the United Kingdom, like all member states, is bound by them. Thus, the freedom of action of the United Kingdom is, in many respects, limited.

Nonetheless, there is an important exception; that is the British "opt-out," i.e., nonparticipation, in the EU's Economic and Monetary Union, whose central feature is the single currency. This sets the United Kingdom apart—and enables it to play an independent role—in a major area of economic activity, one where the U.S.-UK bilateral relationship is unique, as will be described below. With that exception, however, the economic counterpart of the United States is, in large measure, the EU rather than the United Kingdom, or, indeed, any of the other EU member states. Thus, the United States cannot interact in the economic area with the United Kingdom in isolation from the EU, which means dealing with the European Commission and many or all of the member states.

PRIVATE SECTOR RELATIONSHIP

Trade

The simplest measure of bilateral economic interaction is trade— a significant, though not special, relationship. The United Kingdom consistently has been an important trading partner of the United States. In terms of trade in goods, the United Kingdom is currently the fourth ranking overseas U.S. partner—not counting its contiguous neighbors, Canada and Mexico—after Japan, China, and Germany. It accounts for 3.6 percent of total U.S. goods trade, about the same level as Korea, amounting to just over $80 billion per year.[1] However, the composition of U.S.-UK trade has changed dramatically from goods to services, a trend that is likely to continue. In this sector, the United Kingdom, which accounts for 12 percent of world trade in services, ranks as the biggest U.S. trading partner.[2]

Regarding total trade flows in the two directions, the United Kingdom was the destination for 4.3 percent of U.S. exports in 2004, while imports from the United Kingdom were a smaller share of the total—3.1 percent. Interestingly, these shares are lower than those achieved in recent years: export share peaked at 5.3-5.7 percent in 1997-2001, while imports fell within the 3.4-3.8 percent range during the period 1991-2002.[3]

Investment

Trade is, however, a much narrower indicator of economic interaction than investment. Intracompany trade accounts for a significant share of total trade, and sales by foreign affiliates dwarf trade volumes. In addition, of course, investment relations are deeper and more lasting than trade.

Looked at in terms of both investment flows and stock of investment, the United Kingdom is the top destination for U.S. direct investment. In 2004, over $23 billion was invested in the United Kingdom, amounting to 10 percent of U.S. worldwide investment and 28 percent of its investment in Western Europe. The total stock of U.S. investment in the United Kingdom is almost $300 billion, a figure approximately 30 percent greater than that in the next most important destination, Canada.[4] Over one million people in the United

1 U.S. Census Bureau, "Top Trading Partners—Total Trade, Exports, Imports," published February 2005, http://www.census.gov/foreign-trade/statistics/highlights/ top/top0412.html.

2 U.S. Bureau of Economic Analysis, "U.S. International Services: Cross- Border Trade 1986-2003, and Sales Through Affiliates, 1986-2002," published October 2004, http://www.bea.gov/bea/di/1001serv/intlserv.htm.

3 Ibid.

4 On a historical cost basis. U.S. Bureau of Economic Analysis, "U.S. Direct Investment Abroad: Balance of Payments and Direct Investment Position Data," published March 2005, http://www.bea.doc.gov/ bea/di/di1usdbal.htm.

Kingdom work for U.S.-owned companies. Small and medium-sized U.S. enterprises participate very actively in this investment.[5]

By the same token, the United Kingdom predominates as a destination for U.S. investment in the EU. Except for one “bad” year (2001), the United Kingdom accounted for between 28 percent and 49 percent of annual U.S. foreign direct investment (FDI) that flowed into the EU during the 10-year period from 1994 to 2003. Similarly, when measuring the stock of U.S. FDI in the same period (without excluding 2001), the United Kingdom has accounted for a range of 32-41 percent in the EU. Of possible significance, both shares (the United Kingdom as a destination of U.S. FDI in the EU and in the world) peaked in the late 1990s; nevertheless, the United Kingdom easily maintained its number one position.[6]

The attractions of the United Kingdom as a destination for U.S. investment are many—some tangible, others less so. A common language and, to a somewhat lesser extent, common culture rank high on the list. The business environment is clearly favorable: the United Kingdom offers a well-developed infrastructure, receptivity to inward investment (and more generally to “outsiders” doing business in the United Kingdom), a political and legal system that offers confidence to investors that they will be equitably treated, ease of entry (and departure), low taxes, a skilled and well-educated workforce, labor flexibility, a strong research and development (R&D) sector, and, finally, an intangible but significant factor of comfort level.[7]

In the early stages of the EU, the United Kingdom was viewed by many U.S. companies as a gateway or staging area into what began as a customs union and then developed into an increasingly integrated economic area. However, over time the attraction of the United Kingdom was reduced by rising costs, competition from other destinations (notably Ireland, which featured low taxes, a common language, and a plentiful and well-educated workforce), and American firms’ increasing comfort with locating elsewhere in the EU. Thus, there has been some increase in investment in the rest of the EU. Reflecting the decline in manufacturing in the United Kingdom, the share of that sector in U.S. investment in the United Kingdom has fallen from 39 percent to 15 percent. However, the decline was offset by other attractive areas, with most of that money moving into the finance, information technology, and property sectors.[8]

One factor potentially affecting investment in the United Kingdom is the British opt-out of the single currency, and its continued reluctance to join. The “drying up” of inward investment predicted by some when the Euro was introduced, without UK participation, has not taken place. However, the further away British entry into the Economic and Monetary Union seems, the more likely investment in the United Kingdom—not only by U.S. firms—will be adversely affected. That will be particularly so if the UK economy ceases to outperform that of the Eurozone. Observers in the United Kingdom report that Britain’s opt-out has not been a major factor in inward investment decisions thus far, as most investors have assumed that the United Kingdom will eventually join the eurozone. However, firms that operate on small margins and are currency sensitive are concerned about the situation.

Another potentially negative factor in U.S. investment decisions is the further development of EU social legislation—regulating many of the conditions of employment and

5 British-American Business, Inc.
6 U.S. Bureau of Economic Analysis.
7 Ibid.
8 Union des Industries de la Communaute europeenne (UNICE).

the rights of workers—and its extension to the United Kingdom. Although the United Kingdom received an opt-out from this legislation, there are pressures within the EU to terminate this exemption. Were the exemption to be rescinded, the attractiveness of the United Kingdom as a destination for U.S. investment would be diminished. Still, developments in these two areas—the future of the single currency and social legislation—may be affected by the crisis within the EU as a result of the French and Dutch rejection of the draft EU Constitution.

On the other side of the ledger, the United Kingdom remains a popular site for U.S. companies. An estimated 7,500 U.S. firms have offices in the United Kingdom. Of these, 500 are corporate headquarters, often of regional operations. It is estimated that one- half of U.S. companies with corporate offices in Europe have located those offices in the United Kingdom.[9]

Tourism

The United Kingdom is the most important U.S. partner in two- way tourism. Although U.S. residents travel more frequently to Canada and Mexico, expenditures on travel and transportation are highest for visits to the United Kingdom. In 2000, more than four million Americans spent over $11 billion traveling to the United Kingdom, compared with $7.5 billion (the second highest sum) in Mexico. In the other direction, British visitors to the United States number annually just under five million and spend almost $13 billion, figures that place it only slightly below Japan.[10]

Financial Market

Here is perhaps where the "special economic relationship" is most evident—indeed, the word "unique" is not out of place. The historical ties between American and British capital date back to the 19th century, when British investment played an important role in the economic development of the United States. Banking relationships have a long history; many banks were well-established in the other's country in the period between the two world wars, if not before.

One can speak of a single financial market, located in London and New York. Each is a financial powerhouse, and each is an undisputed financial center—London in Europe and New York in the United States. The New York Stock Exchange is the biggest stock exchange in the world, and it, together with New York-based Nasdaq, gives the United States its preeminent position for stock trading. London manages almost half of Europe's institutional equity capital, and 70 percent of Eurobonds are traded in London. It is also the world's largest international insurance and foreign exchange market.[11]

American and British financial institutions are major players in the world, accustomed to working globally. The U.S. investment banking community has acquired a preeminent

9 American Embassy, London.

10 U.S. Bureau of Transportation Statistics, U.S. International Travel and Transportation Trends, 2002.

11 London as a Financial Centre, from http://www.london.gov.uk/london-life/ business-and-j obs/financial-cent re.jsp.

position in London, while UK commercial banks are very competitive and present globally. Of the world's top 15 "tier one capital" banks, over one-half are American or British (four banks each).[12] There are more American banks in London than in New York (a reflection of the prevalence of U.S. regional—not New York—banks that have international operations).

These developments were facilitated by the similarity of economic and legal systems and the role of stock and bond markets in the two countries. It also has spurred the expansion of American-British ties in other related sectors, notably insurance and law firms.

In one manifestation of this relationship, U.S. bank claims on and liabilities to the United Kingdom are vast, second only to the Cayman Islands. U.S. claims on the United Kingdom and Cayman Islands at the end of 2004 were both about half a trillion dollars, with the next country, the Bahamas, accounting for only about one-fifth of that amount. U.S. liabilities to the British were about $430 billion (for the Cayman Islands, it was double that figure). The total U.S. banking relationship (claims and liabilities) with the United Kingdom has grown from the equivalent of 10 percent of world trade in 1978 to 19 percent in 2004.[13]

Defense Industry

Although close relationships exist in a number of industrial sectors, probably none is closer than in the defense industry. However, unlike the other sectors, government policies and actions largely determine the nature and extent of the relationship. Closely held and subject to government control, U.S. defense technology sharing takes place at a higher level with the United Kingdom than with virtually any other country (Australia and Canada also vie for that position).

Trade in defense equipment is significant, and it flows in both directions. American firms are routinely invited to bid on British defense tenders, and they have registered many successes. The United Kingdom is by far the largest overseas buyer of American products. Major British purchases have included the Apache helicopter, Airborne Warning and Control System (AWACS), and Airborne Stand-off Radar (ASTOR). Moreover, the United Kingdom is the launch customer for the C-130J aircraft.

By the same token, UK companies are among the most active participants in the "special security arrangement," under which U.S.-based subsidiaries of foreign companies can be certified to bid as subcontractors on U.S. tenders. The most notable recent instance was the U.S. Navy's decision in early 2005 to accept the Lockheed-Martin-led bid for the new Presidential helicopter fleet, which includes a British component.

Significant shares of the U.S. market are held by such British firms as Rolls Royce, Martin Baker, and Smith Industries. However, the leading British player is BAE, the fifth largest supplier of hardware to the U.S. military (and the largest foreign supplier). Like other British firms, BAE has been looking to increase its business opportunities in the United States. Its recent multibillion dollar purchases include Lockheed-Martin's electronic assets and United Defense Industries, the latter ($3.5 billion) being the largest foreign takeover of an

12 The Banker, 2004, Top 1000 World Banks, from http://www.thebanker.com/news/fullstory.php/aid/1699/Top_1000_World_Banks.html.

13 U.S. Department of the Treasury, Treasury International Capital System, "U.S. Banking Liabilities to Foreigners" and "U.S. Banking Claims on Foreigners," published April 2005, http://www.treas.gov/tic/ticliab.html and http://www.treas.gov/ tic/ticl.

American defense company. By any measure, BAE is a significant player in the U.S. defense industry sector, employing over 25,000 in its U.S. operations.

A further example of close cooperation is the Joint Strike Fighter project, in which the United Kingdom is a major partner. BAE is an associate prime contractor, participating in the work and technology on the new aircraft, which will be purchased by both governments.

The dispute that erupted in 2004 between the United States and the EU over the possible lifting of the latter's embargo on arms sales to China placed the British defense industry in a delicate position. While it did not want to forgo business opportunities in China, at the same time it did not want to jeopardize existing and potential business and the transfer of technology with the United States. On balance, the latter consideration prevailed, and BAE, for one, announced publicly it would not participate in trade with China. The British government generally reflected industry's position, at first going along with the French and German-led initiative to lift the embargo, but backing away quickly when vociferous U.S. opposition surfaced.

GOVERNMENT-TO-GOVERNMENT RELATIONSHIP

Multilateral

The world's multilateral economic agenda is vast, and so is the range of multilateral institutions that deal with it. Both the U.S. and UK governments interact on these many issues as they operate in a multilateral context.

In general, the two governments convey similar messages on issues relating to the world economy—what policies national governments should follow to enhance economic growth, operation of the international monetary system, trade policy, operation of the international financial institutions, and the like—in the course of what might be called normal international discourse, including more specifically the G-7/G-8 and the Organization for Economic Cooperation and Development (OECD). On the whole, the United States and United Kingdom work together in those forums to promote their mutual interests.

In some areas, however, there is a significant difference in policy. The most notable example is the environment, particularly in attitudes toward the Kyoto Convention. The United Kingdom has agreed with the consensus view within the EU — and indeed virtually the rest of the world—and worked toward the adoption of the Convention, while the United States has firmly refused to accede to it. Nonetheless, the United Kingdom accepts that the United States will not accede to Kyoto, and thus seeks to find common ground in other aspects of environmental policy.

On the other hand, the two governments have traditionally seen eye-to-eye on trade, where they have been leaders in efforts to build and maintain a liberal trading system, including the current work on the Doha multilateral trading round. However, on trade, the United Kingdom cannot carry out an independent policy because competence for trade lies with the EU. Thus, the United Kingdom remains one voice out of 25—albeit a strong and influential one—on all trade issues. Nonetheless, that has not prevented U.S. and UK negotiators on the Doha round from working closely together.

European Union

The United States and EU have grappled with a host of trade disputes over the years, while at the same time enjoying an unprecedented and flourishing economic relationship (a sometimes- overlooked, but critical, fact). Looking through the list of recent issues, one finds some concordance of position, but also many instances where the United States and the United Kingdom are on opposite sides of the argument.

- *EU regulation of chemical substances*: With similar industrial interests and views on regulation (less is better than more), the two governments have fought for an extensive watering- down of the proposal of the European Commission for registering, evaluating, and authorizing chemicals (REACH).
- *U.S. foreign sales corporation*: In the long struggle over U.S. legislation, the United Kingdom played a constructive role in the ultimately successful effort to keep the issue from getting out of control, giving the United States leeway in terms of time and modalities for settlement. Following the adoption of new tax provisions in the United States, the British government sought to prevent a return of the issue to the World Trade Organization (WTO) and the reimposition of sanctions by the EU.
- *EU banana regime*: The United Kingdom historically protected the banana exports of its former colonies in the Caribbean at the expense of Latin American producers, and thus it was not particularly sympathetic to U.S. efforts to prevent a restrictive EU regime from replacing the various national regimes. However, it believed the EU should comply with the WTO ruling in favor of the United States, a view that was reinforced by U.S. retaliation against imported cashmere sweaters.
- *Biotechnology/genetically-modified organisms*: In the long-running U.S.-EU battles over a number of issues in this area, the United Kingdom generally has supported the U.S. view that decisions should be based on scientific evidence, despite strong opposition from the British public that is very “pro- environmentalist.”
- *U.S. safeguard action against steel imports*: Like the rest of the EU, the United Kingdom, which exports significant quantities of specialty steel to the United States, sharply criticized President Bush’s first-term action (subsequently rescinded). It pressed for, and received, exemptions from the increased tariffs.
- *Airbus subsidies*: As a major participant in the Airbus consortium, the United Kingdom has stoutly defended Airbus against U.S. allegations of unfair subsidization and criticized what it considers to be comparable subsidies by the U.S. military to U.S. commercial aircraft manufacturers. Nonetheless, it favors a negotiated settlement rather than seeking recourse to the WTO.
- *EU’s Common Agricultural Policy* (CAP): Because of the nature of its agriculture and its domestic agricultural policy, the United Kingdom has been among the sharpest internal critics of the CAP, thus lending support to the United States in its long-standing efforts to reduce the distortions it has caused to world agricultural trade. Prime Minister Blair made this clear in the EU budgetary dispute in June 2005.
- *Regulatory convergence*: This is a major undertaking designed to reduce the impediments arising from differences in regulatory regimes in the United States and EU. While American and British regulators generally share a similar regulatory

> philosophy, some problems have arisen from differences between the regulatory structures in the two countries. The United Kingdom has been bothered by the reluctance of the U.S. Securities and Exchange Commission to recognize decisions of British regulators and the problems caused by regulation of insurance at the state, rather than national, level. On the other side, U.S. regulators occasionally have felt that the UK Financial Services Authority has not adopted sufficiently tough positions in the EU, where it plays an influential role.

Whether in agreement or not, there is intense, extensive, and positive interaction between the two governments. U.S. government officials have found their British counterparts to be open and helpful. The British are good sources of information on the inner workings of the EU for their American colleagues. However, this occurs primarily when the two governments are on the same side of an issue. Not surprisingly, when they are not, the United Kingdom is considerably less helpful.

Traditionally, there has been a tendency for some parts of the U.S. government to assume that the United Kingdom is on its side on issues under consideration at the EU, and that the British can, or should, be counted on to promote U.S. views. As seen above, the first premise is by no means universally correct. While overall the British outlook and objectives are in accord with those of the United States, on many specific issues that simply is not the case. With regard to the British role inside the EU, the United Kingdom is an active and influential player in the EU deliberations. Suspect in the eyes of many other members for Britain's "outsider" status—i.e., opt-out of the Euro and generally weak support for further integration and market regulation—British officials have to take care not to be perceived by other member states as carrying water for the United States as they pursue UK policy objectives.

Bilateral

Significant bilateral economic differences are rare. The major exception is the civil aviation relationship. This relationship is governed by a long-standing bilateral agreement, Bermuda II, which specifies the conditions under which American and British carriers can operate between the two countries. It has long been a bone of contention, with the United States chafing under what it considers to be unduly restrictive provisions, particularly as regards access of its carriers to Heathrow Airport; and the United Kingdom complaining about U.S. restrictions on foreign ownership of U.S. airlines and the ban on foreign carriers flying between points inside the United States. The United Kingdom has stoutly resisted U.S. efforts to bring the bilateral agreement more closely into accord with the series of "open skies" regimes it has negotiated with almost all European countries in recent years. However, after an unsuccessful 2-plus year effort to renegotiate Bermuda II bilaterally, the issue will move from the bilateral to the EU sphere. The European Court of Justice has confirmed that civil aviation agreements fall within the competence of the EU, rather than the individual member states, and thus this issue will be added to the U.S.-EU portfolio.

CONCLUSIONS AND POLICY RECOMMENDATIONS

The U.S. economic and business relationship with the United Kingdom is without any doubt among its most important. The United Kingdom is a major economic partner, both in the public and private spheres. In some respects the relationship is distinctive, unique, and—yes—special.

Are there ways this relationship can be improved, i.e., rendered more effective in meeting the two countries' objectives? On the business side, the answer is probably "not to any significant extent." The framework within which businesses operate and business decisions are made is firmly established, well-known, and not notably in need of change. On the government-to-government side, there is little apparent need for structural or institutional change. The governments know each other well and communicate freely and frequently.

The one area where improvement could be made is the quality of government-to-government interaction. This has two aspects. First, exchanges between American and British bureaucrats should be expanded. A program similar to the existing exchange of U.S. and British diplomats, under which Americans serve a tour in the Foreign and Commonwealth Office and British do likewise at the State Department, should be introduced for the UK Department of Trade and Industry and the Treasury. In addition, British bureaucrats visiting Washington should regularly add the U.S. Congress to their schedule. Both sides can profit from an improved understanding of the other's points of view and positions in the decisionmaking process.

Second, the selection of the American ambassador to the United Kingdom should be made on the basis of competence rather than political indebtedness, as has almost invariably been the case. Unless the function of the ambassador is deemed to be superfluous to bilateral dialogue and interaction—certainly not the view of the British government, which has invariably sent its most qualified diplomat—it behooves the United States to send ambassadors with the experience and skills to promote U.S. interests and enhance this special relationship, whether it be a career or a noncareer person. Indeed, at this time of heightened transatlantic misunderstanding, it is all the more essential for the United States to field an ambassador who can articulate U.S. policy and seek to influence government policy and public opinion abroad.

Finally, in the EU context, it is essential that the remarkably effective relationship between American and European trade negotiators Robert Zoellick and Pascal Lamy be replicated by their successors. The personalities of their successors, Peter Mandelson and Robert Portman, give grounds for hope, but only time will tell how effectively their relationship works as they grapple with a range of difficult issues, which will necessarily affect the bilateral relationship between the United States and the United Kingdom.

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THE GERMAN ECONOMY AND U.S.-GERMAN ECONOMIC RELATIONS*

Raymond J. Ahearn and Paul Belkin

ABSTRACT

Germany is the world's fifth largest economy and the largest in Europe, accounting for about one- fifth of the European Union's (EU) GDP. Germany is also the largest European trade and investment partner of the United States. Mutually profitable and growing U.S.-German commercial ties historically have been facilitated by a strong German economy. The health and functioning of the German economy, as well as its approaches to international economic policy issues, thus, are of considerable importance to the United States as well as to the rest of Europe.

By most standards, post-war West Germany registered impressive economic performance in the first decades of its existence. But beginning in the mid-1990s, the German economy has been on a much lower growth path, averaging about 1.5% of GDP per year. Unemployment has also risen steadily. These trends, which are expected to be exacerbated by a steep decline in German GDP growth in 2009, raise questions about the long-term vitality and strength of the German economy.

A number of factors help explain Germany's declining growth rate. One factor has been the high cost associated with integrating the formerly communist East German economy into the Federal Republic since reunification in 1990. A second has been the growing cost of Germany's generous social security and welfare programs and associated regulations which some believe may undercut incentives for work and entrepreneurship. A third is an economy that is more geared towards exporting than domestic investment and consumption.

With few exceptions, German governments have generally been reluctant to advance what many economists consider necessary but unpopular economic policy reforms, including cut-backs in welfare programs and labor market protections. Some believe that Chancellor Angela Merkel's September 2009 reelection in coalition with the pro-business Free Democratic Party (FDP) could increase the likelihood of market-friendly reforms being enacted, but any radical restructuring of Germany's social market economy is considered unlikely.

With declining economic growth and rising expenditures on social protections, Germany faces significant budgetary and resource constraints. This resource crunch could limit Germany's flexibility in pursuing domestic and international policy goals, arguably making Germany less capable of compromise on matters of potential economic advantage. In this regard, Germany's domestic economic challenges could limit its

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policymaking flexibility. This has affected not only the economic and trade leadership role Germany has traditionally played in Europe, but also its position on issues that directly affect U.S. interests such as the global economic downturn and economic sanctions.

A prosperous German state remains critical to both the U.S. and European economies. Difficulties Germany may have in regaining a stronger economic position are important concerns, affecting the U.S.-German partnership's ability to mutually address and manage a range of bilateral, regional, and global challenges. This report elaborates on these themes in three parts: the first section examines Germany's economic performance in historical perspective and assesses some of the domestic factors that may be contributing to Germany's less than optimal performance; the second discusses the reform challenges facing Germany's political leaders; and the third section evaluates a few salient U.S.-German economic policy differences and strains that seem to be influenced by Germany's weakened economic situation.

OVERVIEW

With a population of 82 million and a GDP of $3.6 trillion, Germany is the world's fifth largest economy (after the United States, China, Japan, and India) and the largest in Europe, accounting for about one-fifth of the gross domestic production (GDP) of the European Union (EU) [1]. Based on a per capita income of around $44,280 (2008), Germany is one of the world's high-income countries. Germany has also been the world's number one exporter of goods and the largest European trade and investment partner of the United States. Although its economic and commercial policies are increasingly determined within the EU, Germany plays a key role in influencing EU policies. The health and functioning of the German economy, as well as policy approaches adopted by the government, are not only of bilateral and regional importance, but also of global importance to the United States.

Since its founding in 1949, the Federal Republic of Germany has experienced a continuous rise in living standards [2]. GDP per person has risen by a factor of 6 since 1950. This increase in material well-being has helped create a very stable middle class. German firms remain competitive internationally and the work force tends to be highly skilled. The economy is heavily dependent on exports. In 2008 exports of goods and services accounted for 47% of Germany's GDP—more than three times the rate in the United States. Germany's strong export performance in goods or merchandise is also denoted by the term Exportweltmeister (world champion exporter). At the same time, relatively weak consumer demand is a consistent feature of the German economy.

Germany has been a driving force in European integration, including the creation of the European Monetary Union. Germany's EU partners remain its prime trade customers and suppliers. In 2008, 63% of German exports went to other EU member states and 64% of its imports came from other EU member states [3]. The United States is Germany's largest trading partner outside of Europe. In 2008, 7.2% of German exports went to the United States and 4.2% of its imports came from the United States. In turn, Germany is the United States' largest European trading partner and its fifth largest trading partner worldwide, accounting for 4.5% of U.S. total trade [4]

The two countries also share strong foreign direct investment (FDI) ties. The United States in 2008 accounted for $110 billion, or over 25%, of Germany's total stock of outward

FDI and was the second most important provider of FDI in Germany. Germany's stock of FDI in the United States stood at $212 billion in 2008, making Germany the fifth largest foreign investor in the United States [5]

These investments drive trade and create jobs. In 2007, 62% of U.S. imports from Germany consisted of related party trade—trade between German parent companies and their own affiliates in America. German companies doing business in the United States employ about 670,000 people, or one in every 200 people in the private sector. U.S. companies operating in Germany employ nearly 800,000 people, which accounts for nearly one out of every 35 jobs in the private sector [6].

Mutually profitable, growing, and beneficial U.S.-German commercial ties historically have been facilitated by a strong German economy. By most standards, West Germany registered an impressive economic performance in the 1950s and 1960s, the first decades of its existence. Powered by export-led economic growth based on low wages and high-level engineering, the Federal Republic of Germany grew at an average of 6.3% per year during this twenty-year period. The economy grew at a less rapid, but still strong pace of 3.6% per year in the 1970s and 1980s. But beginning in the mid-1990s, the German economy has been on a much lower growth path, averaging around 1.5% GDP growth per year (as compared to an OECD average growth rate of 2.7%). Unemployment has ratcheted upward since 1970, from virtually full employment to a situation where in some years 10% of the population is out of work and another 4% can't find work but are in government programs. These trends, which are expected to be exacerbated by a 4.8% to 6% decline in German GDP growth this year, raise questions about the long-term vitality and strength of this European powerhouse [7].

A number of mostly domestic factors may account for Germany's suboptimal economic performance. These include the heavy and continuing costs of reunification with East Germany in 1990, escalating costs associated with generous social security and welfare programs, rigid labor market laws and perceived over-regulation, and an economy more geared towards exporting than consumption. Amidst the current global economic slowdown, questions have been raised concerning the impact that Germany's export dependency has on the domestic economy, particularly for growth.

Some of the aforementioned factors are at the same time valued by many Germans as essential features of the country's so-called social-market economy. Since the founding of the Federal Republic and reunification in 1990, German policymakers have consistently pursued parallel national goals of export-driven economic growth and social cohesion through a robust system of social welfare programs. Most Germans appear to continue to take pride in Germany's position as a leading exporter and to support government-funded programs aimed at reducing economic disparities within their society. In turn, German political leaders have displayed a willingness to sacrifice a degree of economic growth for what they perceive as social cohesion.

These preferences are evident in the reluctance of most German governments to pursue the kinds of economic reforms advocated by many economists. Most recently, from 2005-2009, a so-called grand coalition government of the center-right Christian Democratic/Christian Social Union (CDU/CSU) and the left-of-center Social Democratic Party (SPD) proved reluctant to advance unpopular cut-backs in welfare programs and labor market protections. Some believe that Chancellor Angela Merkel's (CDU) September 2009 reelection in coalition with the pro-business Free Democratic Party (FDP) could increase the likelihood of market-friendly reforms being enacted, but any radical restructuring of Germany's social market economy is considered unlikely. Failure to enact substantial reforms could mean that the problems posed by an aging population and Germany's system of social benefits will place an even larger strain on the economy in the future.

Germany's Political Parties:
Overview and Key Economic Policy Positions

The Christian Democratic Party and Christian Social Union (CDU!CSU). Founded by West Germany's first post-war Chancellor, Konrad Adenauer, the CDU runs in federal elections with its Bavarian sister party, the CSU. The parties jointly pursue a center-right policy platform, with the CDU generally more conservative on economic issues than the CSU and the CSU more conservative on social values associated with the Catholic church. During the previous government (2005-2009), Merkel was criticized by some within her party and by members of the FDP (see below) for being too reluctant to pursue free-market reforms such as a further liberalization of the labor market and reducing the tax burden on employers. In the face of the economic downturn, Merkel and her partners in the CSU have been cautious about pursuing such reforms and have emphasized the need to provide support to the poor and unemployed as well as to the business community.

The Social Democratic Party (SPD). Germany's oldest political party, the SPD has evolved from a socialist party to a social democratic party, but continues to see itself as the representative of the German working class and enjoys close ties to Germany's trade unions. Now in opposition for the first time since 1998, the party has been challenged to overcome internal divisions between its more centrist wing represented by some of the party's veteran policymakers and a left wing of younger lawmakers. The internal debate within the SPD has been exacerbated by the emergence of the Left Party, which has sought to distinguish itself as a left-wing alternative to the SPD. Under former Chancellor Schröder, the SPD championed stringent economic reforms that were opposed by most Germans and some of the party's base. In opposition, the party appears poised to oppose economic policies it perceives as too "pro-business" such as tax cuts for employers, and to seek to strengthen protections for German workers and the poor and unemployed.

The Free Democratic Party (FDP). The junior coalition party in the current government, the FDP considers itself a liberal party, advocating individual freedom and limited government involvement in economic and social issues.

Since its inception in 1948, the party has governed in coalition with both the CDU/CSU and SPD, but is considered a more natural ally of the CDU. While in opposition from 1998 to 2009, the FDP distinguished itself by advocating free-market, pro-business policies and the protection of individual civil liberties. The FDP favors extensive tax cuts and a reform of Germany's social welfare structure, including its public health system. Some commentators speculate that a return to government could soften the FDP's calls for stronger reforms. Party leader Guido Westerwelle is Vice Chancellor and German Foreign Minister.

The Left (Die Linke). The Left Party was formed in 2007 as a merger of the Party of Democratic Socialism (PDS)— the successor to East Germany's ruling Socialist Union Party—and the Electoral Alternative for Labor and Social Justice (WASG), based in western Germany. The most left-wing party in the German parliament espouses a platform of social solidarity in the face of globalization. The party calls for redistribution of wealth through taxes on corporations and the rich, a minimum wage, curbs on privatization, and more self-determination for workers. The party enjoys strong support in eastern Germany and is considered a potential future coalition partner of the SPD. Should the SPD and The Left overcome existing differences, the grouping could represent a leftward shift in German politics.

Alliance '90 ! The Greens. Founded in 1980 as an opposition movement, the Green Party has become a widely respected mainstay in German politics. The Greens have had continuous representation in the German parliament since 1983 and were a junior coalition partner in the Schröder government from 1998 to 2005. The party has long- advocated enhanced environmental protection and sustainable development and has promoted achieving economic growth through such development. In the Schröder government, the Greens successfully pushed for a gasoline tax which channeled revenues to spur clean energy development. Although the party is on the left of the political spectrum, it has entered into coalition governments with the CDU at the regional level and is considered less beholden to trade unions and more open to economic reform than the SPD

As a result of its declining economic growth, aging population, and the growing costs of maintaining generous social security programs, Germany, as many other industrialized countries, faces a resource crunch. This resource crunch arguably has limited Germany's flexibility to maneuver domestically and appears to have been a factor in the evolution of somewhat more assertive German international economic policies. With dwindling economic and financial resources, Germany arguably has become less capable of compromising on matters of potential economic advantage. This has affected not only the trade and economic leadership role that Germany has traditionally played in Europe and the world economy, but also its position on issues that directly affect U.S. interests. These include different approaches in dealing with the global economic downturn and economic sanctions.

In short, a prosperous German state remains critical to both the U.S. and European economies. Difficulties Germany may have in regaining a stronger growth pattern are an important concern, affecting the U.S.-German partnership in addressing a range of bilateral, regional, and multilateral challenges.

This report elaborates on these themes in three parts: the first part examines Germany's economic performance in historical perspective and assesses some of the domestic factors that may be contributing to Germany's less than optimal growth pattern in recent years. The second section discusses the reform challenges facing German political leaders. The third section evaluates selected U.S.-German economic policy differences and strains that may be influenced by Germany's economic situation.

GERMANY'S ECONOMIC PERFORMANCE: FACTORS EXPLAINING DECLINING GROWTH

In the first decades of its existence, West Germany experienced impressive economic performance. Powered by export-led growth and close collaboration between business, government, and labor, the Federal Republic of Germany was hailed as an "economic wonder" (Wirtschaftswunder) as it averaged 8.2% growth rates during the 1950s, 4.4% in the 1960s, and 2.8% in the 1970s. In the 1980s, Germany's economic performance began to slip further, falling to an annual average increase of 2.3%. As shown in Table 1, with only a few years of exceptions, the growth rate has continued to decline since 1990 [8] In the 1990s, Germany recorded an average growth rate of only 1.6% and a meager 0.6% between 2001 and 2005. The economy did bounce back in the three years from 2006-2008, with growth averaging 2.3%. But the economy was again hard hit in late 2008 and early 2009 by the global economic downturn. Germany's economy is expected to contract by 4.8% to 6% this year, compared with a 4.2% drop in the Euro-zone overall [9].

Once Europe's growth engine, Germany since the mid-1990s has had, along with Italy, one of the lowest growth rates in Europe. The aggregate output of the German economy, for example, increased by 7% between 2000 and 2009 compared to a Euro Area increase of 12.6% [10]

Table 1. Germany: Annual GDP Growth Rates for Selected Years (in percent change)

1950-1960	1960-1970	1970-1980	1980-1990	1991-2000	2001-2005	2006	2007	2008	2009[a]
8.2	4.4	2.8	2.3	1.6	0.6	3.2	2.6	1.0	-6.0

[a.] Projected.
Source: German Federal Statistical Office, OECD.

Table 2. Germany: Unemployment Rate, 2000-2010

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009[a]	2010[a]
9.6	9.4	9.8	10.5	10.6	11.7	10.8	9.0	7.8	10.1	11.6

[a]. Projected.
Source: EIU database, OECD World Economic Outlook, June 2009.

Slower German economic growth, in turn, has been accompanied by high unemployment (see Table 2). In the 1960s, both West and East Germany had almost no unemployment. In 1970, about 150,000 people or 0.7% of the labor force were unemployed—compared to over 3 million today. But by 2005 unemployment reached 11.7% nationwide and 18% in the states of the former East Germany [11]. When the economy did bounce back in the three years from 2006-2008, with growth averaging 2.3%, unemployment also fell from nearly 5 million to around 3.3 million, but the unemployment rate barely dipped below 8%. The OECD also predicts that the number of unemployed will rise to 5.1 million and that the unemployment rate will increase sharply to 11.6% by the end of 2010 [12]

Many economists argue that unemployment in the German economy is higher than the unemployment data indicate. This "hidden" unemployment is allegedly due to a large number of workers employed in government schemes or subsidized in early-retirement programs. In addition, the government funds a so-called "short-term working benefit" (Kürzarbeit) through which it subsidizes 60%-67% of lost income for individuals whose working time has been reduced by their employer. According to some estimates, the program has saved at least 400,000 jobs and 1.4 million employees are working shorter hours [13].

High unemployment translates into underutilization of the German labor force and foregone production. The fact that the German labor force, on average, tends to work fewer hours than its counterparts in most industrialized countries, and enjoys more paid leave and holidays, could further impede more robust economic growth [14]. On the other hand, as noted above, many Germans appear comfortable foregoing potential gains in economic growth in order to maintain relatively generous social benefits.

A number of factors help explain Germany's declining growth record. One factor has been the high costs of integrating the formerly communist East German economy into the Federal Republic. A second factor is Germany's generous social welfare provisions which may undercut incentives for work and entrepreneurship. A third is an economy that may be excessively dependent on exports, and saddled with labor market rigidities and other barriers that make investment in the domestic economy less attractive than investing abroad. These trends are discussed below.

The Costs of Reunification

With German reunification in 1990, West Germany realized what had been its single most important national objective. Reunification also represented a major change in the country's economic condition. In practical terms, a relatively strong West German economy of about 63.2 million people took over a reeling economy of 16.1 million people which had been essentially isolated from the West for over 40 years. For the former East Germany, this meant a drastically new environment for its population. German policymakers set out to privatize state-owned firms, production was to be reoriented towards the markets of the West, and new roads, housing, and public infrastructure began to be constructed [15]. The results of these policies have been at best mixed and today, some estimate the total value of transfers from west to east since 1989 at upwards of $2 trillion.

The West German economy was fairly strong when the reunification process began. Price stability had been achieved, the government budget was balanced, and the country's transactions with the rest of the world (i.e., its current account) were in surplus by almost 5% of GDP. The East German economy, on the other hand, had a per capita GDP just 40% of that of its western neighbor.

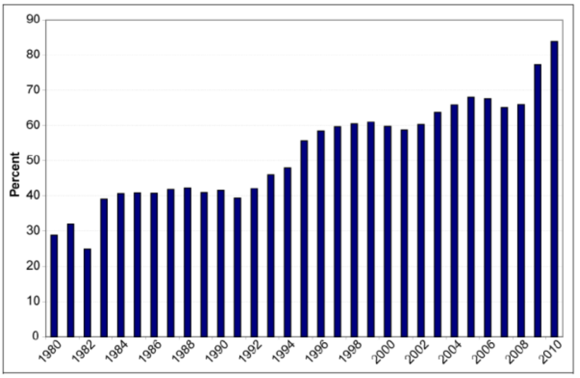
In hindsight, some observers think that the strong economic situation in the west perhaps led the government to underestimate the economic burden that reunification would entail and caused it to commit a number of policy mistakes in the process. One oft-cited example is the decision to exchange the East German currency at a one-to-one rate for the West German deutschmark. This action effectively quadrupled East German wage costs in terms of deutschmarks. While the one- to-one currency conversion raised East German wage costs to only 30 percent of the West German level, subsequent increases may have undermined the attractiveness of East Germany for investors [16].

A second scrutinized policy decision was to extend West Germany's social welfare system, with its wage-replacement benefits in terms of early retirement, unemployment compensation, and social assistance, to East Germany. These benefits arguably prevented wage rates from settling at a level that would have made East German labor competitive, particularly given the lower level of productivity of East German workers [17].

Proponents of the one-to-one currency valuation and the decision to extend West Germany's social welfare system east argue that these moves were both inevitable and necessary given the political context. One of the West German government's primary goals with regard to reunification was to avoid a mass migration of people from east to west and to ensure social and economic cohesion between east and west. In explaining the rationale behind the one-to-one currency valuation, then-West German Foreign Minister Hans-Dietrich Genscher has said, "If we had not brought the deutschmark to the east, the east would have come to the deutschmark" [18]. West German leaders believed that their best policy option was to extend the West German currency and its social market economy east despite the potentially negative consequences for the regional economy.

German reunification required, and still requires, large annual public transfers to the east, estimated to be roughly 3%-4% of western Germany's GDP and more than one-third of the federal budget. This sum has placed a heavy burden on the economy of western Germany [19]. It is also estimated that only one-quarter of total transfers to the east are used for investment, either in the private sector or for infrastructure. Most of the transfers are thought to go to public and private consumption [20]

The budgetary transfers were financed to a large extent by issuing bonds rather than by increasing taxes, leading to a doubling of government debt. As shown in Figure 1, in the nearly twenty years since reunification, total government debt as a percentage of gross domestic product has doubled, rising from 39.4% in 1991 to a projected 83.8% in 2010. Debt service payments on this amount of debt has equaled in recent years around 15% of total federal budget expenditures, or between 2.2% and 2.4% of GDP (as compared to the OECD average of between 1.7% and 1.8% of GDP) [21].



Note: 2009 and 2010 figures are projections.
Source: EIU database.

Figure 1. Germany's Public Debt as % of GDP.

The higher debt and interest rate burden has had an adverse impact on Germany's fiscal policy stance. Due to the rising interest payments on the new debt, the leeway for tax reductions has been severely reduced. In the process, tax rates for German firms have remained higher than those in other EU countries [22].

Despite the magnitude of transfers from the west to the east, the challenge of bringing the economy of the east up to the standards of the west persists. The eastern German economy still depends upon resource transfers from western Germany for 45% of its total expenditures. While eastern German aggregate income has almost reached the western German level, aggregate productivity is only about 60% of the western German level. At the same time, in some areas of eastern Germany per capita GDP is less than half that in western Germany. Some eastern areas are also confronting population declines of 20%. Moreover, there are few indicators to suggest that the eastern German economy, after nearly two decades since reunification, is close to becoming self-sustaining. Continuing dependency on transfer payments could represent a heavy burden on western German businesses and employees in the years ahead [23].

Social Welfare Costs

After World War II, West Germany constructed the so-called "social-market economy" that remains the foundation of the current German economic model [24]/ The basic idea was to create a competitive economy safeguarded by social protections with minimal government intervention in markets. At its core, the approach attempts to generate a more stable and equitable distribution of income than the outcome which market forces alone would achieve. It does so through a range of institutional arrangements that generally include market capitalism, strong protection of labor and unions, a relatively large welfare state, and tight regulation of markets. Born out of the traumatic experience of the economic and political chaos of the 1 920s and 1930s, it was "an attempt to harness free market capitalism while simultaneously avoiding the social problems created by unfettered laissez-faire, on the one hand, and a centrally-planned economy, on the other." [25]

German social programs consist of old age pension support, nursing or long-term care insurance, health insurance, and unemployment insurance. These programs were greatly expanded in the 1970s to allow more citizens to share in the fruits of the then prospering West German economy. Unemployment compensation and social assistance benefits were raised, working time was reduced and early retirement options were created. The pension insurance system was expanded to the self-employed and public university tuition fees were done away with.

Despite recent reforms that have limited the scope and duration of benefits, German welfare programs remain quite generous compared to those provided by other industrialized countries. Until 2004, unemployment compensation, for example, provided for replacement of more than 50% of a person's previous net earnings and for an unlimited period of time [26]. The old-age pension system provided a retirement income worth nearly 70% of the net average wage before retirement [27]. Moreover, an estimated 40% of Germany's adult population (pensioners, social- welfare recipients, unemployed, accident victims, and students) receive some form of state income transfer, with even higher percentages in eastern Germany [28].

Most economists believe unemployment and welfare payments should aim to insure against hardship caused by unemployment or other life changing events without undermining incentives to work. Yet, there is evidence that some German programs have had an impact on incentives to work by granting much of this assistance on condition of labor income not being earned. That is to say that under some German programs, if labor income is earned, much of the assistance is cut. The so-called “wage replacement” incomes provided by these programs, thus, can contribute to unemployment by operating as wage floors. This is because people receiving state assistance could be unwilling to take a job in the private sector at a wage that is not substantially higher than the wage-replacement income provided for remaining unemployed [29].

Offering incentives not to work may put upward pressure on private sector wages and thereby undercut the competitiveness of German workers. It may also saddle German businesses with added costs because the bulk of the expenditures of the social welfare system are financed by contributions paid half by employees and half by employers [30].

The burden of taxes and social security contributions on German employees is high. Non-wage labor costs, in the form of social security contributions (pension, unemployment, and health insurance) have for years exceeded 40% of workers’ pay. Many economists maintain that cutting these taxes on labor would be the most effective way to revive the labor market and reduce unemployment, particularly among workers with low-skills [31]

Germany’s population size has been declining since 2002. Against the backdrop of an aging population, social welfare costs continue to escalate [32]. Germany’s share of public social expenditure in GDP today exceeds 30% [33]. Combined with the increasing numbers of pension and retirement claims forecast for the coming decades, the costs and job market consequences of the social benefits system could limit the maneuvering space for fiscal policy in the future and could continue to have adverse effects on incentives for work and entrepreneurship that many consider critical for stimulating faster growth [34]

Export Dependency Costs

Germany’s strong export performance has been a constant feature of the German economy since the founding of the Federal Republic. A future Chancellor, Ludwig Erhard, set the tone for German trade policy when he was minister for economics in 1953 by stating that “foreign trade is not a specialized activity for a few who might engage in it, but it is the very core of our economic and social order.” Subsequently, it has become common to speak of the German “export mystique” and efforts to increase competitiveness. German diplomatic missions rarely make visits abroad without including select businessmen in their official delegations.

Various data illustrate the growing role that exports have played in Germany’s economy. In 1950, exports represented 9.3% of GDP. Once the postwar economic boom got under way, exports rose to 17.2% of GDP in 1960. The rise continued to 23.8% in 1970, to 26.7% in 1980, and to 33% in 1990. By 2008, German exports were accounting for 47% of GDP, compared to less than 20% in Japan and about 13% in the United States [35].

Since 2004, Germany has been the world’s top exporter of merchandise or goods, surpassing the United States, Japan, and China [36]. The title of Exportweltmeister (export champion) is a source of great pride for many Germans. The main German exports—cars, precision machinery and chemicals—have come to symbolize a German identity based on skill, quality, and reliability [37]. In addition, many German small and medium-sized companies have also demonstrated exporting prowess in niche markets, including beverage-filling equipment, vacuum technology, surgical instruments, and binoculars and telescopic sights [38].

What impact Germany's exporting success has had on its overall economy over the past 10 to 15 years, however, is a matter of debate. One view is that Germany's exporting success has not been as positive for addressing core economic problems such as production and employment. Under this view, Germany has maintained its lead in exports by systematically outsourcing and off- shoring the labor-intensive parts of production to low-wage countries, primarily in Eastern Europe. Consequently, the import content of German exports has increased dramatically over the last several decades from 15% to 40%. Thus, the increase in exports cannot automatically be equated anymore with a commensurate increase in domestic production and employment [39].

A second view is that Germany has maintained its export competitiveness by pursuing a policy of systematic wage deflation, thereby reducing unit labor costs. From 2001 until today, Germany kept a tight lid on wages and, as a result, wages are still at almost the same level today as they were eight years ago [40]. In this way, Germany was able to raise its share of internal EU exports substantially, mostly at the expense of its EU neighbors who did not exercise similar wage restraint [41]. This bottom-up process of sustained wage moderation and unit cost reduction was reinforced by corporate-led changes to working conditions and time. According to one economist, "this move lowered labor costs for exporting firms while it made imports more expensive, further improving German price competitiveness relative to its European partners." [42].

German wage discipline may also have tilted demand in favor of exports and away from consumption. Even as exports boomed and jobs have been created, sluggish wages mean that the gains from national income growth go mostly to profits. In the process, consumer spending has suffered, falling to a low of 56% of GDP—well below the 65% of GDP level experienced in most western economies. The increase in the rate of the value-added tax (VAT), from 16% to 19% in early 2007 may have resulted in a further check on consumption [43].

Observers raised concerns about Germany's export dependency in 2008 and in early 2009 in the face of the global economic slowdown. With the collapse of foreign demand, German exports are expected to decline in 2009 by over 20%, making Germany's deep recession export-led. Exports of cars, machinery, and chemicals can provide a narrow and potentially vulnerable base for prosperity in an integrated world economy.

To keep consumption from dropping even further, the previous grand-coalition government implemented a range of policies intended to stimulate domestic economic growth and to support the German private sector. In December 2008 and January 2009, the parliament passed domestic stimulus measures totaling EUR 71 billion (about $100 billion) for 2009 and 2010. The so-called "short-term working benefit" (Kürzarbeit) through which the government subsidizes individuals whose working time has been reduced was expanded and the government also subsidized the sale of new cars through a "cash for clunkers" program. German economists and officials also emphasize the positive effects on domestic demand of so-called "automatic stabilizers," public expenditures for guaranteed social welfare benefits such as unemployment programs.

The German economy has shown some signs of picking up since the second quarter of 2009. Many observers see this as evidence that the German export-led growth model is indeed sustainable [44]. These proponents, contrary to G-20 pledges to correct current account imbalances, also tend to argue that other countries could benefit by reducing domestic consumption, increasing savings and by implication, running a current account surplus, as Germany does. As shown in Table 3, Germany has been running current account surpluses for the past decade.

Some economists counter that a large economy cannot run on "export fuel" alone and that German policymakers should look for ways to make the economy more balanced by encouraging consumption at home.

Table 3. Germany's Current Account Position

Year	Current Account Balance ($ billions)	Current Account Balance As % of GDP
1995	-29.6	-1.2
1996	-16.8	-0.6
1997	-10.2	-0.1
1998	-17.1	-0.8
1999	-28.0	-1.3
2000	-33.9	-1.2
2001	0.3	0.0
2002	41.4	2.0
2003	47.9	1.9
2004	126.8	4.6
2005	142.2	5.1
2006	190.1	6.5
2007	265.9	8.0
2008	243.4	6.6
2009[a]	90.3	2.8
2010[a]	100.0	3.0

Source: OECD.
[a.] Projected.

This, in turn, would require Germans to spend and invest more at home, thereby running smaller current account trade surpluses. They argue that for a sustained recovery of the world economy to occur, trade surplus countries like Germany will have to run smaller surpluses to accommodate the smaller current account deficits that countries like the United States will have to experience by exporting more to the rest of the world [45]

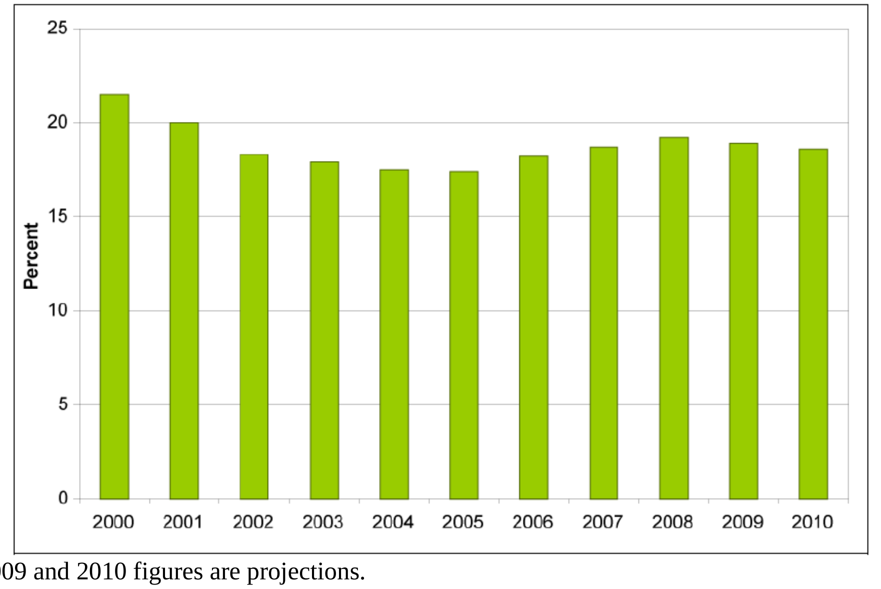
From an economic perspective, Germany's large and enduring current account surpluses reflect a persistent excess of domestic savings over domestic investment. While Germany's gross national savings has increased from an average of about 21% of GDP from 1990 thru

2003 to an average of 24% of GDP between 2004 and 2008, its gross fixed investment share in GDP, as shown in Figure 2, has declined from 21.5% in 2000 to 17.4% of GDP in 2005 before increasing to 18.4% of GDP in 2008.

Table 4. Germany: Net Direct Investment Flows ($ billions)

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
150	-13	34	26	-30	-30	-70	-125	-133	-6	-36

Source: EIU Country Database.



Note: 2009 and 2010 figures are projections.
Source: EIU database, OECD.

Figure 2. Germany: Fixed Investment as % of GDP.

Germany's declining investment rate can also be viewed as the mirror image of net direct investment flows. As shown in Table 4, Germany has experienced rising direct investment outflows over the last decade. The largest net outflows of $125 billion in 2007 and $133 billion in 2008 occurred in the years of Germany's largest current account surpluses.

In the view of some economists, Germany's declining investment rate and net capital exports are driven by domestic barriers or rigidities in the markets for labor and products. Among the most notable barriers or rigidities often cited are the wage replacement policies that serve to maintain a narrow gap between the best- and worst-paid employees. These policies may limit the earnings of the most skilled workers across all sectors, tempting many to find work abroad, and could be stunting the emergence of a low-wage service sector that could cater to the home market. If the wage replacement policies tend to prop up the pay of unskilled workers, services become more expensive and difficult to supply, thereby contributing to the pool of domestic savings going abroad [46].

Other indications of rigidities that affect decisions to invest in Germany include barriers to starting a new business. Permits for building new facilities, limited shop hours, and regulations on new products tend to stifle competition and deter new investments. According to the *World Bank's 2009 Doing Business Survey*, Germany ranked 102nd out of 181 countries on these and other criterion.

REFORM EFFORTS AND POLITICAL CHALLENGES

As illustrated in the first section of this report, the economic challenges facing German policymakers include low economic growth, high unemployment, and a deterioration of public finances. Also as shown, these problems are linked to the continuing costs of reunification, rising social welfare costs, and the dependency on export-led growth. Moreover, troubling demographic trends—Germany's population has been shrinking since the 1970s and its birthrate is one of Europe's lowest—are further exacerbating the strain on the social market economy.

.German policymakers, politicians, and scholars have proposed or considered a number of reforms aimed at reinvigorating and strengthening the German economy. These include changes in social and labor policies that provide protections at the expense of a more efficient and dynamic economy, as well as reforms that would create an economy driven more by domestic demand than exports. Given the significant proportion of the German public that directly benefits from the status quo, political opposition to reforms has been and continues to be significant.

Past Efforts

Successive German governments have recognized the importance of reforming the German economy to bring about increased economic growth. However, all have found it difficult to sell tough reforms to voters and vested interests. The most notable reform efforts since reunification were undertaken in 2003 and 2004 by the left leaning coalition government of the Social Democratic Party (SPD) and the Green party, under the leadership of then-Chancellor Gerhard Schröder (SPD). Schröder's far-reaching reform program, known as Agenda 2010, aimed at boosting growth and employment and consolidating public finances through tax reforms, greater labor market flexibility, and limited cuts in state benefits and subsidies.

The cornerstone and most controversial aspects of Agenda 2010 were a series of labor market reforms, including the so-called Hartz IV reform, which sought to merge unemployment and welfare benefits.47 One of the most publicized of these initiatives shortened the period for which unemployment compensation could be received by most people from 32 months to 12 months. The Hartz IV law abolished an existing program under which the long-term unemployed would receive up to 57% of their last regular net income and replaced it with less generous social assistance benefits already available to poor individuals, regardless of employment history. These changes were publically justified by the need to pare back government expenditures, but it was also hoped that the reforms would lower real wages and help create new jobs [48].

Most experts agree that the Agenda 2010 reforms likely played a role in boosting GDP growth and reducing unemployment in 2006 and 2007. However, at the time of implementation, the reform program was broadly unpopular, caused deep rifts within the SPD, and arguably cost Schröder the Chancellorship. Once the reforms were implemented, political support for the SPD plummeted below 30 percent and he was forced to resign as chairman of the party. With his eroding mandate, Schröder was compelled to call an early election in 2005, which the SPD lost. Many observers believe the fall-out from Agenda 2010 also greatly affected the electoral outcome in 2005. The SPD remained in the governing coalition, but as a junior party to its long-time rival, Merkel's center right Christian Democratic Party (CDU).

Both Merkel and the SPD appear to have taken a lesson from Schröder 's electoral defeat. Although Merkel campaigned in 2005 as a reformer promising to liberalize restrictions on business and to unburden taxpayers, as head of a grand coalition government with the SPD, she adopted a cautious and modest approach to economic reform [49]. Merkel and her supporters argue that more ambitious reforms were not possible, given the coalition's reliance on the left-leaning SPD. However, others argue that Merkel was wary of championing unpopular reforms of the welfare system, regardless of her coalition partner. Ultimately, the CDU/CSU-SPD grand coalition government passed just one significant reform in the spirit of Agenda 2010, a gradual rise in the retirement age to 67. More often, with Merkel's help, the government rolled back reforms by lengthening the time for paying unemployment benefits to older workers, offering pensioners relief from rising prices, and introducing minimum wages in half a dozen industries, including postal and security services [50].

Future Challenges and Prospects for Reform

Germany's reform challenges at the broadest level include efforts to redesign the welfare state and encourage the development of a more balanced economy. Less equity and a lower level of worker protection may be needed if a higher growth path and a higher rate of employment are to be achieved. Given that Germany's population is expected to decline by 3.5 million by 2020, with a steady rise in individuals over the age of 65, the earlier the necessary adjustments are made, the more effective they may be.

Assuming that expenditures on social security programs need to be reduced, benefits may have to be redefined. This could entail a variety of changes such as increasing the retirement age or eliminating social security coverage for many small risks or conditions. Other reform suggestions to make German workers more competitive include working longer hours, substituting wage supplements for wage replacements, and shortening the period of university education before students enter the workforce [51]. To deal with distortions in the labor market, changes in governance have been proposed. Most of the proposals involve more decentralized ways of determining wages and job security in the marketplace [52]

To deal with Germany's dependency on export-led growth, some experts believe that Germany must try to develop a more balanced economy by promoting service industries such as health care and education through tax policy and de-regulation. Yet, current political and business leaders appear united in the belief that exports must remain the foundation of German prosperity. This strategy hinges on the hope that world demand for German exports will eventually reinvigorate the German economy [53]. Indeed, some proponents of the

German economic model challenge the notion that the economy is in need of sweeping structural reform. They point out that economists have been urging such reforms for decades during which time the economy has consistently proven its resilience and continued to sustain itself. Furthermore, the value most Germans place on the state’s long-standing social welfare programs suggests that they may be willing to forgo a level of GDP growth in exchange for the increased social cohesion presumed to be brought about by such programs.

Despite a general consensus among economists that structural reforms to the German economy may be necessary to boost long-term economic growth, the short- to medium-term prospects for such reform appear slim. German politicians have been reluctant to advocate unpopular limits on social welfare spending at a time of economic contraction and increased unemployment. This reluctance was evident in the 2009 election campaign, during which there was very little debate over German economic policy and the need to revamp the German social welfare system or to deregulate the economy. Nor was there much debate about the need to stimulate domestic demand or nurture the growth of services [54]. Whether Merkel’s newly elected center-right government will change this calculation remains to be seen. However, early signs suggest that an immediate need to stabilize a fragile economy, reduce record budget deficits, and cope with rising unemployment could take precedence over efforts to launch deeper structural reforms [55].

The 2009 Election: Emerging fragmentation of the German political system?

Since 1949, Germany’s political landscape has been dominated by the country’s two largest political parties, Chancellor Merkel’s center-right Christian Democratic Party/Christian Social Union (CDU/CSU) and the left-ofcenter Social Democratic Party (SPD). One of these parties has been at the helm of every post-war German government. The CDU/CSU and SPD have, however, slowly ceded support to smaller political parties on both sides of the political spectrum—a fact illuminated by the 2009 election. Although Merkel’s CDU/CSU won 33.8% of the vote, the most of any party, the CDU/CSU’s total was 1.4 percentage points less than in 2005. More significantly, the SPD won only 23% of the popular vote, 11.2 percentage points less than in 2005. The drop in electoral support for the CDU/CSU and SPD contrasted with gains for three smaller parties. The center- right, free market-oriented Free Democratic Party (FDP) and the far-left Left Party (Die Linke) each achieved their best ever electoral results, winning 14.6% and 11.9% of the vote, respectively; the Green Party won 10.7% of the vote.

Merkel and the CDU/CSU formed a government in coalition with their preferred and traditional coalition partner, the FDP.

Nonetheless, observers believe the growing popularity of the FDP and the Green Party, and the emergence of The Left Party, a successor of East Germany’s communist party, could signal an emerging fragmentation of the German political system.In particular, the ascendency of the populist Left Party appears to be putting pressure on the SPD to redefine itself, either as a center-left or more left wing party.

The degree to which the FDP will influence the policies of the new government remains to be seen, but differences between the CDU/CSU and

FDP, particularly on economic policy, have emerged. According to some analysts, this political realignment could potentially undermine German policy and leadership on a host of international issues, thereby making it more difficult for the United States and other countries to work with Germany on resolving mutual challenges [56].

A number of factors may account for the decline in popular support for the CDU/CSU and SPD, including public dissatisfaction with the grand coalition government of 2005-2009, during which the traditional rivals governed together in an arrangement some might compare to a U.S. Administration run jointly by Democrats and Republicans

In her first address to the German parliament since being re-elected in September 2009, Chancellor Merkel bluntly stated that she expects the German economy to face increasing challenges in the coming year, including higher unemployment. She said her government's primary goal in addressing this challenge is to spur economic growth: "without growth, no investment; without growth, no jobs; without growth, no money for education; without growth, no support for the weak" [57].

The government's prescription for such growth appears to be a mix of tax cuts, continued government spending to keep unemployment down, and a longer-term effort to rein-in such spending. The Merkel government has extended the Kürzarbeit program by which it subsidizes employers to keep part-time workers and has said it will implement tax cuts worth EUR 24 billion (about $36 billion) for companies and the middle class over the next four years.

In advocating a balance between market-led growth and strong social spending, Merkel seems poised to continue to advocate economic policies based on the traditional social market economy model. Longer term structural reforms are not expected to feature prominently in the current government's plans.

U.S.–German Economic Policy Strains and Differences

Given weak economic growth and the rising costs of maintaining generous social security programs, Germany faces budgetary constraints, as do many other industrialized countries. With dwindling economic and financial resources, Germany arguably has become less willing to compromise on matters of potential economic advantage [58]. In this regard, Germany's domestic economic challenges could limit its policymaking flexibility [59]. This has affected not only the economic and trade leadership role that Germany traditionally has played in Europe, but also its position on issues that directly affect U.S. interests. These include different approaches in dealing with the global economic downturn and economic sanctions.

Trade Leadership

Germany in the past has been a key ally of the United States on international trade issues. Given its heavy export orientation and dependence on the international economy, Germany traditionally has been a strong voice for trade liberalization, both within the EU and the world trading system, as well as the decisive swing vote between French and British views on trade policy. Every successful multilateral trade round in the past has depended on Germany to use its bilateral economic clout to influence the policies of more inward-looking countries in Europe. German support for a liberal trade policy and generalized opposition to blatantly protectionist proposals, with few exceptions, has been provided by the major political parties and leading stakeholders in the private sector [60]

Yet, in recent years, German leadership of the free trade bloc within Europe has weakened. It was first compromised in the 1990s' Uruguay Round of multilateral trade negotiations when then- Chancellor Helmut Kohl backed restrictive agricultural trade proposals the French government was advocating in an effort to advance European integration. The trend solidified in 2002 when then-Chancellor Gerhard Schröder agreed with France on setting parameters for agricultural liberalization within the EU. The same budget agreement on reform of the Common Agricultural System (CAP) continues to serve as a constraint to achieving a breakthrough in the on-going Doha Round of trade negotiations under the World Trade Organization [61].

Germany is also providing less unconditional support for European integration than it used to, particularly when the European integration under question entails international trade pressures from increased labor mobility and low-wage service providers. This was first evident in the Schröder government's decision to demand transition periods of up to seven years before granting full labor mobility to the citizens of new Central and Eastern European EU member states. Another instance of German opposition to further market liberalization in Europe involved rejection of the European Services Directive. This directive would have opened highly protected low-wage services (such as cleaning and transport) and high-wage services (such as public infrastructure and health) to competition from the rest of the EU—a proposal that was opposed by unions and the left-wing of the SPD [62]

The German government announced in May 2009 that it was keeping labor restrictions in place on workers from the eight Central and European countries that joined the EU in 2004. The controls had been expected to be rescinded this year, but Germany invoked a clause allowing two more years in case of "serious labor market disturbance, or threat of them." The idea that free movement of East European labor would threaten "serious disruption" is questionable given that Germany still has shortages of skilled labor in some areas [63]

Chancellor Merkel and the previous grand coalition government faced criticism from within Europe and elsewhere for its role lobbying General Motors (GM) to sell a majority stake in its Opel unit to Magna International, a Canadian-Austrian group, and Sberbank, its Russian partner. In May 2009, the Merkel government approved EUR 4.5 billion (about $6.7 billion) in loan guarantees to enable the takeover in return for which Berlin reportedly sought a pledge that Magna would not close factories in Germany where Opel employed some 25,000 workers, half of its 50,000 employees in Europe. The deal led to speculation that plants in Belgium, Spain, and the UK would be closed in order to keep the German plants open. This prompted critics, including the Belgian government, to cast Germany's action as "protectionist" and raised questions as to whether the sale would conform to the European Union's rules on permissible state aid to companies [64].

On November 3, 2009, GM angered German officials by deciding to maintain its European business and pull out of the Berlin-backed proposal to sell Opel. Chancellor Merkel and others sharply criticized the decision, which they fear could lead to job losses in Germany. GM will reportedly seek financial support from European governments to realize its plans to restructure Opel. However, the German government is expected to show little support for any deal that involves significant job losses in Germany [65]

Responding to the Global Economic Downturn

The United States and Germany have differences over the causes and appropriate policy responses to the global economic downturn. Obama Administration officials have criticized Germany for what some consider a relatively cautious response to the crisis. They have also taken aim at a perceived German reluctance to support common European approaches to fixing the banking sector, to join in coordinated cooperative spending programs, and to deal with the Central European financial crisis [66].

German political leaders have vigorously defended their policy response to the crisis, arguing that they have taken substantial action to stimulate the German economy. They have also urged the United States and others to commit to an “exit strategy” from fiscal stimulus measures which they feel could lead to potentially debilitating deficits and dangerous inflation. Moreover, they have argued that such domestic spending measures will do little to address the root causes of the crisis, which they tend to view as inadequate regulation of global financial markets. Indeed, many in Germany view profligate consumption and unregulated markets in the United States and UK as having been the cause of the global crisis. These critics argue that the downturn could have been avoided had others behaved as prudently as Germans by cutting wage costs and public expenditures.

Many U.S. policymakers and politicians counter that Germany shares responsibility for the downturn because it has run-up large current account surpluses over the last six years. These surpluses, combined with those run by China and Japan, funneled excess savings to the rest of the world [67]. Under this view, if the United States had not decided to run an accommodating monetary policy in the 2001 to 2002 period, which contributed to the expansion of easy credit and the financial crisis, aggregate global demand would have fallen short of supply and unemployment would have increased worldwide. The imbalances in the global economy, according to this view, required that the United States serve as the world’s “consumer of last resort” to keep the world economy growing [68]

Many U.S. observers have argued that a reduction of Germany’s large current account surplus could be a crucial component in the global rebalancing that will be necessary to bring the world economy back on a more sustainable growth path. As part of this process, domestic demand in Germany must increase faster than it has in the past. German leaders tend to reject this line of argument, citing concern that increased spending would impose long-term debt on a shrinking population and arguing that the basic features of their export-oriented and social market economy model are solid [69]. Even though Chancellor Merkel, at the September 2009 G-20 meeting in Pittsburgh, signed the leaders’ statement pledging to adopt the measures needed to “lay the foundation for strong, sustained, and balanced growth in the 21st Century,” most German leaders appear to reject the idea that global economic recovery requires fundamental changes in the German way of doing business [70].

Although it was widely criticized for an initially cautious domestic response to the global economic crisis, Germany has implemented a range of policies to stimulate economic growth and to support the German private sector. In December 2008 and January 2009, the parliament passed domestic stimulus measures totaling EUR 71 billion (about $105 billion) for 2009 and 2010. German officials also emphasize the positive effects on domestic demand of so-called "automatic stabilizers," public expenditures for guaranteed social welfare benefits such as unemployment programs. In total, they estimate that Germany's fiscal stimulus measures amount to about 1.5% of German GDP.

Unlike the U.S. focus on increasing consumption, Germany's stimulus packages have been geared towards creating incentives for private investment and infrastructure projects, and for stabilizing exports. Germany's high household savings rate (11.4% of disposable income in 2008 compared to 1.8% in the United States) has provided the justification for not providing tax breaks to stimulate consumption. However, the new Merkel government has pledged a series of tax breaks for companies in the hope that this will decrease unemployment, among other things. Berlin has also focused on tightening financial regulation.

While most applaud Germany for adopting significant stimulus measures, there is still a view among some U.S. policymakers that Washington is shouldering the burden of getting the world economy moving again. Related to this concern is the perception that heavily export dependent Germany could use demand created by the United States and UK to surge German exports into these counties as demand rises. Germany would thus benefit from U.S. domestic stimulus as the United States adds to its domestic debt [71].

Merkel has committed her new government to restoring growth to the German economy. The governing coalition has agreed to pass significant tax cuts for German businesses and the middle class in the coming four years. However, any additional and broader fiscal spending measures are considered highly unlikely because of a strong desire to prevent future inflation. The new government will also be hindered in any effort to support global rebalancing by increasing German domestic demand by new budget rules approved by the parliament this year. The new rules, written into Germany's constitution, the Basic Law, set a legally binding deficit ceiling to take effect in 2016. Under the constitutional amendment, the federal deficit will not be allowed to exceed 0.3 5% of GDP and individual states will be constitutionally barred from running deficits after 2020. Even if the rule proves impractical and needs to be changed in the future, in the interim, according to one analyst, "Germany will again try to be more austere than the rest of the world" [72]

Economic Sanctions

The United States and Germany have in the past had policy differences over the use of economic sanctions as a foreign policy tool. Germany has traditionally been reluctant to use economic sanctions, despite U.S. urgings. Those in Germany who oppose economic sanctions tend to question whether sanctions are the most effective means to achieve foreign policy aims. They argue, for example, that sanctions have at times proved counterproductive by serving to unite citizens in the targeted country against those implementing them. They add that without strong multilateral backing, sanctions are likely to fail; if only a few countries continue to trade with the targeted state, the implementing countries lose their leverage, the argument goes.

U.S. and other critics contend that Germany's position on sanctions is greatly influenced by commercial interests and the economy's strong dependence on industrial exports. German business groups often oppose calls for economic sanctions and their views are thought to carry considerable political weight, particularly with the right-of-center CDU and FDP parties. For example, industrial lobbies have reportedly played an important role in demanding that German foreign policy elevate commercial relations as a priority factor in Germany's policies towards Russia and China, two of its fastest growing markets [73]. Observers highlight German policy toward Iran as the most pertinent example of this influence.

As a member of the so-called EU-3 (France, Germany and the United Kingdom), Germany has been at the forefront of EU and U.N. efforts to prevent Iran from developing nuclear weapons. However, of the EU-3, Germany has reportedly been the most reluctant to endorse more stringent sanctions against Tehran. Berlin continues to face pressure from the United States and others to limit civilian commercial ties with Iran. Along with Italy and China, Germany remains one of Iran's most important trading partners. Although German exports to Iran dropped 25% between 2005 and 2007, they reportedly grew 10% between 2007 and 2008. Germany has in the past argued that sanctions without Russian and Chinese support would both be ineffective and hurt the German economy.

On the other hand, Germany's two largest banks, Deutsche Bank and Commerzbank AG, have withdrawn from the Iranian market and officials in Berlin report that new export credit guarantees to companies doing business in Iran have dropped by more than half since 2005 [74]. While some interpret weakening German-Iranian economic ties as a sign that Berlin is intent on increasing economic pressure on Tehran, others argue that German-Iranian trade remains robust and that politicians in Berlin are unlikely to seek further cuts in commercial ties [75]

Currently, German officials reportedly are more inclined to impose economic sanctions on Iran than they have been in the past, but simultaneously question their effectiveness. Public support for stronger actions if sanctions fail is also weak in Germany. According to one poll, only one in five Germans back the option of using military force to stop Iran's nuclear programs if diplomacy fails, compared to one in two Americans [76]

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THE EUROPEAN PARLIAMENT[*]

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ABSTRACT

The European Parliament (EP) is one of the three key institutions of the 27-member European Union (EU), and the only EU institution whose members are directly elected. The current EP has 736 members. The most recent EP elections were held on June 4-7, 2009. Members of the European Parliament (MEPs) serve five-year terms.

Once limited to being a consultative assembly, the EP has accumulated more power over time. It performs important functions in the EU's legislative and budgeting processes, and exercises a degree of supervision over the two other main EU institutions, the Council of the European Union (Council of Ministers) and the European Commission. Although the EP does not formally initiate EU legislation, it shares "co-decision" power with the Council of Ministers in many policy areas, giving it the right to amend or reject proposed EU legislation. The recently ratified Lisbon Treaty increases the EP 's role further, giving it amendment and veto authority over the vast majority of EU legislation (with some exceptions, such as tax matters and foreign policy). Moreover, supporters argue, as the only directly elected EU institution, the EP increasingly plays an important checks-and-balances role on behalf of Europe's citizens.

Members of the European Parliament caucus according to transnational groups based on political affiliation, rather than by nationality. No single group has ever held an absolute majority in the European Parliament, making compromise and coalition-building important elements of the legislative process. Following the June 2009 election, the center-right Group of the European People's Party (EPP) and the re-named center-left Group of the Progressive Alliance of Socialists and Democrats in Europe (S&D) remain the two largest political groups. Every two-and-a-half years (twice per parliamentary term), MEPs vote to elect a President of the European Parliament to lead and oversee its work and to represent the EP externally. The EP has 20 standing committees that are key actors in the adoption of EU legislation and 36 delegations that maintain international parliament-to-parliament relations.

Although supporters point to the EP's growing institutional significance, the European Parliament faces several challenges of public perception. Some skeptics contend that the EP lacks the legitimacy of national parliaments and exercises little real power. Other analysts observe that the complexity of the EU legislative process contributes to limited public interest and understanding of the EP 's role, leading in turn to a trend of declining turnout in European Parliament elections. Another issue is whether MEPs reflect national or European interests—many MEPs tend to campaign on national rather than European issues and many voters view EP elections as a national mid-term

[*] This is an edited, reformatted and augmented version of CRS Report RS21998, dated February 25, 2010.

election. Criticism has also been directed at the costs incurred by what many consider duplicate facilities—while much of the work of the EP takes place in Brussels, monthly plenary meetings are held in Strasbourg, France, and administrative sections of the EP Secretariat are based in Luxembourg.

Ties between the EP and the U.S. Congress are long-standing, and the Transatlantic Legislators' Dialogue—the formal mechanism for EP-Congressional exchanges—is expected to continue its activities during the second session of the 111th Congress. Also see CRS Report RS21372, *The European Union: Questions and Answers,* by Kristin Archick and Derek E. Mix.

ROLE OF THE EUROPEAN PARLIAMENT

The European Parliament (EP) is one of the three key institutions of the European Union (EU). The EU is a treaty-based, institutional framework that defines and manages economic and political cooperation among its 27 member states (Austria, Belgium, Bulgaria, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and the United Kingdom). The EP is the only EU institution whose current 736 members are directly elected. Once limited to being a consultative assembly, the EP has accumulated more power over time. Analysts observe that the EP and its advocates have consistently sought to expand its role and responsibilities in the EU policy process. Many believe that successive EU treaties have granted enhanced powers to the EP in order to increase democratic accountability in EU policy-making.

The European Parliament performs important functions in the EU's legislative and budgeting processes, and exercises a degree of supervision over the two other main EU institutions, the Council of the European Union (Council of Ministers) and the European Commission. However, the EP does not initiate legislation.

In most cases, that right rests with the Commission, which functions as the EU's executive and guarantor of the EU's treaties. The Commission implements and manages Council decisions and common policies, ensuring that member states adopt and abide by the provisions of EU treaties, regulations, and directives [1] The Council, the EU's main decision-making body, is composed of ministers from the national governments and enacts legislation based on Commission proposals [2]. In most cases, the Council's adoption of legislation occurs jointly with the Parliament, in a process known as "co-decision."

Legislative Process

The role of the European Parliament in the legislative process has expanded steadily over time as the scope of EU policy has grown. Initially limited to offering non-binding opinions and proposing amendments ("consultation procedure"), the EP gained more power to affect EU legislation in the "cooperation procedure" of the 1986 Single European Act.

The Maastricht Treaty of 1992 (which entered into force in 1993) substantially increased the EP's role, mostly in areas related to the EU's common internal market, with the introduction of the "co-decision procedure." In the "co-decision procedure," the EP and the

Council share legislative power and must both approve a Commission proposal for it to become EU law.

The Amsterdam Treaty of 1997 (which entered into force in 1999) simplified the "co-decision procedure" and extended it to many additional policy areas (ranging from the environment to social policy).

As more decisions within the Council of Ministers have become subject to qualified majority voting (rather than unanimity) to allow for greater speed and efficiency of decision-making, the Parliament's power of "co-decision" has come to be viewed as playing an increasingly important checks-and-balances role at the European level to the Commission and Council [3]

The "Co-decision Procedure"

The EU's "co-decision procedure" can be summarized as follows: (1) if Parliament and the Council of Ministers agree on a Commission proposal, it is approved; (2) if they disagree, the Council forms a common position; the EP can then either accept the Council's common position, or reject or amend it, by an absolute majority of its members; (3) if the Council cannot accept the EP's amendments, a conciliation meeting is convened, after which the EP and the Council approve an agreement if one can be reached. If they are unable to agree, the proposal is not adopted.

On December 1, 2009, the Lisbon Treaty—the EU's latest institutional reform effort—went into effect. The Lisbon Treaty roughly doubles the Parliament's right of "co-decision" to 80 policy areas, including agriculture and justice and home affairs issues such as immigration and police cooperation. In doing so, the Lisbon Treaty gives the EP a say in most all legislation passed in the EU. Tax matters and foreign policy, however, are among the areas in which EU member states retain decision- making authority and to which the "co-decision procedure" does not apply (the Parliament may give a non-binding opinion). The Lisbon Treaty technically renames the "co-decision procedure" as the "ordinary legislative procedure," although "co-decision" remains the more commonly used term.

Additionally, in the "assent procedure," the EP must, by a simple "yes" or "no" majority, approve the accession of new EU member states and the conclusion of all official agreements with third parties, such as association and trade agreements with non-member states. If the Parliament does not consent, such agreements cannot enter into force.

Budgetary Process

The EP and the Council exercise joint powers over allocation of the EU's annual budget, such as the amount of funding dedicated to infrastructure as opposed to education [4]. It is similar to the way that the U.S. House and Senate Budget Committees allocate the President's budget request to various programs. However, neither the EP nor the Council can affect the size of the EU budget— that amount is fixed through percentages contributed from member states' gross national incomes (GNI) and value added tax (VAT) revenues, as well as from external customs duties.

The budgetary procedure begins with the Commission proposing a preliminary draft budget to the Council. The Council examines the preliminary draft budget and establishes the draft budget, which is then sent to the EP for a first reading. The EP may approve the draft budget or vote to attach proposed amendments or modifications, returning it to the Council for a second reading. After a conciliation meeting with Parliament representatives, the Council then votes whether to take account of the Parliament's proposed amendments and modifications and returns the draft budget as amended to the EP for its second reading. The EP must then vote to adopt the budget in order for it to become operational. If disagreements persist at this stage, the EP can reject the entire draft budget.

Until recently, the EP had the last word on "non-compulsory" expenditures, such as development aid, but the Council had the final say on "compulsory" expenditures, such as spending related to agriculture or international agreements. The Lisbon Treaty eliminates the distinction between "compulsory" and "non-compulsory" expenditures, and thus gives the EP the right to decide on the entire budget jointly with the Council. Of particular importance, the EP gains more control over agricultural spending, which accounts for over a third of the EU budget. The EP's budgetary power is considerably greater than that exercised by most parliaments in EU member states, and this "power of the purse" gives the EP significant institutional weight in the EU.

Additionally, the EP examines the Commission's implementation of previous budgets through the "discharge procedure." In order to close the budget books of a given year, the EP must vote to grant "discharge" based on reports of the EU Court of Auditors and a recommendation of the Council. In cases of fraud or mismanagement, the EP may postpone or refuse discharge pending a resolution. With its decision, the EP also presents the Commission with binding recommendations and observations regarding implementation of the budget.

Supervision and Oversight Responsibilities

The Parliament plays a supervisory role over the European Commission and the Council of Ministers. As described above, the Parliament's co-decision and budgetary powers grant it a degree of control over the Commission and the Council in many areas. The EP also monitors the management of EU policies, can conduct investigations, inquiries, and public hearings, and may submit oral and written questions to the Commission and the Council.

The EP must approve the Council's nomination for Commission President—thus, the relative strengths of the political groups in the EP (see below for more information) can affect who is nominated by the member states to this post. The member states and the EP 's largest political group, which is center-right in political orientation, supported the re-appointment of 2004-2009 Commission President José Manuel Barroso for the 2009-2014 term. Barroso is a former conservative Portuguese prime minister. However, the support of other political groups was needed in order to achieve the majority necessary to approve the nomination. After a series of meetings during which Members of the European Parliament (MEPs) scrutinized and questioned Barroso's draft program of "political guidelines" for the next five years, the EP voted on September 16, 2009 to confirm his new mandate as Commission President, by a vote of 382 to 219 (with 117 abstentions).

The EP also has the power to accept or reject a newly proposed Commission as a whole (rather than individual nominees). Since 1995, the EP has held U.S. Senate-style confirmation hearings for newly designated Commissioners, who are nominated by the member states for five-year terms. On February 9, 2010, the EP voted to approve the so-called Barroso II Commission for the term ending in 2014 [5]. Although a new Commission was supposed to have been in place by November 2009, it was held up because of delays in the ratification of the Lisbon Treaty by some member states. Following the treaty's entrance into force in December 2009, the confirmation process for the new Commission was further slowed when the initial Bulgarian nominee withdrew her candidacy in mid-January 2010 after a contentious hearing before the Parliament. Some MEPs expressed serious concerns about her past financial dealings and questioned her competence for her portfolio [6]. A similar situation occurred in 2004, when MEPs essentially forced the original Italian nominee to the Commission to withdraw due to concerns about his views on homosexuality and women's rights. Some observers view these episodes as signs of the EP 's growing confidence and institutional clout.

The EP also has the power to dismiss the entire Commission (although, again, not individual Commissioners) through a vote of censure. To date, the EP has never adopted a motion of censure. However, in 1999, the entire Commission opted to resign rather than face a formal censure by the EP over alleged corruption charges.

ORGANIZATION OF THE EUROPEAN PARLIAMENT

Members of the European Parliament serve five-year terms, and have been directly elected since 1979 [7]. Voting for the EP takes place on a national basis, with the number of MEPs elected in each country based on population size. Germany, for example, has the largest number of MEPs (99), while Malta has the smallest (5).

The most recent EP elections were held on June 4-7, 2009, with 736 seats at stake [8] Roughly 375 million European citizens were eligible to cast a ballot in 2009. In EP elections, EU citizens may vote—or run for a seat—in their country of residence, without necessarily holding citizenship in that country. Turnout has declined in every EP election, from 63% in 1979 to a new low of 43% in 2009. Although the overall number is comparable to turnout in U.S. mid-term elections, analysts observe that relatively low voter participation compared to national elections indicates a lack of awareness and understanding in the EU about the EP.

Political Groups

Once elected, Members of the European Parliament caucus according to transnational groups based on political affiliation, rather than by nationality. A political group must consist of at least 25 MEPs from a minimum of seven EU member states. As in the last EP, there are seven political groups—containing over 100 individual political parties—in the new EP, plus a number of "nonattached" or independent members. Many group arrangements proved relatively stable and carried over from the previous term. However, numerous national parties shifted their group allegiance; one previous group collapsed; one new group was formed; and, reflective of shifting composition, two groups changed their name.

Each group appoints a chair or co-chairs, and maintains a bureau and secretariat to manage its internal organization. Prior to a vote, MEPs within each group study the legislative proposals in question with the support of committee reports, discuss prospective amendments, and seek to arrive at a consensus group position. National and partisan divisions within groups routinely impact this process—and individual MEPs are not bound to vote according to the group position.

No single group has ever held an absolute majority in the European Parliament, making compromise and coalition-building important elements of the legislative process. Some analysts assert that distinct ideological definitions between groups are becoming more complicated, as voting blocs form increasingly according to specific issues and interests. Nevertheless, the two largest groups have tended to dominate the Parliament historically.

Table 1. Political Groups and Seats in the European Parliament: Results of the 2009 Election (736 seats total)

	Total Seats	%
European People's Party [Christian Democrats] (EPP; center-right)	265	36
Progressive Alliance of Socialists and Democrats in Europe (S&D; center-left/socialists)	184	25
Alliance of Liberals and Democrats for Europe (ALDE; liberals)	84	11.4
Greens/European Free Alliance (Greens/EFA; greens and regionalists)	55	7.5
European Conservatives and Reformists (ECR; right-wing, anti-Federalist)	54	7.3
European United Left/Nordic Green Left (GUE/NGL; far-left and former communists)	35	4.8
Europe of Freedom and Democracy (EFD; euroskeptics)	32	4.3
Non-attached members	27	3.7

Source: http://www.europarl.europa.eu/parliament/archive/elections2009/en/index_en.html.
Note: Percentages are rounded.

In the 2009 elections, the Group of the European People's Party [Christian Democrats] (EPP) retained its position as the largest political group in the EP. The EPP is center-right in political orientation and contains MEPs from Germany's Christian Democratic/Christian Social Union (CDU-CSU), France's Union pour un Mouvement Populaire (UMP), Spain's Partido Popular (PP), Italy's People of Freedom, Poland's Civic Platform, and numerous other Christian Democratic, conservative, center-right, and centrist national parties. The chair of the EPP is French MEP Joseph Daul.

In relative terms, the strength of the EPP in the 2009 elections increased significantly due to a sizeable drop in support for center-left parties. Although circumstances and issues differed in each EU member state, some analysts interpreted these results as indicating greater public preference for the approaches of conservative and center-right parties in the handling of the global financial crisis and recession [9].

The *Group of the Progressive Alliance of Socialists and Democrats in Europe (S&D)* is the EP 's second-largest political group. The S&D is center-left in political orientation and includes Germany's Social Democratic Party (SPD), France's Socialist Party, the UK Labour Party, Spain's Socialist Party, and numerous other Socialist, Social Democratic, and center-left parties. The chair of S&D is German MEP Martin Schulz.

The EPP and the S&D have a history of cross-ideological legislative partnership, and cooperated in a "Grand Coalition" in the 2004-2009 EP (S&D was then called the PES—the Socialist Group in the European Parliament). Critics argue that the consensus-seeking of the Grand Coalition makes politics in the European Parliament stale and paradoxical. Other observers note that maximizing consensus and unity lends the European Parliament greater institutional weight. As a general rule, most MEPs prefer consensus outcomes that are endorsed by a large and broad majority. It appears that another EPP-S&D Grand Coalition is likely for 2009-2014.

The third-largest group is the Group of the Alliance of Liberals and Democrats for Europe (ALDE). ALDE is centrist and liberal in political orientation. In European political terminology, "liberal" connotes an emphasis on free market economics, individual rights, social equality and equal opportunity, and de-centralized government. ALDE includes the UK Liberal Democrat Party, Germany's Free Democrat Party (FDP), and Ireland's Fianna Fail. The chair of ALDE is Belgian MEP (and former Belgian Prime Minister) Guy Verhofstadt.

The *Greens/European Free Alliance Group (Greens-EFA)* is largely comprised of Europe's numerous Greens—leftist in political orientation with a strong emphasis on pro-environment politics and human rights—and several independent or regional parties (e.g., Scottish, Welsh, Basque, and Catalonian) with a leftist or center-left outlook. The co-chairs of the Greens-EFA are French MEP Daniel Cohn-Bendit and German MEP Rebecca Harms.

The UK Conservatives, increasingly uncomfortable with the strong pro-integration stance represented by the EPP, broke with the EPP in 2009 and formed a new European Conservatives and Reformists Group (ECR). The UK Conservatives' major partners in the ECR are Czech Civic Democrats and Poland's Law and Justice Party. The group is right-wing in political orientation and strongly opposed to a "federalist" Europe. The chair of ECR is Polish MEP Michal Kaminski.

The *European United Left/Nordic Green Left Group (GUE-NGL)* consists of parties that are strongly leftist in orientation, some with a Green emphasis. Member parties include Germany's Die Linke, the French Communist Party, and the Irish party Sinn Fein. The group is pro-EU and pro-integration, but strongly critical of existing EU structures, policies, and overall direction. The chair of GUE-NGL is German MEP Lothar Bisky.

The *members of the Europe of Freedom and Democracy Group (EFR)* are "euroskeptics" and critics of the EU who oppose further European integration and demand greater transparency in the EU. Its largest contingents are from the UK Independence Party (UKIP), which advocates UK withdrawal from the EU, and Italy's Lega Nord. The co-chairs of EFR are British MEP Nigel Farage and Italian MEP Francesco Enrico Speroni.

Many of the "non-attached" or independent members of the EP hail from far right extremist parties, which made gains in the 2009 EP elections in a number of countries, such as the Netherlands, Austria, and Hungary. However, these far right MEPs still hold a relatively small number of seats and appear to have little cohesion among themselves. Analysts note that they have been unable to form a political group and as a result are likely to have minimal impact in the current EP; membership in a political group gives MEPs more influence as groups receive more funding and more speaking time in the EP than do non-attached members [10]

The EP President

Every two-and-a-half years (twice per parliamentary term), MEPs vote to elect a President of the European Parliament. The majority coalition in the EP (previously and usually an EPP "Grand Coalition" with the Socialists) has traditionally agreed to split the position of EP president over each five-year term. At the opening session of the new EP in mid-July 2009, Members elected Polish MEP Jerzy Buzek of the EPP as the new President of the European Parliament. Buzek, a former prime minister of Poland, is the first ever EP President from one of the central and eastern European member countries that joined the EU in 2004. Martin Schulz of S&D is expected to take over as EP President for the second half of the EP 's current term.

The President of the EP represents the EP externally, and in relations with the other EU institutions. The President oversees the work of the Parliament and is responsible for ensuring that its rules of procedure are followed. The President is assisted in managing the Parliament's internal organization and affairs by a Bureau composed of 14 Vice-Presidents and six Quaestors drawn from across the EP 's political groups. The signature of the President is the final step in approval of the EU budget, and the President co-signs, together with the President of the Council, legislation adopted under the co-decision procedure. In addition, the President seeks to affect broader EU policies by promoting a few key issues as EP priorities. Since his election in July 2009, Buzek has stressed employment, energy security and the environment, foreign policy and human rights, and EP reform as priorities for his presidency [11]

Committees

The EP has 20 standing committees. These committees are key actors in the adoption of EU legislation. Each committee appoints a chairman, three vice-chairmen, and has a secretariat. The appropriate committee (e.g., the Committee on the Environment, Public Health, and Food Safety would deal with legislation on pollution) appoints a Member as "rapporteur" to draft a report on the Commission proposal under consideration. The rapporteur submits a draft report to the committee for discussion, which is then voted on and possibly amended.

The committee's report is then considered in plenary, amended, and put to a vote. The EP thus adopts its position on the issue. In terms of their importance and strength, EP committees rival those in the U.S. Congress and surpass the role of committees in most national European legislatures.

Ad hoc committees may also be established to investigate or oversee specific issues. For example, in 2006, the EP formed a Temporary Committee that examined the role of EU member states in hosting secret CIA detention facilities and aiding CIA flights related to the rendition of terrorism suspects.

Delegations

The European Parliament plays a role in the EU's international presence through its 36 delegations, each composed of about 15 MEPs. These delegations maintain parliament-to-parliament contacts and relations with representatives of most countries around the world. For example, the EP has interparliamentary delegations for relations with the United States and the NATO Parliamentary Assembly, as well as with Iran, Israel, the Palestinian Legislative Council, and the Korean Peninsula.

Administration

A Secretariat of approximately 5,000 non-partisan civil servants provides administrative and technical support to the Parliament. In addition, MEPs have their own staff assistants and political groups also have their own staff.

Location

Strasbourg, France, is the official seat of the EP; plenary sessions are held there for one week a month. For two weeks a month, the EP's standing committees meet 300 miles to the northwest in Brussels, Belgium, where the European Commission and the Council of Ministers are located. Generally, there is also one "part plenary" session (two days) in Brussels each month. One week is set aside for meetings of the political groups, which are usually held in Brussels. MEPs must have offices and lodgings in both cities. Meanwhile, administrative services sections of the EP 's Secretariat are based in Luxembourg, about mid-way between Strasbourg and Brussels. Most EP staff, however, live in Brussels and either commute to France or communicate via telephone or email during full plenary sessions. The costs of having three addresses are high in terms of both time and money, and continue to be a contentious issue (see below).

Languages

Simultaneous interpretation of all parliamentary and committee debates is provided in the EU's 23 official languages. All parliamentary documents are translated into and published in 21 of these languages (Irish and Maltese are sometimes excepted), and some documents must be translated into all 23. Such extensive translation services represent a significant administrative cost.

CHALLENGES

The European Parliament faces several challenges of public perception. Some skeptics contend that the EP, despite being a directly-elected body, lacks the legitimacy of national parliaments and exercises too little power relative to the other EU institutions. Such observers characterize the EP largely as a debating chamber with little binding influence on EU policy.

Others maintain that the legislative process of the EU is overly complex and often deals with highly technical issues, leading to a lack of public understanding about the role and significance of the EP. Limited public awareness and understanding of the EP ’s activities, they argue, is reflected in the consistently declining turnout in European Parliament elections since 1979. Low voter participation, in turn, feeds back into skepticism of the EP ’s legitimacy as a representative institution, and fuels wider charges of a democratic deficit and a lack of transparency in EU policy-making.

EP advocates assert that “co-decision” and its institutional supervisory roles have substantially enhanced the Parliament’s influence. The Lisbon Treaty, in effect, gives the EP veto authority over the vast majority of EU legislation. Observers have noted that the EP has already put some of its new powers acquired under the Lisbon Treaty to use. In mid-February 2010, the EP rejected a U.S.-EU agreement negotiated by the Commission and approved by the Council of Ministers that would have continued allowing U.S. authorities access to European financial data (known as the SWIFT agreement) to help counter terrorism. By a vote of 378 to 196, MEPs blocked the extension of the SWIFT accord on privacy and civil liberty grounds. Prior to the Lisbon Treaty, the EP did not have the authority to veto such international agreements [12] Supporters also claim that the EP ’s influence is growing even in strictly consultative areas, such as the EU’s common foreign policy, where the “co-decision procedure” does not apply and where decisions rest largely with the member states. They maintain that the EP has become a forum for debate on international issues, and uses its power of assent on cooperation accords with third parties, as well as Parliamentary resolutions, to promote issues such as human rights.

Closely related to the question of the EP ’s legitimacy is the issue of whether MEPs reflect national or European interests. The Parliament claims to represent the people of Europe, while the Council speaks for the national governments, and the Commission represents the interests of the EU as a whole. Some analysts observe that the political groups of the EP represent a nascent form of EU-wide politics. Studies on voting behavior in the EP have shown that ideology holds greater influence than nationality, with MEPs voting with their party groups almost 90% of the time [13]. On the other hand, some observers contend that MEPs often promote parochial national interests. Past examples include Italian and Spanish MEPs defending olive growers, and British and Irish MEPs joining forces to oppose tax harmonization measures. And some point out that many MEPs campaign on national rather than European issues. With 27 different national elections for the EP, European citizens vote based on a wide array of different issues. Many voters essentially view EP elections as a national mid-term election—an indication of voter opinion as to the performance of the national government—rather than as a vote on Europe-wide issues.

Another major concern is costs, which the EP has long been under public pressure to reduce. The fact that MEPs and their staffs regularly shuttle between three cities leads to travel and hotel bills that, in the past, have consumed roughly 15%-20% of the EP ’s budget. Yet, the suggestion that the EP should consolidate its operations in one city has met with strong opposition in the host countries of France, Belgium, and Luxembourg, which fear the loss of symbolism and prestige, in addition to jobs and other economic benefits. Strasbourg was originally chosen as the seat of the EP to serve as a symbol of peace between France and Germany, and both countries argue it should continue to do so. Construction of multi-million-dollar buildings in Brussels and Strasbourg in the late 1990s to accommodate the growth in MEPs following EU enlargement also stirred controversy.

After many years and several failed attempts, MEPs succeeded in 2005 in reforming the Parliament's salary and expense regime. Some MEPs had long complained about pay disparities because they received the same salary as members of their respective national parliaments. For example, Italian MEPs had earned roughly three times more than their Spanish counterparts. Previous efforts to reform the pay system had foundered on the concerns of some member states about the costs of the reforms. Under the new deal, which began in 2009 with the new EP, all MEPs will be paid the same amount in exchange for instituting a reimbursable system for business and travel expenses; previously, MEPs received a flat-rate travel allowance that did not require receipts and contributed to what some consider the Parliament's "gravy train" image.

THE EUROPEAN PARLIAMENT AND THE U.S. CONGRESS

Ties between the EP and the U.S. Congress date back to 1972, when a U.S. Congressional delegation first visited the EP in Brussels and Luxembourg. Since then, with a few exceptions, Congressional-EP exchanges have taken place twice a year, and have provided the opportunity for sustained dialogue. The U.S. Congress-EP exchange is the oldest and widely considered the most prestigious of the EP 's interparliamentary dialogues.

In 1999, the EP and the U.S. Congress launched the *Transatlantic Legislators' Dialogue* (TLD) as their official response to the U.S.-EU commitment in the 1995 New Transatlantic Agenda to enhance parliamentary ties between the EU and the United States. With the TLD, the two sides have committed to regular meetings twice a year to discuss a wide range of topical political and economic issues. The EP's Delegation for Relations with the United States represents the EP in the TLD and is led by a chairman, who is elected by the delegation's members and has responsibilities equal to those of a committee chair. The most recent TLD meeting took place in December 2009 in New York City (the venue for the TLD usually alternates between the United States and Europe). Congress and the EP have also conducted video conferences on specific areas of mutual concern. However, some American analysts observe that the TLD remains relatively obscure, with ambiguity regarding which U.S. members actually belong, and no role given to the U.S. Senate [14]

Many MEPs would like to enhance cooperation with the U.S. Congress even further. In March 2009, the EP adopted a resolution, which among other measures, asserted that the U.S. Congress and the EP should promote closer ties between legislative committees and should create a reciprocal legislative "early-warning" system to identify potential legislative activities that could affect relations between the United States and the EU. In January 2010, the EP also deployed two staffers to Washington to establish a EP-Congress liaison office; these EP staffers will seek to keep the EP better informed of legislative activity in the U.S. House and Senate by attending hearings, following legislation, and establishing working relationships with Members of Congress and their staffs. The EP also hopes that the U.S. Congress will consider the possibility of setting up a similar Congressional liaison office in Brussels [15].

REFERENCES

[1] The European Commission is composed of 27 Commissioners—one from each EU member country—who serve a five-year term. The head of state or government of each member country nominates their country's Commissioner. Commissioners, however, do not serve national interests, but rather represent the interests of the EU as a whole. One is selected to lead and represent the Commission as the Commission President. The others hold a distinct portfolio (e.g., agriculture, energy, trade), similar to U.S. department secretaries and agency directors, and are responsible for overseeing legislation and member state compliance, and for representing the Commission, on that issue. Seven Commissioners are double-hatted as Commission Vice Presidents in addition to their portfolios.

[2] Meetings of the Council of Ministers are configured according to the subject under consideration (e.g., foreign ministers would meet to discuss the Middle East, agriculture ministers to discuss farm subsidies).

[3] In qualified majority voting in the Council of Ministers, countries are allotted a number of votes in rough proportion to their population size. Passage of a measure currently requires at least half of the member states (two-thirds if not a Commission initiative) and 255 out of the 345 total votes, representing at least 62% of the total EU population. Under the Lisbon Treaty, a simplified formula for qualified majority voting will be introduced in 2014 but not fully implemented until 2017.

[4] The EU's 2009 budget is EUR 133.8 billion (approximately $187 billion)

[5] The previous 2004-2009 Commission served in a caretaker capacity until the new Commission was confirmed.

[6] Bulgaria quickly named a new nominee for its Commission post; her confirmation hearing before the Parliament was held on February 3, 2010. "Barroso has no plans to reshuffle portfolios," Europolitics, January 21, 2010.

[7] Prior to direct elections, MEPs were appointed by their national parliaments.

[8] There were 785 seats in the European Parliament of 2004-2009; under the EU's 2001 Nice Treaty, which entered into force in 2003, this number was reduced to 736 for the parliamentary term 2009-2014. The Lisbon Treaty sets the number of MEPs at 751 starting in 2014. With the Lisbon Treaty now ratified, it is expected that 18 additional MEPs will be added to the EP, temporarily raising the number of MEPs for the current term to 754.

[9] "Voters steer Europe to the right," *BBC News*, June 8, 2009.

[10] "Euro MPs build new alliances," BBC News, July 2, 2009; Stephen Castle, "Far right is left out at EU's assembly," *International Herald Tribune*, July 15, 2009.

[11] For more information, see the website of the EP President, http://www.ep-president.eu

[12] "MEPs hail historic rejection of SWIFT deal," Agence Europe, February 13, 2010.

[13] See Simon Hix, Abdul Noury, and Gerard Roland, How MEPs Vote (Brighton, UK: Economic and Social Research Council), 2002

[14] For more information, see the European Parliament's website on the Transatlantic Legislators' Dialogue, http://www.europarl.europa.eu/intcoop/tld/default_en.htm. Also see the section on the TLD in CRS Report RL34735, Transatlantic Regulatory Cooperation: A Possible Role for Congress, by Raymond J. Ahearn and Vincent Morelli.

[15] European Parliament resolution (A6-01 14/2009), adopted March 26, 2009.

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THE EUROPEAN UNION'S REFORM PROCESS: THE LISBON TREATY*

Kristin Archick and Derek E. Mix

ABSTRACT

In December 2007, leaders of the European Union (EU) signed the Lisbon Treaty. With the completion of ratification by the Czech Republic on November 3, 2009, all 27 EU member countries have ratified the document, and it is expected to come into force on December 1, 2009. The Lisbon Treaty reforms the EU's governing institutions and decision-making process to enable the EU to operate more effectively. The treaty grew out of the proposed "constitutional treaty" that foundered after French and Dutch voters rejected it in referendums in 2005.

The Lisbon Treaty seeks to give the EU a stronger and more coherent voice with the creation of a new position, President of the European Council. This individual will chair the activities of the 27 EU heads of state or government, working to facilitate consensus and ensure policy continuity, guide the strategic direction of policy-making, and give the EU greater visibility on the world stage. Additionally, the Lisbon Treaty creates the new position of High Representative of the Union for Foreign Affairs and Security Policy, a de facto EU foreign minister who would be supported by a new EU diplomatic service.

The Lisbon Treaty makes changes to the EU's internal decision-making mechanisms. These changes have been designed to streamline the process and make it less susceptible to gridlock or blockage by a single member state. The treaty attempts to address concerns about democratic accountability and transparency in EU policy-making by granting a greater role to the directly elected European parliament, national parliaments, and citizens' initiatives.

The Swedish Presidency of the EU is planning to use a special EU Summit, probably taking place in mid-November 2009, to resolve remaining institutional questions about the treaty's implementation. A number of important decisions need to be made, including who to appoint to the new President and "foreign minister" positions, and how the exact role of these positions will be defined.

Experts assert that the Lisbon Treaty would have positive implications for U.S.-EU relations. While the treaty is unlikely to have major effects on U.S.-EU trade and economic relations, some believe that it could allow the EU to move past its recent preoccupation with distracting internal questions and take on a more active and effective role as a U.S. partner in tackling global challenges. There are indications that adoption of the Lisbon Treaty would make the EU more amenable to future enlargement, including to the Balkans and perhaps Turkey, which the United States strongly supports.

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On the other hand, skeptics maintain that a stronger EU poses a potentially detrimental rival to NATO and the United States.

This report provides information on the Lisbon Treaty and possible U.S.-EU implications that may be of interest to the 111th Congress. Also see CRS Report RS21372, *The European Union: Questions and Answers,* by Kristin Archick and Derek E. Mix.

BACKGROUND

The European Union (EU) is an economic and political partnership that is unique in history. Built upon a series of treaties and embodied in a set of governing institutions, the EU represents a voluntary pooling of sovereignty among 27 countries [1]. These countries have committed to a process of integration by harmonizing laws and adopting common policies on an extensive range of issues. Notable areas of shared sovereignty include a customs union; a common trade policy; a single market in which goods, people, and capital move freely; a common currency (the euro) that is used by 16 member states; and many aspects of social and environmental policy. EU member states have also taken significant steps in the development of a Common Foreign and Security Policy (CFSP) and closer police and judicial cooperation [2]

EU Institutions

The European Commission is essentially the EU's executive and has the exclusive right of legislative initiative. It ensures that the provisions of EU Treaties are carried out by the member states. The 27 Commissioners, including a President, are appointed by agreement among the governments of the member states for five-year terms. Each Commissioner holds a distinct portfolio (e.g., agriculture). The President of the Commission sets its policy priorities, organizes its work, and represents the Commission internationally.

The Council of the European Union (Council of Ministers) is comprised of ministers from the national governments. As the main decision-making body, it enacts legislation based on proposals put forward by the Commission. Different ministers participate depending on the subject under consideration (e.g., economics ministers could convene to discuss unemployment policy). The presidency of the Council currently rotates among the member states every six months.

The European Parliament consists of 736 members. Since 1979, they have been directly elected in each member state for five-year terms. The Parliament cannot enact laws like national parliaments, but it shares "codecision" power in many areas with the Council of Ministers, can amend or reject the EU's budget, and must approve each new European Commission.

The European Council brings together the Heads of State or Government of the member states and the President of the Commission at least twice a year. It acts principally as a guide and driving force for EU policy.

The *Court of Justice* interprets *EU* law and its rulings are binding; a *Court of Auditors* monitors the Union's financial management. Additionally, a number of advisory bodies represent economic, social, and regional interests.

A group of leaders from six countries— Belgium, France, Germany, Italy, Luxembourg, and the Netherlands—began the process of integration after World War II in an effort to ensure peace and promote economic prosperity in Europe.

As cooperation between these countries deepened, new members were added to the group: Denmark, Ireland, the United Kingdom joined in 1973, Greece in 1981, Portugal and Spain in 1986, and Austria, Finland, and Sweden in 1995. In 2004, eight formerly Communist countries of central and eastern Europe—the Czech Republic, Estonia, Hungary Latvia, Lithuania, Poland, Slovakia, and Slovenia—plus Cyprus and Malta joined the EU. Bulgaria and Romania joined in 2007, bringing the number of member countries to 27.

With enlargement and a progressively wider policy scope came the need to reform the EU's institutional arrangements and procedures to reflect the heightened complexity of decision- making. The landmark Maastricht Treaty of 1993 set out the blueprint for an EU of 12 members and the Treaty of Amsterdam (1999) refined arrangements for a Union at 15. The Treaty of Nice (2003) further amended the workings of the EU to prepare for eastward enlargement [3] Although the Treaty of Nice was intended to enable an enlarged Union to function effectively, skeptics argued that the treaty set up an overly complex and inefficient decision-making process. In addition to being slow and cumbersome, critics have long charged that EU institutions and decision-making lack transparency and are unintelligible to the average European citizen.

As the scope of EU policy continues to grow, future enlargement beyond 27 members is likely: Iceland, Turkey, and the countries of the Western Balkans are in line for admission. In this context, as well as in the context of perceived institutional shortcomings, many leaders and analysts advocated the adoption of a new EU treaty that enacts what they have considered to be necessary internal reforms. The Lisbon Treaty is the results of these efforts.

The Constitutional Treaty

The Lisbon Treaty grew out of the so-called constitutional treaty, an earlier failed attempt to merge the EU's existing treaties into a single document while enacting institutional reforms. Already in December 2001—before ratification of the Treaty of Nice and the EU's eastward enlargement—EU leaders announced they would convene a Convention on the Future of Europe to examine the EU's institutional arrangements and make proposals that would increase democratic legitimacy and encourage the development of the EU as a stronger global actor.

The Convention began work in March 2002 under the leadership of former French President Valéry Giscard d'Estaing and finalized a 240-page "Draft Treaty establishing a Constitution for Europe" in July 2003 [4]. After a period of discussion and negotiation among the member state governments, EU leaders signed the treaty in October 2004 and set November 2006 as the target date for its adoption.

However, in order to come into effect the treaty had to be ratified individually by all 27 member states through either parliamentary approval or public referendums. In May 2005, French voters rejected the document in a national referendum, and in June 2005 Dutch voters followed suit. Although a number of EU members had already approved the treaty by this point, these setbacks effectively ended its prospects. In both France and the Netherlands, some arguments against the constitutional treaty reflected concerns that it would entrench liberal economic ideas that could undermine social protections. In addition, many French and Dutch voters viewed a "no" vote as a way to express dissatisfaction with their unpopular national governments, EU bureaucracy, and Turkey's prospective EU membership.

The Lisbon Treaty

In January 2007, as Germany took over the six-month EU presidency, Europe remained in what some analysts called a "period of reflection"—a condition of stasis born in the uncertainty that followed the rejection of the constitutional treaty. German Chancellor Angela Merkel made reviving the stalled reform process one of her key priorities, seeking a new treaty deal that would institute crucial reforms. Analysts say that Merkel received a key assist with the May 2007 election of Nicolas Sarkozy as President of France: Sarkozy shared Merkel's goal of reviving the constitutional treaty in some form, at least in part to restore France's role as a leader in Europe following its 2005 "No" vote.

Germany and others that had ratified the constitutional treaty wanted to preserve as much of the original document as possible. However, some changes were considered necessary in order to address concerns raised by French and Dutch voters, as well as to satisfy countries such as the UK, which sought to protect its national sovereignty in some areas, and Poland, which wanted more voting weight in the Council of Ministers.

After contentious negotiations at the June 2007 EU Summit, EU leaders announced the outlines of a new "reform treaty" that would amend, rather than replace, the existing EU treaties. EU leaders also dropped the term "constitution," given that it had become negatively associated in some countries with creating an EU "superstate." As an amendment to existing treaties, EU leaders sought to present the new document as one that would be ratified by parliaments, thereby avoiding the risks of public referendums. However, alone among the member states, Ireland was still required by its national law to hold a public vote on any major change to the existing body of EU rules.

After working out the text at a July 2007 Intergovernmental Conference, EU leaders signed the new treaty—now called the Lisbon Treaty—in December 2007 [5]. Analysts assessed that over 90% of the substance of the constitutional treaty had been preserved in the Lisbon Treaty. EU officials initially hoped that the Lisbon Treaty would be ratified by all 27 member states and enter into force before the June 2009 European Parliament elections. However, rejection of the treaty in Ireland's June 2008 referendum threw the timetable for adoption into disarray. Ireland approved the treaty in a second referendum on October 2, 2009, and the Czech Republic completed the last of the 27 national ratifications on November 3, 2009. EU leaders are now planning for the Lisbon Treaty to come into effect on December 1, 2009.

Key Reforms

Major changes under the Lisbon Treaty aim to achieve three broad goals:

1) A stronger and more coherent EU voice. The Lisbon Treaty creates the new position of President of the European Council to help ensure policy continuity and raise the EU's profile on the world stage. This individual will chair the meetings of the 27 EU heads of state or government (the European Council, whose meetings are commonly termed EU Summits), working to facilitate consensus and help guide the strategic direction of EU policy. The President of the European Council will be elected by member states for a term of two and one-half years, renewable once.

Internally, creation of this position also addresses some of the concerns about the personnel and financial burdens, especially for smaller members, of the rotating six-month presidency system. A modified system of rotation will remain to help coordinate and chair meetings of the Council of Ministers, other than in the area of foreign policy.

The Lisbon Treaty also creates another important new position to boost the EU's international visibility: High Representative of the Union for Foreign Affairs and Security Policy. The position was originally called the EU "foreign minister" in the constitutional treaty, but this term was dropped due to British objections. Nevertheless, this individual will be the EU's chief diplomat, exercising the current responsibilities of both the Council of Minister's High Representative for the Common Foreign and Security Policy (Javier Solana) and the Commissioner for External Relations (Benita Ferrero-Waldner). The High Representative will therefore be an agent of the Council of Ministers (representing the member states) and hold the title of a Vice-President of the European Commission. The High Representative will have extensive staff support with the creation of a European External Action Service, in effect a new EU diplomatic corps.

The Lisbon Treaty also promotes steps toward building a stronger common EU defense policy. As proposed in the constitution, the Lisbon Treaty asserts that the EU shall seek "the progressive framing of a common Union defense policy," which "will lead to a common defense." It will establish a "mutual assistance clause" permitting a member state that is the victim of armed aggression to ask for military assistance from the other members. Member states may also engage in "structured cooperation," which would allow a smaller group of members to cooperate more closely on military issues.

2) More streamlined decision-making. After a contentious debate with Poland, EU leaders agreed on a simplified formula (ultimately similar to that proposed in the constitutional treaty) for the Council of Ministers' Qualified Majority Voting (QMV) system. Decisions made by QMV would pass if supported by 55% of member states, representing 65% of the EU's population. As a concession to Poland, this new "double majority" system is to be introduced in 2014 (instead of 2009-2010), gradually phased in over three years, and not fully implemented until 2017.

The use of QMV is also expanded to policy areas previously subject to unanimity, especially in matters related to police and judicial cooperation (the UK, however, has been granted an opt-out in this area). Unanimity will continue to be required (any member state may veto a common policy) in sensitive areas such as taxation and most aspects of foreign and defense policy.

The Lisbon Treaty had initially planned to slim down the size of the European Commission starting in 2014. To help decrease gridlock, EU leaders had proposed reducing the number of Commissioners from one per member state to correspond to two- thirds of the number of member states. However, concessions related to Ireland's attempt to ratify the treaty shelved this idea, and the Commission is set to remain at one Commissioner per member state.

3) Increased transparency and democratic accountability. In many policy areas, the directly elected European Parliament holds the right of "co-decision" with the Council of

Ministers: both institutions must approve a piece of legislation for it to become law. The Lisbon Treaty extends the European Parliament's "co-decision" powers to include many additional policy areas, including agriculture and "home affairs" issues.

The treaty also gives national parliaments a greater role in EU policy-making and more authority to challenge draft EU legislation. The treaty introduces the concept of citizens' initiatives, whereby European citizens may petition the European Commission with legislative suggestions.

Additionally, the Lisbon Treaty makes the Charter of Fundamental Rights—a declaration of citizens' basic political, economic, and social rights—legally binding for all EU institutions and member states. Poland, the Czech Republic, and the United Kingdom negotiated "opt-outs" from applying the Charter.

Implementing the Treaty

With the ratification process completed in all 27 member states, Sweden, which holds the six- month EU presidency for the second half of 2009, is planning to hold a special EU Summit in mid-November. At the summit, EU leaders are expected to debate and settle lingering institutional questions about how the Lisbon Treaty will be implemented, with the goal of bringing the treaty into effect on December 1, 2009.

Key questions about the treaty's implementation still remain unanswered, and a number of tough decisions will need to be made. These key questions concern the appointment of the new President of the European Council and the new EU "foreign minister." Considerable debate and political maneuvering are expected surrounding these appointments. There is disagreement within the EU as to the type of role these positions should play, and many observers assert that the first appointees are likely to define the job descriptions in each case.

Some view the President of the European Council as someone that would actively assert leadership and guidance, likely a highly visible, "heavyweight" former national head of state or government. Others view the position as more of a coordinator and manager, who would build consensus and reflect the group decision. Such a President would still likely be a former senior leader, but not necessarily one with "A-list" stature. The reported early candidacies of former British Prime Minister Tony Blair and current Luxembourg Prime Minister Jean-Claude Juncker exemplified these two differing visions. The debate now appears to be turning toward the latter option, with Belgian Prime Minister Herman van Rompuy and Dutch Prime Minister Jan Peter Balkenende emerging as leading candidates.

Conclusions regarding the nature of the President will relate to additional questions about how the President and the presidency countries managing the Council of Ministers will interact. Because the leader of the rotating presidency country was essentially the temporary President of the European Council under the previous arrangements, the role of that individual under the Lisbon Treaty is unclear.

The desired nature of the High Representative of the Union for Foreign Affairs and Security Policy will likely produce similar debate—whether the position should act as a strong, independent-minded leader who both drives and oversees EU foreign policy, or as more of a facilitator who advances the members' consensus. While UK Foreign Secretary David Miliband has recently become a popular suggestion, many others have also been rumored as candidates, including Swedish Foreign Minister Carl Bildt, European Enlargement Commissioner Olli Rehn (Finland), Greek Foreign Minister Dora Bakoyannis, French Foreign Minister Bernard Kouchner, former French Foreign Ministers Hubert Védrine and Michel Barnier. Leaders also need to reach agreement on how the new EU diplomatic corps will be organized.

IMPLICATIONS FOR THE UNITED STATES

Critics contend that the Lisbon Treaty will do little to simplify the EU, and assert that many difficult issues that are often the source of gridlock—such as foreign policy and taxation—will remain subject to national vetoes. However, most argue that the treaty's reforms are necessary andhelpful and will at any rate allow the EU to move past this decade's preoccupation with process and internal questions to focus more time and energy on "doing things."

Many experts assert that passage of the Lisbon Treaty will have positive implications for the U.S.-EU relationship because elements such as the new President and "foreign minister" positions are designed to promote an EU able to "speak with one voice" on foreign policy issues. Such an EU could take on a more active and assertive global role and be a more credible and effective partner for the United States in tackling common global challenges. Others note that the prominence of these new positions—and their resonance in the United States—will depend largely on the individuals appointed to fill them. They wonder, for example, how much of a difference U.S. officials might discern between the new "foreign minister" and the current High Representative position.

U.S. supporters of the Lisbon Treaty also note that efforts to encourage a common EU defense policy and the proposal for "structured cooperation" seek to improve European defense capabilities. A more militarily capable Europe, they argue, could shoulder a greater degree of the security burden with the United States.

Analysts assert that the Lisbon Treaty would remove obstacles to further EU enlargement to the Balkans and perhaps eventually Turkey, which the United States strongly supports: some European leaders have asserted that the streamlining reforms of the Lisbon Treaty could make the political atmosphere more amenable to additional enlargement, and some had called for a freeze on enlargement until the treaty was passed.

Some in the United States contend that a larger and potentially more united EU may seek to rival the United States and had been more sanguine about the Lisbon Treaty's potential demise. They maintain that a more unified EU would likely lessen Washington's leverage on individual members and could complicate U.S. efforts to rally support for its initiatives in institutions such as the United Nations or NATO. These skeptics remain concerned that parts of the Lisbon Treaty that promote greater EU defense coordination could lead to the eventual development of EU military structures that would duplicate those of NATO and weaken the transatlantic link.

U.S.-EU trade relations are unlikely to be significantly affected by the new treaty, which does not alter the roles of the European Commission or Council of Ministers in formulating or approving the EU's common external trade policy. Although EU rules allow the Council to approve or reject trade agreements negotiated by the Commission with QMV, in practice the Council tends to employ consensus and will probably continue to do so regardless of the changes in EU voting procedures.

REFERENCES

[1] The member countries of the EU are Austria, Belgium, Bulgaria, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and the United Kingdom.

[2] See CRS Report RS21372, *The European Union: Questions and Answers*, by Kristin Archick and Derek E. Mix.

[3] For summaries of these three treaties, see http://europa.eu/legislation_summaries /institutional_affairs/treaties/ index _en.htm.

[4] The document can be downloaded at http://european-convention.eu.int/docs/ Treaty/cv00850.en03.pdf.

[5] For a summary or full text of the treaty, see http://europa.eu/lisbon _treaty/full_text/index_en.htm.

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LONG-RANGE BALLISTIC MISSILE DEFENSE IN EUROPE*

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ABSTRACT

Successive U.S. governments have urged the creation of an anti-missile system to protect against long-range ballistic missile threats from adversary states. The Bush Administration believed that North Korea and Iran represented strategic threats, and questioned whether they could be deterred by conventional means. The Bush Administration's position on this issue remained unchanged, even after the intelligence community assessed that the Iranian nuclear weapons program halted in 2003. The Bush Administration built long-range missile defense bases in Alaska and California to protect against missile threats, especially from North Korea. Although the system has been tested, most agree that further testing is necessary. Additionally, the Bush Administration proposed deploying a ground-based mid-course defense (GMD) element of the larger Ballistic Missile Defense System (BMDS) in Europe to defend against an Iranian missile threat. The system would include 10 interceptors in Poland, a radar in the Czech Republic, and another radar deployed in a country closer to Iran, all to be completed by 2013 at a reported cost of at least $4 billion.

The proposed U.S. system has encountered resistance in some European countries and beyond. Critics in Poland and the Czech Republic assert that neither country faces a notable threat from Iran, but that if American GMD facilities were installed, both countries might be targeted by missiles from rogue states—and possibly from Russia. The Bush Administration signed agreements with both countries permitting GMD facilities to be stationed on their territory; however, the two countries' parliaments continue to wait on ratifying the accords, in part, until after the Obama Administration clarifies its intentions on missile defense policy. NATO has deliberated long-range missile defense, and has taken actions that some interpret as an endorsement of the U.S. GMD system.

The GMD plan has also affected U.S.-Russia relations. Former President Putin and his successor, Vladimir Medvedev, have argued that the proposal would reignite the arms race and upset U.S.- Russian-European security relations. U.S. officials dispute Russia's objections, noting that the interceptors are intended to take out Iranian missiles aimed at Europe or the United States and could not possibly act as a deterrent against Russia. Some argue that Russia has been attempting to foment discord among NATO allies. In mid-2007, Russia offered to cooperate on missile defense, proposing the use of a Russian-leased radar in Azerbaijan, but urging that U.S. facilities not be built in Eastern

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Europe. President Bush welcomed the idea in principle, but insisted upon the need for the European sites. Despite ongoing discussions over the issue, sharp Russian criticism of the program has continued.

For FY2008, Congress examined the European GMD proposal and eliminated proposed funding for initial site construction pending formal agreement with Poland and the Czech Republic, independent studies on missile defense options for Europe, and DOD certification of the proposed interceptor. The FY2009 request for the European site was $712 million, which Congress largely supported with funding for site construction available only after Czech and Polish ratification. The Obama Administration proposed $50.5 million for the European site for FGY2010, which with the $618 million remaining and available from the FY2009 budget pending Polish and Czech ratification, the Administration believes is sufficient for the time being.

INTRODUCTION

In the FY2008 defense budget, the Bush Administration requested about $310 million to begin design, construction, and deployment of a ground-based midcourse defense (GMD) element of the Ballistic Missile Defense System (BMDS) in Europe [1]. According to the Administration, the proposed GMD European capability would help defend U.S. forces stationed in Europe, U.S. friends and allies in the region, as well as to defend the United States against long-range ballistic missile threats, namely from Iran. For FY2009, the Administration requested $712 million for development, fielding, and military construction of the European GMD element. Some $618 million is available from the FY2009 defense budget for the European 3rd site, if Polish and Czech ratification goes forward. The Obama Administration proposed an additional $50.5 million.

The proposed system would include 10 silo-based interceptors to be deployed in Poland, a fixed radar installation in the Czech Republic, and another transportable radar to be deployed in a country closer to Iran. Deployment of the GMD European capability is scheduled to be completed by 2013 at an official estimated cost of $4 billion (includes fielding and Operation and Support), according to the Bush Administration.

The prospect of a GMD capability based in Europe raises a number of significant international security and foreign policy questions. Central to the debate for many is how the proposed U.S. system might affect U.S.-European-Russian relations. For FY2008, Congress eliminated funding to start construction of the European site pending final approval of international agreements with Poland and the Czech Republic and an independent study of alternative missile defense options for Europe [2]. Congress largely supported the Administration’s request for FY2009, but restricted funding for site construction until after the Polish and Czech Parliaments ratify the agreements reached with the Bush Administration. Congress continued to withhold funding for deployment of the ground-based interceptor missiles until after the Secretary of Defense certifies to Congress that those interceptor missiles will work effectively.

The Obama Administration

During the 2008 presidential campaign, Senator Obama said he supported the deployment of ballistic missile defenses that were operationally effective. In her January 2009 nomination hearings for Undersecretary of Defense for Policy, Michele Flournoy said the Obama Administration would review plans to deploy elements of a missile defense system in Europe [3]. Flournoy said the plans should be reviewed as part of the QDR (Quadrennial Defense Review) and "in the broader security context of Europe, including our relations with Russia," noting that any final policy decision should consider it in the interest of the United States if Washington and Moscow could agree to cooperate on missile defense. Flournoy also said the final contours of any decision would require close consultations between the Administration and Congress. At his nomination hearing before the Senate Armed Services Committee for Deputy Secretary of Defense, William Lynn responded to a question suggesting he would support making the MDA's budgetary, acquisition, testing, and policy processes more open and similar to the military services. "I think that all our military programs should be managed through those regular processes," he said, and "that would include missile defense. I would think any exceptions should be rare and fully justified" [4] Representative Ellen Tauscher (D-Calif.), head of the House Armed Services Strategic Forces subcommittee, reportedly predicted such changes would be made in the new administration [5]. On the White House website, the Obama Administration says it "will support missile defense, but ensure that it is developed in a way that is pragmatic and cost- effective; and, most importantly, does not divert resources from other national security priorities until we are positive the technology will protect the American public" [6]

In April 2009, Defense Secretary Robert Gates announced a number of recommendations regarding the FY20 10 defense budget. Although Secretary Gates provided some details about a number of BMD programs, little was said about the European 3rd site. Joint Chiefs of Staff Vice Chairman Gen. James Cartwright only offered that there are "sufficient funds in '09 that can be carried forward to do all of the work that we need to do at a pace we'll determine as we go through the program review, the Quadrennial Defense Review, and negotiations with those countries."

The President's Budget was released later in May 2009. It includes $50.5 million for the European 3rd site. Additionally, there is about $618 million from FY2009 appropriated funds for the European 3rd site pending Polish and Czech ratification of the missile defense agreements signed in 2008. The Obama Administration is in the midst of a major BMD Review and the Quadrennial Defense Review (QDR). Hence, the Administration's commitment to the specifics of the European 3rd site as proposed by the Bush Administration has not been made, although it has made clear there is sufficient funding available to proceed with the site should both Poland and the Czech Republic ratify the missile defense agreements.

THE THREAT

The Bush Administration argued that North Korea and Iran constituted major strategic threats. North Korea claims to have tested a nuclear device and has a ballistic missile and satellite launch program. The Bush Administration argued that Iran continues to acquire and develop ballistic missiles of various ranges [7]. Iran successfully launched a small satellite into orbit for the first time in early February 2009. Until recently, the Bush Administration argued that Iran had an active nuclear weapons development program. In November 2007, a U.S. National Intelligence Estimate (NIE) stated that "in Fall 2003, Tehran halted its nuclear weapons program," but that Iran is also keeping open the option to develop nuclear weapons at some point. The Iranian nuclear weapons program reportedly also included developing a warhead that could fit atop an Iranian ballistic missile [8].

The Bush Administration regarded both countries as unpredictable and dangerous, and did not believe they could be constrained by traditional forms of military deterrence, diplomacy, or arms control. On a trip to attend a meeting of NATO foreign ministers in early December 2007, Secretary of State Rice told reporters: "I don't see that the NIE changes the course that we're on" to deploy a European missile defense system [9] Accompanying her on the trip, Undersecretary of State John Rood, lead U.S. negotiator for the European missile defense talks, added: "the missile threat from Iran continues to progress and to cause us to be very concerned.... Missile defense would be useful regardless of what kind of payload, whether that be conventional, chemical, biological, or nuclear." [10]

According to long-standing unclassified U.S. intelligence assessments, Iran may be able to test an ICBM (Intercontinental Ballistic Missile) or long-range ballistic missile capability by 2015 if it receives foreign assistance, such as from Russia or China. Many in Congress and elsewhere share this specific assessment, or that the potential threat may not emerge by 2015 but is sufficiently worrisome to address it now. Many therefore believe it prudent to move forward with plans to deploy a long-range missile defense system in Europe to defend U.S. forward deployed forces in Europe, friends and allies, and the United States against long-range ballistic missile threats. Some in the larger international security policy and ballistic missile proliferation community argue that evidence of an Iranian ICBM program is scant and unpersuasive. Additionally, the Iranian government reports (which cannot be verified) that Iran only has a limited missile capability with a range of about 1,200 miles [11] and that it has stopped development of ICBM range missiles. Nonetheless, Iran continues to test ballistic missiles, some of which are capable of reaching as far as NATO's Southern Flank (i.e., Turkey). Also, Iran recently successfully tested a short-range ballistic missile using solid rocket motors, a development many see as indicative of Iran's interest in building longer range ballistic missiles.

Although some Europeans have expressed concern about Iran's suspected nuclear weapons program, some U.S. friends and allies in Europe continue to question the Administration's assessment of Iran's potential ICBM threat or of Iran's threat to Europe itself.. Hence, some question the need for a GMD element of the U.S. BMDS in Europe. In December 2008, the European Council of the European Union approved a two-year study of ballistic missile proliferation trends. More recently, MDA Director Gen. O'Reilly testified before Congress [12] that MDA's projections of the threat from long-range ballistic missiles from rogue nations was off "by a factor of 10-20."

THE SYSTEM

The U.S. Department of Defense began deploying long-range missile interceptors in Alaska and California in late 2004 to address long-range missile threats primarily from North Korea. Currently, the U.S. GMD element of the BMDS includes more than two dozen silo-based interceptors in Alaska and several in California. As part of an integrated Ballistic Missile Defense System (BMDS) capability, the United States also has a number of ground-based radars in operation around the world, space-based assets supporting the BMDS mission, command and control networks throughout the United States and the Pacific, as well as ground-mobile and sea- based systems for shorter-range BMD.

What remained necessary as part of the global BMDS, according to the Bush Administration, was an ability in the European theater to defend against intermediate-to-long-range ballistic missiles launched from Iran. The Department of Defense (DOD) argued it was important to U.S. national security interests to deploy a GMD capability in Europe to optimize defensive coverage of the United States and Europe against potential threats both into Europe and against the United States.

There have not been a large number of intercept flight tests of the deployed GMD element. Nonetheless, the Bush Administration and many U.S. military leaders expressed confidence in the deployed system [13] Nonetheless, most agree there is the need for further operational testing. Some observers continue to question how much confidence there should be in the system's potential operational or combat effectiveness based on the types of tests conducted and the test results to date.

The current GMD program began flight tests in 2002. This effort was built on several earlier long-range BMD programs with decidedly mixed results themselves since the early 1980s. Since 2002, a number of GMD intercept flight tests have taken place with mixed results [14]. In each of these tests, most all other flight test objectives were met.

In 2002, the GMD moved to the operational booster and interceptor. The interceptor system flew two developmental tests in 2003 and 2004, and the GMD element of the BMDS was deployed in late 2004 in Alaska and California. Two planned intercept flight tests of the new configuration for December 2004 and February 2005 were not successful. After technical review, the interceptor successfully demonstrated a booster fly-out in 2005. In September 2006, a successful flight test exercise of the GMD element as deployed took place. (Although a missile intercept was not planned as the primary objective of this data collection test, an intercept opportunity occurred and the target warhead was successfully intercepted.) Additional intercept flight tests of the deployed element whose primary objectives were intercepts of long-range ballistic missile targets were originally scheduled for later in 2006, but then subsequently postponed. Then a May 2007 intercept test was scrubbed when the target missile failed to launch as planned. A follow-on attempt scheduled for summer 2007 was completed successfully on September 29, 2007. The Missile Defense Agency reported a successful intercept in December 2008, but some were critical of this assessment as the test objective was for the intercept to occur amidst a field of decoys, which decoys failed to deploy from the test target.

Supporters and many military officials express confidence in the deployed system, but others continue to question the system's potential effectiveness based on the mixed intercept flight test record. Most observers agree, however, that additional, successful flight testing is necessary. Supporters add that a significant number of non-flight tests and activities are conducted that demonstrate with high confidence the ability of the GMD element to perform its intended mission [15].

What would the European element of the BMDS look like? The proposal is to deploy up to 10 Ground-based Interceptors (GBI) in silos at a former military base in Poland. It should be noted that the proposed GBI for the European GMD site will not be identical to the GBIs deployed now in Alaska and California. Although there is significant commonality of hardware, there are some differences. For example, the European GBI will consist of two rocket stages in contrast to the three-stage GBI deployed today [16]. This particular 2-stage configuration has not been tested and is a basis for additional questions about the proposed system's effectiveness. Proponents of the system would argue that the 2-stage version is fundamentally the same as the 3-stage system, however [17]. In Europe, the GBI reportedly will not need the third stage to achieve the range needed to intercept its intended target [18]. This issue has raised the question for some observers as to whether other U.S. systems designed for shorter or medium-range ballistic missile threats, such as Patriot, THAAD (Terminal High Altitude Area Defense), or Aegis (sea-based BMD) might be more appropriate for addressing the current and prospective Iranian ballistic missile threat to Europe. DOD's Missile Defense Agency (MDA) believes these systems would not be adequate to counter prospective Iranian ballistic missile threats over the mid-term and longer.

Deployment of the silos and interceptors in Poland is scheduled to begin in 2011 with completion in 2013. The interceptors will be deployed at Redzikowo, near the town of Slopsk in northern Poland. The field of the 10 interceptors itself is likely to comprise an area somewhat larger than a football field. The area of supporting infrastructure is likely to be similar to a small military installation.

In addition, a U.S. X-Band radar (a narrow-beam, midcourse tracking radar), that was being used in the Pacific missile test range, would be refurbished and transported to a fixed site at a military training base in the Czech Republic. The site currently identified is in the heavily forested Brdy Military Training Area, about 150 kilometers southwest of Prague. The X-Band radar with its large, ball-shaped radome (radar dome) is several stories in height.

A second, transportable forward acquisition radar would be deployed in a country to be determined, but closer to Iran. Some European press accounts once mentioned the Caucasus region, but the Bush Administration never publicly indicated where this radar might be located.

Additionally, the proposed GMD European capability would include a communications network and support infrastructure (e.g., power generation, security and force protection systems, etc.) A few hundred U.S. personnel would be engaged in securing and operating both the interceptor and radar sites. The Administration intends for the United States to have full command authority over the system.

The FY2008 request was $310.4 million for the proposed European GMD across several program elements of the Missile Defense Agency (MDA) budget. The total reported GMD costs for the European site are about $4 billion (FY2007-FY2013), including Operation and Support costs through 2013. Although relatively small in U.S. defense budget terms, the FY2008 request represented a significant commitment to the proposed European system. The FY2009 request was for $712 million. The FY20 10 request is for $50.5 million.

In 2007, both the House and Senate Armed Services Committees asked for studies of alternatives to the Administration's proposed European GMD deployment (see

"Congressional Actions"). This classified review was provided to Congress in August 2008. Some, such as Representative Tauscher, suggested the Administration consider instead a combination of sea-based (Aegis SM-3) and land-based systems (PAC-3, THAAD). MDA Director General Henry Obering argued that most of the current Aegis fleet would be required to defend Europe, and that the cost would be considerably greater than the current Bush Administration proposal [19] MDA's assessments, however, assume the need for 24/7 coverage. Assessments based on deployment on a contingency basis or crisis reduce significantly the estimated cost of such alternatives. Separately, the Center for Naval Analyses (a federally funded research center) conducted an analysis of alternatives for the Navy's next big surface combatant ship [20].

That review reportedly included recommendations about future naval BMD requirements that might bear on any discussion of alternatives to the proposed European GMD plan.

In May 2009, the U.S.-based EastWest Institute released a report critical of the ability of the European 3rd site to defeat Iranian ballistic missile threats [21]. The report concluded that the threat from Iran was not imminent and that the proposed European 3rd site would not be effective against an Iranian ballistic missile threat. Missile defense supporters have taken strong issue with the report's conclusions. Similarly, a fact sheet prepared by staff of the House Armed Service Committee said the proposed European 3rd site would not provide any capability against Iran's current ballistic missile inventory [22]

THE LOCATION

In 2002 the Bush Administration began informal talks with the governments of Poland and the Czech Republic over the possibility of establishing missile defense facilities on their territory. Discussion of a more concrete plan—placing radar in the Czech Republic and interceptor launchers in Poland—was reported in the summer of 2006. The issue was increasingly debated in both countries. In January 2007, the U.S. government requested that formal negotiations begin. Agreements have been struck with both countries, and both the Polish and Czech parliaments must now ratify the accords. The two governments have grappled with several issues as the debate has evolved.

Poland

Some analysts maintain that in Poland the notion of stationing American GMD facilities was more or less accepted early on in the discussions and that the main questions subsequently have revolved around what the United States might provide Warsaw in return. Some Poles believe their country should receive additional security guarantees in exchange for assuming a larger risk of being targeted by rogue state missiles because of the presence of the U.S. launchers on their soil. In addition, many Poles are concerned about Russia's response. Both of the past two Polish governments reportedly requested that the United States provide batteries of Patriot missiles to shield Poland against short- and medium-range missiles [23].

Formal negotiations on the base agreement, which requires the approval of the Polish parliament, began in early 2007 under the populist-nationalist Law and Justice (PiS) party, led by Jaroslaw Kaczynski. As talks began, Civic Alliance (PO), then the leading opposition party, had questions about the system—particularly the command and control aspects—and urged the government to ensure that it be integrated into a future NATO missile defense program. The former ruling leftist party supported deployment of the missiles, but also called for greater transparency in the decision-making process. The smaller parties of the governing coalition expressed some skepticism, mainly for reasons of sovereignty, and indicated support for a public referendum [24]

In snap elections held on October 21, 2007, Poles turned out PiS and replaced it with a center- right two-party coalition led by PO; its leader, Donald Tusk, became prime minister. During the campaign, Tusk indicated that his government would not be as compliant toward the United States as PiS, and that it would seek to bargain more actively on missile defense.

As he left office, former Prime Minister Kaczynski urged the incoming government to approve the missile defense proposal, arguing that an agreement would strengthen relations with the United States. In a post-election news conference, however, Tusk was cautious about the plan: “If we recognize that the anti-missile shield clearly enhances our security, then we will be open to negotiations.... If we recognize, jointly in talks with our partners from the European Union and NATO, that this is not an unambiguous project, then we will think it over.” Two weeks later, however, newly minted Defense Minister Bogdan Klich stated that Poland should again “weigh the benefits and costs of this project for Poland. And if that balance results unfavorably, we should draw a conclusion from those results.”[25] Foreign Minister Radek Sikorski later indicated that the new government would discuss the project with Russia.

Talks between Warsaw and Washington resumed in early 2008. Some observers forecast that the new Polish government would strongly renew the argument for the United States to provide additional air and/or short-range missile defenses [26]. On February 2, 2008, during a visit by Sikorski to Washington, D.C., U.S. Secretary of State Rice voiced support for strengthening Poland’s air defenses. Although there was said to be agreement “in principle” on the missile defense issue, an accord was not signed when Prime Minister Tusk visited the United States in the following month [27].

The major sticking point in the negotiations was the question of U.S. assistance for Poland’s military “modernization,” mainly in the form of PAC-3 air defense. During Prime Minister Tusk’s visit to Washington DC in March 2008, however, President Bush declared, “Before my watch is over we will have assessed [Poland’s] needs and come up with a modernization plan that’s concrete and tangible.” Nevertheless, the meeting of the two leaders did not result in a deal being struck. In addition, Poland was anxious that the two projects not be too explicitly linked, for fear of further alienating Russia. Concerning the likely future of the program, Polish Ambassador to the United States Robert Kupiecki in spring 2008 told a Polish parliamentary committee that “there are serious reasons to think that the project will be continued” by Bush’s successor, no matter whom it might be. A Czech newspaper reported that MDA Director Obering “said [on April 2 that] the United States will be interested in stationing the radar in the Czech Republic even if it does not reach agreement with Poland” [28]. What this might have meant for the overall system without the interceptors sited in Poland was not clear. However, some suggested that the radar would be useful if used in conjunction with other medium-range BMD systems, such as Aegis, in the absence of GMD interceptors based in Poland. In addition, Bush Administration officials reportedly held discussions on the interceptor basing issue with the government of Lithuania [29]. In early July, the Polish media reported that a meeting in Washington between Foreign Minister Sikorski and Secretary Rice failed to produce an agreement [30].

In a surprise move on August 14, Polish and U.S. government officials initialed an agreement; the formal accord was signed six days later by Rice and Sikorski. Some observers believe that the negotiations, which had stalled in July, received impetus from concerns over Russia's military incursion into South Ossetia in early August. While some U.S. officials denied an explicit linkage between the two events, U.S. Defense Secretary Gates on August 15 commented that Russia's neighbors have "a higher incentive to stand with us now than they did before, now that they have seen what the Russians have done in Georgia" [31]. Under the agreement, Poland received from the United States enhanced security guarantees, which Minister Sikorski likened to a "kind of reinforcement of Article 5 [the NATO treaty's mutual defense clause]" [32] The United States also pledged to help modernize Poland's armed forces, in part by providing a battery of Patriot air defense missiles, which reportedly would be re-deployed from Germany and would initially be manned by U.S. military personnel.

Most public opinion surveys have indicated that a majority of Poles disapprove of a missile defense base being established in their country. Most objections appear to be based on concerns over sovereignty, as well as over the belief that the presence of the system would diminish rather than increase national security and might harm relations with neighboring states and Russia. However, the Russian military action in Georgia and its subsequent threats to place tactical missiles in Kaliningrad (see below) may have increased support in Poland for the missile shield – and for the battery of Patriots [33].

The Polish legislature did not immediately ratify the agreement. Parliamentary speaker Bronislaw Komorowski said that he would not "rush" the vote, and added that "it would be worth knowing if the election result in the U.S. would have an influence on the U.S. attitude towards this program." In an August 19 news conference, Prime Minister Tusk said that he had requested Foreign Minister Sikorski to discuss missile defense with "both candidates John McCain and Barack Obama – and both conversations, although less decisively in the second case, indicated support for the project." [34] President Kaczynski's office criticized Prime Minister Tusk for postponing ratification until after elections. Despite the delay, U.S.-Polish negotiations on GMD continued. In addition, the Poles continued to hold high-level discussions with Moscow [35].

Shortly after the U.S. elections, President-elect Obama spoke by phone with President Kaczynski; there was apparent confusion on the Polish side over whether or not President-elect Obama had made a commitment to continue with the GMD plan. During a meeting with residents of the village near which the interceptors would be based, U.S. Ambassador to Poland Victor Ashe reportedly said that the GMD project would likely be in suspension until such time as the Obama Administration had formulated its policies [36].

In a mid-November 2008 interview, Foreign Minister Sikorski estimated the chances of the system's continuation at more than 50 percent. He added, however, that budgetary pressure might lead to the project being "put on hold" – a regrettable possibility, in his view. Sikorski has also noted that, "[t]here are clauses in the agreement that say it can be cancelled if there's no financing." During an address delivered in Washington in late November, Sikorski said that he hoped the GMD project would continue, as it was a sign of transatlantic cooperation. He also implied that hosting the interceptor base would bolster Poland's security, commenting that "everyone agrees that countries that have U.S. soldiers on their territory do not get invaded" [37] Polish President Kacyzynski and Foreign Minister Sikorski both have expressed hope publically that the Obama Administration will continue the program [38].

Some observers believe that Polish MPs, like their Czech counterparts, are reluctant to approve a treaty that may not be acted upon. Olaf Osica, a fellow at Warsaw's Natolin European Center, commented that "[o]ne of the worst scenarios for the Polish government would be if the agreement is ratified and then it turns out that Americans are no longer committed to it" [39].

On May 21, 2009, a U.S. State Department spokesperson confirmed that the U.S. government intended to proceed with the transference by year's end of a battery of 96 Patriot missiles to Poland, regardless of the status of the treaty regarding the missile defense interceptors. There has been some debate over whether or not the Patriots would be permanently installed or temporarily, for training purposes, and whether they would be armed or unarmed [40].

Czech Republic

In September 2002, the Czech defense minister, a member of the Social Democratic Party (CSSD), announced that he had "offered the United States the opportunity to deploy the missile defense system on Czech soil" [41] In June 2006, inconclusive elections toppled the CSSD government and replaced it with a shaky coalition led by the center-right Civic Democratic Party (ODS). As with the outgoing government, the new one voiced support for GMD. However, the CSSD, now in opposition, began to backpedal on its support as polls showed increasing public skepticism, and by mid-2006 only the ODS was unambiguously backing deployment. When a relatively stable ODS-led government was finally formed in January 2007, the ODS apparently persuaded its coalition partners to support GMD (the Greens made their agreement contingent upon NATO approval). In January 2007, it was announced that the United States had requested that official negotiations be started, and in March the Czech government formally agreed to launch talks.

In October 2007, U.S. Defense Secretary Robert Gates visited Prague to discuss several issues— including the planned radar installation—with Czech leaders. During the visit, he reportedly proposed that, in the interest of transparency, Russia be allowed to station personnel at the radar site. Czech Prime Minister Topolanek had no immediate comment but appeared to concur with Gates's observation that the presence of Russians on Czech territory would have to be approved by Czechs first. Gates also suggested that activation of the missile defense system could be delayed until such time as there was "... definitive proof of the threat—in other words, Iranian missile testing and so on." On the same day, however, President Bush delivered a speech in which he called the need for the missile defense project "urgent." Some analysts argued that the U.S. proposal to include Russia might complicate Topolanek's efforts to secure approval for an eventual agreement with the United States [42] On March 19, 2008, a State Department official announced that the Czech Republic had agreed to join in proposing to Russia an agreement that would permit reciprocal inspections of missile defense radar facilities. However, during an April 7 interview, Czech Foreign

Minister Schwarzenberg said, “If Russians want to check something on our soil, they will have to speak with us first” [43]

On December 5, 2007, the Czech Foreign Ministry issued a statement asserting that the U.S. intelligence community’s conclusion that Iran had suspended its nuclear weapons program in 2003 would not affect Prague’s decision to host the radar facility, as the threat has the potential to re-emerge in the future.44 In late January 2008, Jiri Paroubek, leader of the opposition CSSD party, argued that, because of the high and increasing public resistance to the radar, the government should freeze negotiations until after the results of the November 2008 U.S. presidential elections were known. He also urged that Prime Minister Topolanek report on the substance of his upcoming talks on the issue with President Bush [45]

During a visit to Washington in late February 2008, Topolanek said that the two sides were “three words” away from an agreement. On April 3, 2008, during the NATO summit in Bucharest, Czech media reported that Foreign Minister Karel Schwarzenberg had announced that Prague and Washington had reached an accord over the terms of the proposed U.S. radar base, and that a treaty would be signed in May. The signing was postponed due to scheduling conflicts, and finally took place on July 8, during a visit by Secretary of State Rice. As part of the deal, the United States reportedly agreed to provide ballistic missile defense—from Aegis system-equipped U.S. Navy vessels—for the Czech Republic [46]

The agreement must now be ratified by the parliament, and approval is not a foregone conclusion. In April 2008, Schwarzenberg said that he thought “the conclusions of the NATO summit regarding US MD should be sufficient for the junior government Green party to vote in favor of the radar.” However, a Czech newspaper stated that “[a]t the moment the government lacks at least five votes.” Although the Green Party leadership reportedly called for its members to oppose the radar despite the NATO summit declaration, some members reportedly intend to support the project.47 On July 9, 2008, Czech Deputy Foreign Minister Tomas Pojar expressed confidence that parliament would ratify the treaty by the end of the year or early in 2009, and added that “it is probable that the [ratification] vote will be after the election in the United States, however, that does not mean that it would be after the new (U.S.) President takes office.”

At the end of October, the Czechs announced that ratification would take place after the inauguration of the next President. Prime Minister Topolanek explained that “We want a delay to make sure about the attitude of the new American administration.” In mid-November, Miloslav Vlcek, chairman of the lower house of parliament—a member of the opposition CCSD— confirmed that a ratification vote would not be held until after Barack Obama had been inaugurated; in addition, he expressed doubts that the treaty would be approved, and also suggested that the radar deployment might face a constitutional challenge. Although the Czech Senate on November 26 ratified the agreement by a vote of 49-31, it still must pass muster in the chamber of deputies, where approval is less certain.48 A scheduled March 18, 2009, vote on the treaty was postponed—likely until after the Obama Administration has indicated whether or not it intends to proceed with the plan. Parties on both sides of the issue are hopeful that the new U.S. government will validate their position on missile defense [49]

In addition to the changes in the U.S. government, the missile defense issue is being complicated by the current crisis in Czech political life. On March 24, 2009, the Czech ruling coalition failed a narrow no-confidence vote, and Prime Minister Mirek Topolanek offered his government’s resignation. The turnaround came as a complete surprise to most observers, who had reasoned that the various factions and parties would make efforts to patch over their political differences during the time (January-June 2009) that Prague is holding the six-month revolving European Union (EU) presidency. On May 15, President Vaclav Klaus announced the installation of an interim government, intended to complete the Czech EU presidency and govern the country until new parliamentary elections can be held—most likely in October 2009. In the meantime, Jan Fischer, who is head of the caretaker government, stated in a meeting with NATO Secretary General Jaap de Hoop Scheffer that the Czech decision over whether to proceed with the U.S. radar should be the responsibility of the next elected government [50]

The effort to form a new government may be hampered by disagreements within as well as between political parties. Recent polls show the opposition CSSD with a lead. The political crisis adds some uncertainty to the future of the missile defense agreement, as the CSSD has opposed the planned radar. Public opinion surveys consistently have shown strong (60%-70%) opposition to the plan among Czechs, who share many of their Polish neighbors' concerns [51]. With memories of the Nazi occupation and the harsh 1968 Soviet crackdown still fresh in the minds of many Czechs, the public has been resistant to the notion of any foreign troops—unfriendly or allied— being stationed on their soil.

POLICY ISSUES

U.S. proponents of the missile defense program note that the bases being planned would be part of a limited defensive system, not an offensive one. The missiles would not have explosive payloads, and would be launched only in the event that the United States or its friends or allies were under actual attack. Critics respond that Europe does not currently face a significant threat from Iran or its potential surrogates, but that Polish and Czech participation in the European GMD element would create such a threat. If American GMD facilities were installed, they argue, both countries would likely be targeted by terrorists, as well as by missiles from rogue states— and possibly from Russia—in the event of a future confrontation.

Debate in Poland and the Czech Republic

Some proponents of the proposed GMD European capability system assert that cooperation would help consolidate bilateral relations with the United States. In Poland in particular there is a sense, based in part on historical experience, that the United States is the only major ally that can be relied upon. Therefore, some Poles argue, it would be beneficial to strengthen the relationship by becoming an important U.S. partner through joining the missile defense system. In addition, some Czechs and Poles believe that the missile defense sites would become a prestigious symbol of the two countries' enhanced role in defending Europe. Some would argue that the Czechs and the Poles see this formal U.S. military presence as an ultimate security guarantee against Russia; when asked shortly before Poland's October 21, 2007, parliamentary elections about the missile defense issue, former Prime Minister Kaczynski singled out Russia as a threat [52]

Opponents, however, contend that this is not a valid reason for accepting missile defense facilities because the two countries, which joined NATO in 1999, already enjoy a security guarantee through the alliance's mutual defense clause. Polish missile defense skeptics also maintain that their country does not need to improve its bilateral security relationship with the United States because it has already shown its loyalty through its significant contributions to the military operations in Iraq and Afghanistan and the global war on terrorism. Some Polish and Czech political leaders reason that the United States may proceed with missile defense with or without them, so they may as well be on board. However, the missile bases are unpopular among the Czech and Polish public, and any government that agreed to host such facilities might lose political support. In addition, some Czechs and Poles may be speculating whether it would be worthwhile to expend political capital on the GMD bases, as the issue may become moot. One Polish observer asserted that if the project is discontinued, "Poland will become an international laughingstock" [53] A Czech member of parliament noted that, if the U.S. Congress determines not to fund a European arm of missile defense, "[t]he USA will thus solve the problem for us" [54]

Some Czechs and Poles have argued that the extra-territorial status of the proposed bases would impinge upon national sovereignty. However, the Czech position is that the base "would be under the Czech Republic's jurisdiction." [55]. In addition, some have raised questions over command and control—who would decide when to push the launch button and what would the notification system be? Polish and Czech government leaders reportedly acknowledge that the time between the detection of the launch of a missile by a hostile regime and the need to fire off an interceptor would be so brief as to preclude government-to-government consultations.

Opponents have also cautioned that the interception of a nuclear-tipped missile over Polish or Czech territory could result in a rain of deadly debris. Supporters argue that an enemy missile would not be intercepted over Eastern Europe, and that even if it were, the tremendous kinetic energy of impact would cause both projectiles to be obliterated and any debris burnt upon atmospheric reentry. Skeptics point out, however, that testing of these systems is never performed over populated areas.

European/Russian Response

The proposed U.S. system has encountered resistance in some European countries and beyond. Some critics claim that the program is another manifestation of American unilateralism and argue that, because of opposition by major European partners, Polish and Czech participation in the GMD program could damage those countries' relations with fellow EU members [56] Supporters, however, counter that the establishment of a missile defense system would protect Europe as well as the United States.

Some European leaders have asserted that the Bush Administration did not consult sufficiently with European allies or with Russia on its GMD plans. German Foreign Minister Frank-Walter Steinmeier faulted the Bush Administration for failing to adequately discuss the proposal with affected countries. Former French President Chirac cautioned against the creation of "new divisions in Europe." Bush Administration officials, however, maintained that these arguments were disingenuous, as they had held wide-ranging discussions on GMD with European governments, and with Russia, both bilaterally and in the framework of the NATO-Russia Council [57].

In addition, critics charged that establishing a European GMD base to counter Iranian missiles implied a tacit assumption on the part of the Bush Administration that diplomatic efforts to curb Iran's nuclear and ballistic missile aspirations were doomed to failure, and that Iran's future leaders would be undeterred by the prospect of nuclear annihilation. Finally, an analyst with the Swedish Transnational Foundation Research Center has argued that the U.S. missile defense system is being built in order to enable the use of a first strike [58].

Europeans also have raised questions about the technical feasibility of the program as well as its cost-effectiveness. According to a wire service report, "Luxembourg's Foreign Minister Jean Asselborn called the U.S. [missile defense] plan an 'incomprehensible' waste of money.... " [59].

Other European leaders, however, including the former prime ministers of Denmark and Britain, indicated that they supported the missile defense project as a means to protect Europe from threats from rogue states. In addition, some European allies do not appear to be averse to the missile defense concept per se. Foreign Minister Steinmeier indicated that Germany and other countries were interested in building a comparable system, but lacked the technological know-how [60].

NATO also has been deliberating strategic missile defenses. A feasibility study of such a program called for in the 2002 Prague Summit was completed in 2005. In the final communiqué of their 2006 Riga summit, NATO leaders stated that the alliance study had concluded that long-range BMD is "technically feasible within the limitations and assumptions of the study," and called for "continued work on the political and military implications of missile defence for the Alliance including an update on missile threat developments." Supporters contend that the U.S. facilities intended for placement in Eastern Europe would be a good fit—and therefore not inconsistent with—any future NATO missile defense. However, other policymakers have recommended that the establishment of any anti-missile system in Europe should proceed solely under NATO auspices rather than on a bilateral basis with just two NATO partners. A Bush Administration official declared that "the more NATO is involved in [GMD], the better" [61]

Some observers have suggested that the Bush Administration chose not to work primarily through NATO because consensus agreement on the system was unlikely. However, in mid-June 2007, alliance defense ministers did agree to conduct a study of a complementary "bolt-on" anti-missile capability that would protect the southeastern part of alliance territory that would not be covered by the planned U.S. interceptors. Bush Administration officials interpreted the move as an implied endorsement of the U.S. GMD plan and an adaptation of NATO plans to fit the proposed U.S. system. In addition, NATO Secretary General Jaap de Hoop Scheffer stated "The roadmap on missile defense is now clear.... It's practical, and it's agreed by all" [62].

The Bush Administration hoped that NATO would endorse missile defense at its 2008 summit meeting, held April 2-4 in Bucharest, Romania [63]. The Summit Declaration stated that the alliance acknowledges that ballistic missile proliferation poses an increasing threat. It further affirmed that missile defense is part of a "broader response," and that the proposed U.S. system would make a "substantial contribution" to the protection of the alliance. It declared that the alliance is "exploring ways to link [the U.S. assets] with current NATO efforts" to couple with "any future NATO-wide missile defense architecture." The declaration also directed the development, by the time of the 2009 summit, of “options” for anti-missile defense of any alliance territory that would not be covered by the planned U.S. installations. These options would be prepared “to inform any future political decision.” In addition, the document declared support for ongoing efforts to “strengthen NATO-Russia missile defense cooperation,” and announced readiness to look for ways to link “United States, NATO and Russian missile defense systems at an appropriate time.” Finally, alliance members stated that they are “deeply concerned” over the “proliferation risks” implied by the nuclear and ballistic missile programs of Iran and North Korea, and called upon those countries to comply with pertinent UN Security Council resolutions [64]

The Bush Administration interpreted the Summit Declaration as an endorsement of its missile defense project; Secretary of State Condoleezza Rice hailed the statement as a “breakthrough document.” Concerning the question of whether ballistic missiles from rogue states were a threat, National Security Advisor Stephen Hadley declared, “I think that debate ended today.” [65] Representative Tauscher welcomed “NATO’s acknowledgment of the contribution that the long- range interceptor site could make to Alliance security” and to make “cooperation with NATO a cornerstone of its missile defense proposal” [66].

In the final communiqué of their December 3, 2008, meeting, the foreign ministers of NATO member states reiterated the language on missile defense that had been included in the Bucharest summit declaration, while also noting “as a relevant development the signature of agreements by the Czech Republic and the Republic of Poland with the United States regarding those assets.” The communiqué also called upon Moscow “to refrain from confrontational statements, including assertions of a sphere of influence, and from threats to the security of Allies and Partners, such as the one concerning the possible deployment of short-range missiles in the Kaliningrad region.” (see below.) The latter statement was likely included at Warsaw’s insistence [67]

NATO’s 2009 summit was held in Strasbourg, France, and Kehl, Germany, in early April. The summit declaration “reaffirmed the conclusions of the Bucharest Summit about missile defence,” but noted that there was more work to be done. Specifically, it recommended that “missile threats should be addressed in a prioritised manner” that addresses “the level of imminence of the threat and the level of acceptable risk.” It tasked the Council in Permanent Session with studying and making recommendations on “architecture alternatives,” including usage of the ongoing Active Layered Theater Ballistic Missile Defense program, which is currently intended to protect deployed NATO forces [68]

European opponents of the proposed U.S. plan also contend that statements by Russian officials are evidence that deployment of the U.S. system would damage Western relations with Russia. At a February 2007 security conference in Munich, former President Putin strongly criticized GMD, maintaining that it would lead to “an inevitable arms race.” Russia has threatened to abrogate the 1987 Intermediate-Range Nuclear Forces (INF) Treaty, which eliminated this class of U.S. and then-Soviet missiles that were stationed in Europe. Putin also announced that Russia had suspended compliance with the Conventional Forces in Europe (CFE) Treaty, [69] and on another occasion indicated Russia might now target Poland and the Czech Republic and transfer medium- range ballistic missiles to the Russian exclave of Kaliningrad. Some U.S. and European officials dismissed Russia’s alleged concerns and have noted that Moscow has known of this plan for years and has even been invited to participate [70]. GMD proponents maintain that the interceptors are intended to take out launched Iranian missiles aimed at European or American targets and could not possibly act as a deterrent against Russia, which has hundreds of missiles and thousands of warheads. The chief of the Czech general staff has noted that "by simple arithmetic, Russian generals can see that U.S. missile defenses cannot imperil Moscow's arsenal." Some Russians contend, however, that the modest GMD facilities planned for Eastern Europe are likely just the harbinger of a more ambitious program.

Russian officials have also argued that North Korean or Iranian missiles would not likely enter European airspace, and that the real reason for GMD is to emplace U.S. radar in eastern Europe to monitor Russian missile sites and naval operations. A Czech military officer dismissed the charge of electronic espionage as "absolute nonsense," arguing that "the radar monitors the already launched missiles, and it cannot monitor what is going on the ground"—a task that is already being performed by U.S. surveillance satellites [71]

Some argue that Russia has other motives for raising alarms about the U.S. missile defense system: to foment discord among NATO member states, and to draw attention away from Russia's suppression of domestic dissent, its aggressive foreign policy actions, and its nuclear technology cooperation with Iran. Observers note that Russia blustered about NATO expansion, too, and argue that Russia's veiled threats may actually stiffen resolve in Prague and Warsaw. Some observers note, however, that Russian acceptance of NATO expansion was conditioned on a tacit understanding that NATO or U.S. military expansion into the new member states would not occur. The European GMD in this regard is seen as unacceptable to Russia.

On June 7, 2007, during the G-8 meeting in Germany, Putin offered to partner with the United States on missile defense, and suggested that a Soviet-era radar facility in Azerbaijan be used to help track and target hostile missiles that might be launched from the Middle East. President Bush responded by calling the proposal an "interesting suggestion," and welcomed the apparent policy shift. The following day, Putin suggested that GMD interceptors be "placed in the south, in U.S. NATO allies such as Turkey, or even Iraq ... [or] on sea platforms." Military and political representatives from both countries have met to discuss the proposal, but some experts point out that Azerbaijan is technically not the ideal place to locate the radar because it would be too close to potential Iranian launch sites; they also argue that the radar is outmoded.

In the meantime, Putin urged the United States not to deploy elements of GMD until his offer had been examined. One week later, however, U.S. Defense Secretary Robert Gates stated that even if the United States were to accept Russia's offer to share use of the Azeri radar, that facility would be regarded as "an additional capability" to complement the proposed GMD sites planned for Europe [72]. In late July 2007, MDA Director Obering said the United States was looking at the proposal very seriously. He said the Azeri radar could be useful for early detection of missile launches, but that it does not have the tracking ability to guide an interceptor missile to a target— which the proposed Czech radar would be able to do.

At a July 1-2, 2007, meeting in Kennebunkport, ME, Putin expanded on his counterproposal by recommending that missile defense be coordinated through offices in Brussels and Moscow. He also suggested the possible use of radar in south Russia and said that cooperation could be expanded to other European countries through the use of the NATO-Russia council—eliminating, he added, the need for facilities in Poland and the Czech Republic. President Bush reportedly responded positively to Putin's new proposal, but insisted on the need for the Eastern European sites [73].

Despite ongoing discussions over the issue, Russian criticism of the program has continued, edged, at times, with sarcasm. During an October 2007 visit to Moscow by Secretaries Gates and Rice, President Putin remarked “of course we can sometime in the future decide that some antimissile defense system should be established somewhere on the moon.” Putin later likened the U.S. placement of the missile defense facilities in central Europe to the 1962 Cuban missile crisis—a comparison disputed by U.S. officials. In late November 2007, Russia rejected a written U.S. proposal on the project, arguing that it failed to include the points Secretary Gates had discussed a month earlier, including “joint assessment of threats, ... Russian experts’ presence at missile shield’s sites, [and] readiness to keep the system non-operational if there is no actual missile threat.... ” [74] In December, the chief of Russia’s army suggested that the launching of U.S. missile defense interceptors against Iranian missiles might inadvertently provoke a counter launch of Russian ICBMs aimed at the United States. However, critics assert that a Russian counterstrike could not be prompted so easily and mistakenly. In February 2008, Putin reiterated earlier warnings that, if construction commenced on the missile defense facilities, Russia would re-target ICBMs toward the missile sites [75].

During President Bush’s post-Bucharest meeting with Putin at the Russian resort of Sochi, the two leaders reportedly sought to find common ground on missile defense; they agreed to introduce greater transparency in the project, and to explore possible confidence-building measures. In the meantime, Russia remains opposed to the proposed European bases. The two sides agreed to “intensify” their dialogue on missile defense cooperation. After the meeting, however, Iran’s ambassador to Poland warned that if the missile defense system is installed, “the United States will acquire supremacy over Russian nuclear forces” [76]

Following the signing of the U.S.-Poland agreement, Russia once more vociferously objected to the missile defense plan. On August 16, a highly placed Russian general officer stated that Poland’s acceptance of the interceptors could make it a target for a nuclear attack. Later, newly inaugurated President Dmity Medvedev reiterated Russia’s conviction that the interceptors constitute a threat, and added that Moscow “will have to respond to it in some way, naturally using military means.” On August 20, it was also announced that the governments of Russia and Belarus had launched discussions on the establishment of a joint air defense system; the move was interpreted by ITAR-TASS as a “retaliatory measure” in response to the planned U.S. missile defense system [77]

The day after the U.S. elections, in his State of the Federation speech, President Medvedev said that Russia would deploy short-range Iskander missiles to the Russian exclave of Kaliningrad, which borders Poland and Lithuania, if the U.S. GMD system is built. However, Medvedev later told a French newspaper that it the United States does not deploy the system, Russia would not transfer its missiles to Kaliningrad. Prime Minister Putin later reiterated that Russia would scrap its plans for the Iskanders if the United States cancelled its European GMD project [78]. Some observers believe that the announcement created more concern in central than in western Europe. Shortly thereafter, however, European Commission President Jose Manuel Barroso stated that “cold war rhetoric” was “stupid,” and U.S. Defense Secretary Gates states that “such provocative remarks are unnecessary and misguided.” [79]

In mid-November 2008, French President Nicolas Sarkozy recommended that the U.S. and Russian plans be discussed by NATO and the OSCE in the spring of 2009, and that, “until then we should not talk about missile or shield deployments which lead to nothing for security, which complicate things and rather make things go backwards." Czech Deputy Prime Minister Alexandr Vondra criticized Sarkozy's remarks as inappropriate, and Polish Prime Minister Tusk stated that GMD was a Polish-U.S. project, and that "I don't think that third countries, even such good friends as France, can have a particular right to express themselves on this issue." Sarkozy later appeared to backtrack somewhat, saying "every country is sovereign to decide whether it hosts an anti-missile shield or not" [80]

In late January 2009, the Russian media reported that Moscow had "suspended" plans to move short-range missiles to Kaliningrad because the Obama Administration was not "pushing ahead" with the European GMD deployment. The Obama Administration has indicated that it is prepared to open talks with Teheran if it is willing to shelve its nuclear program and renounce support of terrorism. On February 7, at the 2009 Wehrkunde security conference in Munich, Vice President Biden stated that "we will continue to develop missile defenses to counter a growing Iranian capability.... We will do so in consultation with our NATO allies and Russia" [81]. During a February 10 visit to Prague, Secretary of State Hillary Clinton said that any change in U.S. policy on missile defense would depend upon Iran, but that "we are a long, long way from seeing such evidence of any behavior change" in Iran [82]

In early March 2009, the media reported that President Obama had sent a letter to President Medvedev offering to stop the development of the missile defense program if Russia cooperated on policy that would help halt Iran's nuclear weapons and missile programs. President Obama denied such a quid pro quo, stating that "what I said in the letter was that, obviously, to the extent that we are lessening Iran's commitment to nuclear weapons, then that reduces the pressure for, or the need for a missile defense system. In no way does that in any—does that diminish my commitment to [the security of] Poland, the Czech Republic and other NATO members" [83]

In a joint statement issued at their "get acquainted" meeting on April 1, 2009, Presidents Obama and Medvedev acknowledged that differences remained in their views toward the placement of U.S. missile defenses in Europe, but pledged to examine "new possibilities for mutual international cooperation in the field of missile defense." Later that month, however, Russian Deputy Foreign Minister Sergei Ryabkov charged that "[U.S.] work in the missile defense has intensified, including in the NATO format." Shortly thereafter, in a Russian media interview, Ryabkov was asked to comment on U.S.-Russia-NATO cooperation on missile defense through the use of Russian radar installations. He explained that the Russian offer is predicated upon the fulfillment of "certain preliminary stages," including the U.S. cancellation of the Poland/Czech GMD facilities, followed by a threat assessment, and then by political and economic measures to eliminate the threat [84]

In May 2009, the East-West Institute, a joint U.S.-Russian research organization, released a report which concluded that (1) Iran likely would not be able to acquire both nuclear weapons and delivery systems within the next five years, and (2) the missile defense system proposed by the Bush Administration for deployment in central Europe would be ineffective against eventual Iranian missiles outfitted with decoy devices and other countermeasures [85]

In early June 2009, a Russian official indicated that Moscow would not likely be willing to reduce its nuclear weapons arsenal unless the United States were to scrap plans to establish its missile defense site in Poland and the Czech Republic. The Russian government also indicated that it might deploy Iskander missiles to Kaliningrad if the United States were to transfer Patriot missile batteries to Poland [86]

In mid-June, Russia reiterated its refusal to collaborate with the United States—and Poland and the Czech Republic—on missile defense vis-à-vis Iran, and would only reconsider cooperation in the event that the Obama Administration abandoned the Bush Administration's plan to station missile defense facilities in central Europe [87]

Some observers believe that the ongoing dialog between Russia and the United States may help reduce tensions. Eventual Russian cooperation in missile defense could remove a significant impediment to the program and could dampen criticism by European and other leaders. It also may open the door to a more favorable attitude by NATO toward missile defense.

CONGRESSIONAL ACTIONS

Fiscal Year 2010

The Obama Administration requested $50.5 million for the European 3rd site. This is in addition to some $618 million available from FY2009 appropriations, pending Polish and Czech ratification of the missile defense agreements reached with the United States.

In June 2009, the House Armed Service Committee marked up H.R. 2647, the FY2010 National Defense Authorization Act. The committee reserves $343.1 million from funds aailable for the MDA in fiscal years 2009 and 2010 to develop missile defenses in Europe for one of two purposes: (1) either the Secretary of Defense continue with research, development, test and evaluation of the proposed radar and interceptor site in Poland and the Czech Republic pending Czech and Polish ratification, and certification by the Secretary of Defense that the proposed interceptors will be operationally effective, or (2) the Secretary may pursue development, testing, procurement and deployment of an alternative integrated missile defense system to protect Europe from threats posed by all types of ballistic missiles. This option is conditional on certification from the Secretary of Defense that the alternative is consistent with NATO efforts to address ballistic missile defense threats, that any alternative addresses ballistic missile threats to Europe in a prioritized manner that includes the level of imminence of the threat and level of risk, and that any alternative be cost-effective, technically reliable and operationally available in protecting Europe and the United States.

Fiscal Year 2009

For FY2009, the Bush Administration requested $712 million for the European GMD Element. The reported cost of the European element is $4 billion (FY2008-FY2013), according to the Administration, which includes fielding and Operation and Support costs.

On May 14, 2008, the House Armed Services Committee approved its version of the FY2009 defense authorization bill (H.R. 5658). The committee provided $341 million for the proposed European GMD site, reducing the total by $371 million ($231 million in R&D funding and $140 million in Military Construction). The committee expressed concerns about the slower-thanexpected pace of the Iranian long-range missile program, the effectiveness of the GMD system based on program testing results, the ability to spend the proposed funds, and the lack of signed and ratified agreements with Poland and the Czech Republic.

On April 30, 2008, the Senate Armed Services Committee approved its version of the FY2009 defense authorization bill (S. 3001). The committee provided full funding for the European GMD Element, but noted that certain conditions have to be met before those funds could be expended: (1) military construction funds cannot be spent until the European governments give final approval (including parliamentary approval) of any deployment agreement, and 45 days have elapsed after Congress has received a required report that provides an independent analysis of the proposed European site and alternatives, and (2) acquisition and deployment funds, other than for long-lead procurement, cannot be expended until the Secretary of Defense (with input from the Dir., Operational Test and Operations) certifies to Congress that the proposed interceptor has demonstrated a high probability of accomplishing its mission in an operationally effective manner.

President Bush signed a continuing resolution into law on September 30, 2008 (P.L. 110-329), which incorporated defense appropriations and authorizing language for FY2009. According to a Press Release from the Senate Appropriations Committee dated September 24, 2008, Congress provided $467 million for the European BMD sites and development and testing of the two-stage interceptor. According to authorizing language, [88] funding for the Czech radar and site will then be available only after the Czech Parliament has ratified the basing agreement reached with the United States and a status of forces agreement (SOFA) to allow for such deployment and stationing of U.S. troops is in place. Funding for the Polish interceptor site will only be available after both the Czech and Polish parliaments ratify the agreements reached with the United States, and a SOFA with Poland is also in place for the site. Additionally, deployment of operational GBIs is prohibited until after the Secretary of Defense (after receiving the views of the Director of Operational Test and Evaluation) submits to Congress a report certifying that the proposed interceptor to be deployed "has demonstrated, through successful, operationally realistic flight testing, a high probability of working in an operationally effective manner and the ability to accomplish the mission."

Fiscal Year 2008

In its report on the FY2008 defense authorization bill, the House Armed Services Committee cited its concern from last year (FY2007) that investment in the European BMD site was premature [89]. In part, the Committee's concerns focus on the need to complete scheduled integrated end-to-end testing of the system now deployed in Alaska and California. Additionally, the Committee notes its reluctance to fund the European site without formal agreements with Poland and the Czech Republic and without knowing the terms under which the estimated $4 billion program costs would be expended. Therefore, the Committee recommended that no funds be approved for FY2008 for construction of the European GMD site [90]. The Committee did, however, recommend $42.7 million to continue procurement of ten additional GMD interceptors that could be deployed to the European site or for expanded inventory at the GMD site in Alaska (as noted in MDA budget documents). Also, the Committee expressed concern over the testing plan and risk reduction strategy for the proposed two-stage GMD interceptor for Europe. The Committee further directed that two studies be done: (1) the Secretary of Defense and the Secretary of State are to submit a report to Congress by January 31, 2008, to include how the Administration will obtain NATO's support for the European GMD proposal, and how other missile defense capabilities such as Aegis and THAAD (Terminal High Altitude Area Defense) could contribute to the missile defense protection of Europe; and (2) an independent assessment of European missile defense options should be done in a timely manner.

In the Senate defense authorization bill, the Armed Services Committee recommended limiting the availability of funding for the European GMD site until two conditions were met: (1) completion of bilateral agreements with Poland and the Czech Republic; and (2) 45 days have elapsed following the receipt by Congress of a report from an FFRDC (federally funded research and development center) to conduct an independent assessment of options for missile defense of Europe [91] The Committee recommended a reduction of $85 million for site activation and construction activities for the proposed European GMD deployment. The Committee also limited FY2008 funding for acquisition or deployment of operational interceptor missiles for the European system until the Secretary of Defense certified to Congress that the proposed interceptor to be deployed had demonstrated, through successful, operationally realistic flight testing, that it had a high probability of working in an operationally effective manner. The Committee noted that the proposed 2-stage version of the interceptor has not been developed and was not scheduled to be tested until 2010 [92]. Therefore, the Committee noted, it could be several years before it is known if the proposed interceptor will work in an operationally effective manner. The Committee indicated that it would not limit site surveys, studies, analysis, planning and design for the proposed European GMD site, but that construction and deployment could not take place prior to ratification of formal bilateral agreements, which MDA estimates would not take place before 2009. Finally, the Committee notes there were a number of near-term missile defense options to provide defense of Europe against short-range, medium-range and future intermediate-range ballistic missiles, such as the Patriot PAC-3, the Aegis BMD system, and THAAD.

In floor debate, the Senate approved an amendment by Senator Sessions (90-5) to the defense authorization bill stating that the policy of the United States is to develop and deploy an effective defense system against the threat of an Iranian nuclear missile attack against the United States and its European allies. Further debate and passage of the defense authorization bill was postponed at the time by the Majority Leader until after debate over Iraq war funding.

On November 13, 2007, President Bush signed into law the FY2008 Defense Appropriations Bill (H.R. 3222; P.L. 110-114). This bill eliminated the proposed $85 million for FY2008 for the European missile defense site construction, but permitted $225 million for studies, analyses, etc. of the proposed European GMD element.

The House passed the FY2008 National Defense Authorization bill (H.R. 1585) on May 17, 2007. The Senate passed its version on October 1, 2007. House and Senate negotiators filed the defense authorization report on December 6, 2007. The House adopted the report on December 12, 2007. The Conference Report contained a number of provisions pertaining to the proposed European GMD element.

First, it cut the $85 million requested for site activation and construction activities. This left about $225 million to fund surveys, studies, analysis, etc. related to the European GMD element in FY2008. Second, the Conference Report required an independent assessment of the proposed deployment of long-range missile defense interceptors and associated radar in Europe and a second independent analysis of missile defense options in Europe before site construction and activation could begin. The conferees noted that if the Polish and Czech governments gave final approval to any successfully completed agreements during FY2008, the Department of Defense had the option of submitting a reprogramming request for those funds ($85 million) to begin site construction in Europe. Third, the conferees strongly supported the need to work closely and in coordination with NATO on missile defense issues.

Finally, the defense authorization bill required that the Secretary of Defense certify that the proposed two- stage interceptor "has demonstrated, through successful, operationally realistic flight testing, a high probability of working in an operationally effective manner" before funds could be authorized for the acquisition or deployment of operational missiles for the European site.

REFERENCES

[1] Some were calling for such an effort in Europe before the Administration formally requested funding in early 2007. For instance, in October 2006, Sen. Sessions noted NATO steps in developing an Alliance-wide theater missile defense capability, and encouraged the deployment of a U.S. long-range missile defense system in Europe. See "U.S. Missile Defense Site in Europe Needed to Support Alliance Strategy," *Space News*, October 9, 2006, p. 19.

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Chairman of the Joint Chiefs of Staff, said he believes the U.S. "Has a viable initial operational capability and we are maturing the system toward a full operational capability." "Answers to Advanced Policy Questions," Senate Armed Services Committee, July 26, 2007; and (3) Dr. Charles McQueary, Director, Operational Test and Evaluation, said: "I can state that the ballistic missile defense system has demonstrated a limited capability against a simple foreign threat. Coupled with the successes of other element-level testing and MDA's integrated ground tests, the BMD system is definitely maturing. My assessment is bolstered by the fact that the MDA is increasing the operational realism of each successive test." Testimony before the Senate Armed Services Committee, April 11, 2007.

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EFFECTS OF THE GREAT RECESSION ON THE SPANISH ECONOMY

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ABSTRACT

This study reviews the effects of the last international crisis on the Spanish economy and the medium-term expectation of economic recovery. The current crisis has occurred after a sharp growth in the Spanish economy for over a decade, higher than the European average. During this period, infrastructures and human capital improved, exports increased, the public debt was reduced and a position of leadership in activities such as tourism, renewable energies and bank intermediation was consolidated. However, similarly to the majority of countries in the world economy, in 2008 Spain fell into deep economic recession. The economic situation is worrying, not so much on account of the significance of the decrease in the GDP, but also on account of the accumulated imbalances in the labour market, in construction and in the financial position of households and businesses, and the faint prospects of recovery as a result. Consequently, the beginning of economic recovery will be later rather than sooner and, in the best-case scenario, not before the second half of 2010. Until then, the unemployment rate, already double that of the EU, will continue to rise and could even reach or exceed 20%, making the possible subsequent recovery even more difficult.

INTRODUCTION

The international economic crisis which broke in 2007 occurred after a sharp growth in the Spanish economy for more than a decade, higher than the European average for the same period. The notable rise in the GDP was based on an increase in consumption and investment in the housing sector, financed by a unique credit expansion aimed at the private sector. During this period, infrastructures and human capital improved, exports increased, the public debt was reduced and a position of leadership in activities such as tourism, renewable energies and bank intermediation was consolidated.

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But this period of development has ended, and it is unlikely that the financial and credit conditions to create a similar climate will return. As with the majority of the countries which make up the world economy, in 2008 Spain entered a deep economic recession which threatened to significantly reduce its GDP by approximately 4% in 2009. However, while most of the G-20 economies halted the decline in the second quarter of 2009 and are beginning to leave the recession behind, Spain's economic activity continues to fall. The International Monetary Fund (IMF) has confirmed that the world economy's financial conditions have improved and that the path to economic growth is opening up. In particular, forecasts for 2010 have been revised upwards in the main developed and developing economies: 1.5% in the US, 0.5% in Germany, 2% in Japan, 9% in China, 6% in India and 3.5% in Brazil (IMF, 2009). This translates into a foreseeable increase in the world's economy of over 3% in 2010.

In relative terms, Spain's previsions with respect to 2009 overall are no worse than those for the Eurozone as a whole: the drop stands at around 4% (IMF, 2009). However, Spain's economic situation is worrying, not so much on account of the significance of the drop in the GDP, but also the accumulated imbalances in the employment market, in the construction market and in the financial position of families and businesses, and the faint prospects of recovery as a result. The modernisation achieved in the Spanish economy in recent years is not proving sufficient to compensate for these maladjustments and ensure a relatively quick exit from the present economic crisis.

The study is structured in the following way. In section 2 the Spanish economy before the global crisis is reviewed. In section 3 we comment on international governance and economic policy criteria with which to try to combat the crisis situation. In section 4 the effects on the Spanish economy are analysed. In section 5 the expectation for economic recovery are studied. Lastly, in section 6, we will comment on the main conclusions of the study.

THE SPANISH ECONOMY BEFORE THE GLOBAL CRISIS

At the beginning of the XXI Century, the evolution of the Spanish economy must be framed in a context of worldwide prosperity, high economic growth and price stability. During the last decade and a half, the Spanish economy has been one of the fastest growing and most successful economies in Europe (Royo, 2009). The country enjoyed the "happy years" that would come to a halt with the economic crisis. Spain was an advanced and small open economy that has followed to the letter the pattern of expansion and contraction of the world economy (Fernández-Villaverde and Ohanian, 2009).

There is an incipient economic literature on the performance of the Spanish economy in this golden period. Felgueroso and Jiménez (2009), Fernández- Villaverde and Ohanian (2009), Myro (2010) and Royo (2009) have analysed the "fiesta" of the Spanish economy from several perspectives. This section of the chapter shows some of the main arguments of this literature because they are a key for understanding the Spanish economic crisis and its recovery possibilities.

The Spanish economy went through an uninterrupted expansion from 1993 to 2008. The expansion was more vigorous than in other advanced economies. The real output increased by 58% in Spain between 1995 and early 2008 (Fernández-Villaverde and Ohanian, 2009). This good economic trend was clear too at the beginning of the new Century, as it is shown in the *Quarterly Bulletin on The Spanish Economy: Recent Developments and Prospects* (Ministerio de Economía y Hacienda, 2000a, 2000b). Since then, Spain's GDP grew at an average rate of 3.6% from 2000 to 2007, 1.4% higher than the EU-15 average. Growth was more moderate in terms of GDP per capita, as the population was growing at a fast rate, the result of a notable increase in immigration (Myro, 2010).

The successful performance of the Spanish economy was shown in the first paragraphs of the diagnosis and challenges of the *The Spanish National Reform Program on Convergence and Employment* (OEP, 2005, P. 13): "The Spanish economy is currently demonstrating a high rate of GDP growth, three times the European average, while the unemployment has dropped below 10% for the first time since 1979. The dynamism of the Spanish economy is not new. The growth in the country´s GDP has been consistently above European levels with a mean differential of close to 1.4% percentage points since 1996".

In 2007, the Governor of the Bank of Spain indicated that the Spanish economy continued its long upturn in 2006 and the buoyancy of activity was proving greater than forecast in early 2006 (Fernández Ordóñez, 2007). This economic activity implied an increase in the rate of employment, from 50% to 65% between 1995 and 2007, as well as in the working population, which increased by just over 7,000,000 people over the same period (Myro, 2010). This implied too a convergence trend towards the level of employment rate in the UE-25 (OEP, 2005).

The analysis of the Spanish employment rates is conclusive: "Since the mid´90s until 2007, the Spanish economy experienced a very strong job creation, allowing the employment rate to increase by about 20 percentage points. Starting from the last position among the EU-15´s countries, Spain converged to the EU-15 average employment rate, surpassing Italy, catching up with France and cutting the distance to countries like UK, Germany or Finland" (Felgueroso and Jiménez, 2009, p. 2).

It has been said that immigration, low interest rates and the liberalisation and modernisation of the Spanish economy were factors that contributed to this spectacular performance (Royo, 2009). Moreover, the years of global expansion were also years of price stability (Fernández-Villaverde and Ohanian, 2009).

According to Myro (2010), the marked growth in production was fundamentally based on four factors:

1) The first factor was the Spain's introduction to the Economic and Monetary Union, that is, the adoption of the euro. This led to greater macro-economic stability, with the guarantee of a lower inflation rate, and it also implied an additional competitive challenge to that generated by Spain's incorporation into the European Economic Community in 1986 and its subsequent transition to the Single European Market. Both aspects have favoured the expansion of internal and external demand (Andrés and Hernando, 1997; Gil et al, 2003).
2) The second factor was the drop in the interest rate, due to a large extent to Spain's joining the Euro, but also (as with all the other developed economies) to the excess cash-flow that existed in international markets.
3) The third factor was the extraordinary increase in the immigrant population, which increased tenfold from 1995 to 2007, going from a number of around 500,000 to more than 5,000,000. According to the *The Spanish National Reform Program on*

Convergence and Employment (OEP, 2005), the Spanish population growth rates at the beginning of the XXI Century were unprecedented in the country´s contemporary history, and this population increase was unexpected. This demographic increase in supply gave employers an abundant source of labour at a relatively moderate cost, and their recruiting allows an increase in demand. This immigration boom has been considered the most significant socio-economic phenomenon of recent years in Spain (OEP, 2005).

4) The fourth and final factor was the boost given to public spending by aid in the form of EU funding, which accelerated GDP growth in Objective 1 regions by approximately l% and the Spanish economy as a whole by 0.5% (De la Fuente, 2003).

These four factors could be complemented with other relevant elements. In this sense, the Governor of the Bank of Spain pointed out that "the importance of reform initiatives in recent decades cannot be ignored, as these have promoted market flexibility and dynamism among agents and institutions. And pivotal too have been the recent macroeconomics and financial policies, which have been a guarantee for stability" (Fernández Ordoñez, 2007).

However, the period of prosperity in Spain has given rise to several basic imbalances which has made it especially vulnerable to the international financial crisis when it clearly broke in 2008 (Fernández-Villaverde and Ohanian, 2009; Felgueroso and Jiménez, 2009; Myro, 2010, Royo, 2009). During the long period of prosperity, Spain experienced a large construction boom and a bubble in the real state market. In this sense, the Spanish and the US economies presented a surprising number of parallelisms (Fernández-Villaverde and Ohanian, 2009).

The construction sector played a key role in the Spanish economy and it reached 15% of GDP, but really the housing construction sector represented 8% of the Spanish GDP (Estrada et al, 2009). The disproportionate prominence of the housing sector in the GDP can be explained by three factors: the existence of low interest rates, easy access to financing (the financial entities themselves encouraged and stimulated family debt) and confidence in the permanent revaluation of property (Myro, 2010).

The Spain price growth rates accelerated to over 20 percent in 2003 and 2004 and continued to have strong gains up to mid-2007 (Fernández-Villaverde and Ohanian, 2009). The increase in house prices created a bubble which was estimated at around 25% of existing prices in 2005 (Restoy, 2006; Taltavull, 2009). But on the spring of 2008 the cycle changed in Spain and the large rally in housing prices was definitively replaced by falls in prices, a high number of foreclosures and increasing difficulties in those financial institutions that had heavily engaged in real state lending (Fernández-Villaverde and Ohanian, 2009).

As Myro (2010) points out, there was a sharp adjustment of house-building activity, with a 3.3% drop in added value and a 10.8% drop in employment, affecting almost 300,000 people. This data deteriorated considerably in the first two quarters of 2009, although in the second term the rate of the drop slowed, as a consequence of the more positive situation of public works, based on the central Government's economic stimulus plans, but not housing construction (Bank of Spain, 2009a and 2009b).

The Spanish economy was specialized in a growth model where the construction sector was a fundamental one. Felgueroso and Jiménez (2009) points out that Spain followed a different growth trajectory than a majority of the EU-25 countries and it lead to a wrong accumulation of human capital and technological skills in order to adopt ICT technologies. In this sense, dropout rates and computer illiteracy have remain high, favouring growth in low skills low productivity sectors and hurting employment opportunities in knowledge intensive sectors. In this sense, there was a slow progress of work productivity in the Spanish economy. Productivity has increased very slightly at an average annual rate of 0.6% between 2000 and 2007, considerably lower to rates in the other EU countries (Myro, 2010). This is an implication of the Spanish model too specialized in low-productivity industries (construction, tourism), although empirical evidence shows that this specialization can currently only explain a small part of the gap in labor productivity with other countries (Felgueroso and Jiménez, 2009). Thus, the Spanish government assumed that the Spanish economic policy should improve the stock of infrastructures, the quality of human capital, R+D+I investment, the level of competition on markets for goods and services products, the labour market institutions and the promotion of business, all variables directly influencing the total factor productivity (OEP, 2005). Nevertheless, Spain´s poor performance in productivity was not surmounted.

Moreover, the Spanish economy suffered a current account balance deficit. At the end of 2007 this reached 10% of the GDP, brought about exclusively by the strength of private demand, given that the Public Administrations acted in a counter-cyclical manner in order to control the inflationary trends that were appearing (Bank of Spain, 2009a and 2009b). This figure exceeded that of most of the other developed economies and reflected the search for funds in international markets in order to make the increase in internal demand viable, an important part of which would be filtered out externally, through greater imports (Myro, 2010).

This was the situation the Spanish economy found itself in when the financial crisis broke in 2008. It is the most serious international economic crisis since the Great Depression of the 1930s, and only the energy and economic crisis of the 1970s comes even close to it. Unlike other crises, the current one has occurred in the “leading world power”, acting as the epicentre of an economic earthquake which has had aftershocks throughout the world’s global economy. In this context, the reflections of economic analysis and economic policy must adapt to a new scenario. The coordination efforts of economic policy, among other factors, penetrate governments’ political agendas, and economic policy is resized within governmental business, the debating of ideas and the level of social demands and attention. To some extent, the international economic crisis has involved the return of a more active economic policy, more in line with Keynesian theoretical postulates than with those which dominated economic science since the second half of the 20th Century. Thus, before looking more closely at the effects of the crisis on the Spanish economy and at expectations of recovery, we must comment on international governance and economic policy criteria on a world level with which to try to combat the crisis situation.

THE INTERNATIONAL ECONOMIC GOVERNANCE

Economic globalisation consists of integrating national economies in the international economy through trade, direct foreign investment, short-term cash flow, the international flow of workers and citizens and the flow of technology (Bhagwati, 2004). Different notions of globalisation exist, from those which understand globalisation to be a phenomenon through which the economic agents anywhere in the world are much more affected by events in the rest of the world than before, to the more technical notion that understands it to be the integration of economic activity, breaking down borders, through markets (Wolf, 2004).

Increasing globalisation has been a reality in the world economy in recent decades, and faced with the problems and imperfections the global economy entails, what we need to do is improve the system of global public institutions which establish the "rules of the game" of globalisation, coordinate governments and affect the incentive structure with which the political and economic actors find themselves. The importance of institutions and governance has been the maxim of the New Institutional Economics programme, drawn up on the basis of contributions made by Ronald Coase and Douglass North, awarded the Nobel prize in Economics and boosted more recently by the awarding of the 2009 prize to Oliver Williamson and Elinor Ostrom (Caballero, 2002). So, according to Stiglitz (2002), the most fundamental change necessary if globalisation is to work as it should is a change in institutional governance, and new international economics has developed advances for understanding institution change (Kingston and Caballero, 2009).

The international economic crisis has shown some weaknesses in the international financial and economic governance system, but institutional reform and international governance is highly complex and far from carrying out substantial changes in spite of the fact that the crisis involves a more receptive climate for such demands. Certainly, the relationship between globalisation and governance goes beyond the debate put forward with regard to the traditional dichotomy State-Market (De Paz, 2008), because the global village has become more interdependent and complex while not enough progress has been made in providing a more coherent and effective system of global governance which represents States and the world population (see, for example, Ramachandran *et al* (2009) for a reflection on the principles of global governance). In this sense, Rodrik (2007) sets out a "political trilemma" between international economic integration, the nation-state and mass politics which represents the difficulty involved in reconciling a governance structure which integrates the three elements.

The governance structure of the international economic system has also been determined by the financial system's regulations and institutions, and the international economic crisis has shown the need to initiate regulatory reforms which include financial institutions and activities previously unregulated and improve existing regulations. In an effort to avoid systemic crises, along with regulatory reforms questions relating to gaps in information on risk and its distribution, to procyclicity, to the harmonisation of regulatory policy and national legal frameworks and to providing liquidity to markets (Kodres and Narain, 2009).

When tackling the question of international economic governance, we should analyse the role played by a wide range of institutions and organisations, such as the International Monetary Fund, the World Bank, the Basle agreements, the World Trade Organisation, the GATT, the European Union or Mercosur, among others. But it is also relevant to analyse the G-20's proposals on international economic governance in the face of the economic crisis, as it allows us to understand the style of the economic policies applied to combat the crisis, as well as some keys to the debate on the possible institutional reform of international governance.

Under the auspices of Germany and Canada, in 1999 the G-20 was created as a forum for cooperation and dialogue between the most developed countries and countries with the most important emerging economies in order to discuss global economic governance and the international financial system. The G-20 was constituted as a group made up of Finance and Economy Ministers and the governors of central banks of twenty members: the eight most industrialises countries in the world which make up the G-8 (Germany, Canada, the United States, France, Italy, Japan, the U.K. and Russia), the main eleven countries with an emerging economy (Saudi Arabia, Argentina, Australia, Brazil, China, India, Indonesia, Mexico, South Africa, South Korea and Turkey) and the European Union as an entity in its own right. The G-20 manages to bring together the economic leaders from a group of countries which together make up the majority of the world’s population and represent almost 90% of the world’s production.

The forming of the G-20 in 1999 was just one more step in global trend bodies of encounter between groups of countries, which had previously given rise to forums such as the G-7 or the G-8. The main novelty lay in including in this new forum the main emerging economies and the European Union itself as a participant with a position of its own regardless of its members. The Asian crisis in the 1990s showed the importance of relying on the emerging economies when tackling questions of international financial architecture, while the process of European construction confirmed the formation of Monetary Union in a Europe which did not want to relinquish its presence in the debate on world economic and financial governance.

When the economic and financial crisis broke in 2007, governments were aware of the need to tackle the global economic crisis in a coordinated way, understanding that the political action taken by just one country would not be sufficient to overcome the crisis scenario: dialogue and coordination between countries would be more necessary than ever to avoid a huge world depression. In this way, it was assumed that independent action in economic policies taken by a hegemonic economic-financial leader in the world economy would be insufficient, plus the non-existence of multi-lateral organisms invested with the effective decision-making capacity to exit the crisis was evident, so the coordination of macro-economic policies was revealed as the only possible way of cushioning the international economic crisis, reactivate credit flow and recover production and employment. And according to Arias (1996), it is in episodes of financial crisis that the benefits of coordination are most obvious.

The last financial crisis, and its rapid impact on the real economy, generated a significant shrinkage of world economic activity in 2008 (see Table 1). In the majority of developed economies this reduction in activity even led to an economic recession which in turn led to a significant increase in unemployment in the majority of these countries which reached rates of nearly 10% (IMF, 2009).

The governments of the world’s leading economies shared in the analysis and diagnosis of the situation and at the G-20 meetings sought a cooperative response to ensure they would apply the right economic policies to deal with the crisis. The G-20 summit agreements reached in Washington, London and Pittsburgh can be qualified by their level of execution but, in general terms, these agreements guided governments’ economic policies in order to restore growth, and they did so wisely. In this sense, the recipe for expansive monetary and fiscal policies (clearly inspired by Keynes) that the G-20 dictated as a means of tackling the crisis and allowing growth to recover was applied in a general way by the Summits’ participating governments and others not present, and the result of this coordinated action largely explains how the world economy did not commit some of the errors of the Great

Depression. The G-20 Agreements cleverly ensured that the expansive macro-economic policies were effectively applied by the governments of developed and emerging economies, although at the same time many countries reached the conclusion that such policies were necessary of their own accord.

This active State intervention, unprecedented since the 1970s, injecting public money through economic reactivation plans began to produce results in 2009. And the majority of economies began to show signs that the reduction of their economic activity was becoming more moderate in the first two quarters of last year (Table 1). Of the developed economies, in the US the review of the GDP for the second quarter (IMF, 2009) shows a quarterly 0.3% adjustment, much lower than the 1.7% drop corresponding to the previous period. Demand indexes published offered positive signs, with advances in consumer confidence and private spending during the summer months.

Table 1. Evolution of the G-20's economies. G-20. 2008-09

	1st Quarter I 2008	2nd Quarter 2008	3rd Quarter 2008	4th Quarter 2008	1st Quarter 2009	2nd Quarter 2009	Inter-annual Variation rate 2nd Quarter 2009 (%)
US	-0.2	0.4	-0.7	-1.4	-1.7	-0.3	-3.9
Canada	-0.2	0.1	0.1	-0.9	-1.6	-0.9	-3.6
Mexico	1.1	0.3	-0.7	-2.4	-5.8	-1.1	-10.3
Argentina	0.8	1.8	1.3	-0.5	0.1	0.3	-0.8
Brazil	1.8	1.5	1.4	-3.4	-1.0	1.9	-1.2
Germany	1.6	-0.6	-0.3	-2.4	-3.5	0.3	-5.9
France	0.5	-0.5	-0.2	-1.5	-1.3	0.3	-2.6
UK	0.8	-0.1	-0.7	-1.8	-2.4	-0.7	-5.5
Italy	0.5	-0.6	-0.8	-2.1	-2.7	-0.5	-6.0
Spain	0.4	0.0	-0.6	-1.1	-1.6	-1.1	-4.2
Turkey	4.6	-4.9	-1.7	-4.4	-3.7	2.7	-7.0
South Africa	0.4	1.2	0.1	-0.4	-1.5	-0.7	-2.8
Japan	0.9	-0.7	-1.3	-3.4	-3.3	0.6	-7.2
Indonesia	2.4	2.8	3.7	-3.7	1.7	2.3	4.0
Australia	0.7	0.3	0.3	-0.7	0.4	0.6	0.6
South Korea	1.1	0.4	0.2	-5.1	0.1	2.6	-2.2
China*	10.6	10.1	9.0	6.8	6.1	7.9	7.9
India*	8.6	7.8	7.7	5.8	5.8	6.1	6.1
Russia*	8.7	7.5	6.0	1.2	-9.8	-10.9	-10.9

*Inter-annual rate because they do not publish quarterly deseasonalised variation data.
Source: International Monetary Fund (IMF) 2009, www.imf.org

The housing market has shown signs of stabilisation in sales and prices. And supply indexes also behaved positively, especially insofar as industrial production and the use of installed capacity were concerned. In the case of the Japanese economy, these positive signs have also been observed, with an increase in the quarterly GDP of 0.6%. And in the Eurozone, the GDP dropped at a slower rate, 0.1% as opposed to the 2.5% drop corresponding to the first quarter. In countries with emerging economies positive signs are also visible, especially China and India, with inter-annual growth rates of 8% and 6%, respectively, and with a significant buoyancy in industrial production (IMF, 2009). On the other hand, the agreements of the G-20 have also emphasised the need for a reform of the international financial architecture defined in the establishment of a new institutional framework, in the strengthening of financial regulation and of multi-lateral financing (Moreno, 2009). Changes to the financial architecture are slow, gradual and at the moment are only partial. For example, progress has been made in the battle against fiscal paradises since the OECD published them in a black list. But the bulk of international financial reform is still ongoing and, as we struggle to exit the crisis, corporate incentives for such reform could be feeble. The G-20 summits in Washington and London outlined an agenda which correctly addressed the coordination and response to the crisis, boosted expansive fiscal and monetary policies and the cleaning up of the financial system. But many of their agreements have been applied with difficulty, imperfectly and slowly, and it is too early yet to conclude whether or not many of such agreements will in fact be put into practice. The Pittsburgh summit continued the agenda of the previous summits, but with a lesser capacity for making progress with the proposals, aware of the difficulties of making all of the previous summits' proposals effective and in a scenario in which the worst of the crisis appeared to be over. The G-20 summits did not manage to establish a new Bretton Woods, but the principal aim of the G-20 was achieved: they prevented the world economy from entering a depression.

EFFECTS OF THE GLOBAL CRISIS ON THE SPANISH ECONOMY

Following the general trend of developed countries, Spain entered a deep recession in 2008. Spain's GDP only grew by 0.9% in 2008 as a result of the effect of contraction worldwide. In the face of this situation, at the beginning of 2009 the Spanish government implemented an economic stimulus plan at a cost of approximately twenty thousand million euros, that is, 2% of the GDP. The plan basically centred on granting public aid to increase and improve infrastructures, promoting public works. Furthermore, and given the importance of the car industry to the Spanish economy, aid was granted to car buyers (as long as it involved renewing vehicles which were more than ten years old).

In spite of all this, and given that expectations were for an improvement in international economic activity, the Spanish economy continued to shrink in the second quarter of 2009, although, similarly to the world economy, at a lesser rate than in the first quarter. In particular, the GDP recorded a 1.1% drop as opposed to 1.6% (Table 1).

This figure entails a 4.2% inter-annual drop and the year is forecast to close with a 3.7% annual drop (Bank of Spain, 2009c). If we look at the GDP components, the national demand dropped by 7%, while the external balance improved slightly, up to 3%.

Within the aggregate demand, and according to estimates made by the Bank of Spain (Bank of Spain, 2009c), only public consumption and investment in other types of construction showed positive inter-annual variation rates, while the negative rates of the remaining components were accentuated. Specifically, the private consumption dropped by more than 5%, the investment in equipment and other products decreased by more than 20%, the construction investment by 12% and housing investment by around 25%. With relation to the foreign sector, exports of goods and services showed a more moderate decline, approximately 2%, to reach a figure of 16% (see Table 2), while imports showed a steep decline of more than 20%.

The decline in economic activity is also evident in other indexes: electricity consumption, cement consumption, fuel consumption, the number of licenses granted for the building of new homes, overnight hotel stays, etc., with inter-annual falls of over 5% (see Table 3).

When we compare both quarters, our attention is drawn to the sharp drop in electricity consumption, the number of licenses requested for the building of new homes and, to a lesser extent, the number of overnight hotel stays. However, we can see that the drops in the industrial production index and the consumer confidence index are more moderate.

Also, the only index which experienced a clearly positive variation in the second quarter of 2009 corresponded to the registration of new road vehicles, given the aid granted by both the Central Government and several regional Governments.

Table 2. GDP and elements of demand within the Spanish economy

	2008	2009	1st quarter 2009	2nd quarter 2009
GDP	0.9	-3.7	-3.2	-4.2
National demand	-0.5	-6.7	-6.1	-7.3
External balance	1.4	3.0	2.9	3.1
Household consumption	-0.6	-5.4	-5.0	-5.7
Gross fixed capital formation (GFCF)	-4.4	-16.1	-15.2	-17.0
GFCF construction	-5.5	-11.7	-11.5	-12.0
GFCF equipment and other products	-2.8	-21.9	-20.1	-23.7
Exports	-1.0	-16.7	-17.6	-15.7
Imports	-4.9	-22.6	-22.9	-22.3

Source: Bank of Spain (2009c).

Table 3. Other Spanish economic short term indicators

	2008	2009	Ist quarter 2009	2nd quarter 2009
Industrial production index	-7.3	-19.7	-18.0	-13.1
Electricity consumption	0.6	-5.3	-0.5	-2.8
Apparent cement consumption	-19.6	-36.6	-21.6	-23.7
Licenses for building of new homes	-52.1	-54.8	-45.3	-52.7
Consumption of petrol and diesel fuels	-4.1	-6.2	-3.2	-3.0
Overnight hotel stays	-1.2	-7.6	-4.9	-6.6
New car registrations	-27.5	-28.8	-0.5	17.8
Consumer confidence index	-34.0	-30.0	-22.0	-21.0

Source: Bank of Spain (2009c) and FUNCAS (Foundation of Savings Banks) (2009).

In short, the most recent indexes show that Spain's economic activity continues to decline, although at a slower rate than in the first quarter of 2009. With regard to supply, every branch of activity, except for the primary activities, which have remained stable, declined significantly in the second quarter of the year (Bank of Spain, 2009c). We would underline the fall in the industrial sector's added value by 17% in the second quarter of 2009 as opposed to almost 20% in the first quarter. The sector's inter-annual drop thus stands at 16.8%. The services sector also showed signs of slowing, its added value falling by 17.4% in the second quarter as opposed to over 21% in the first quarter. As such, the inter-annual drop stands at 15.2%.

The widespread fall in Spain's economic activity in the first two quarters of 2009 was transmitted to the employment market. Job destruction in annual terms intensified until it reached a rate of almost 7% (see Table 4). However, the rate of the fall began to stabilise in line with a more moderate fall in economic activity in the second quarter. In spite of this, the unemployment rate is approaching the 19% mark (Bank of Spain, 2009c).

Job destruction and the increase in unemployment have modified the income expectations of Spanish households downward. This translates into a widespread drop in consumption, as we mentioned above, while it also has repercussions on family saving. Simultaneously, and according to data provided by the Bank of Spain, the number of new lines of credit granted to businesses and families dropped by around 11% and 9% in 2008 and the first quarter of 2009, respectively. That is, an acute credit restriction occurred, preventing people from consuming more than what their available income would allow (the opposite of what occurred in the phase of economic expansion). All of this translates into a significant increase in family saving, from 11% of available income in 2008 to 18% of income in 2009.

If we also bear in mind that non-financial company saving is increasing at the same rate as in the household sector, private saving is on the up and has stood at almost 6% of the GDP since the end of 2008 (Bank of Spain, 2009c).

Table 4. Employment and unemployment variation rates in the Spanish economy

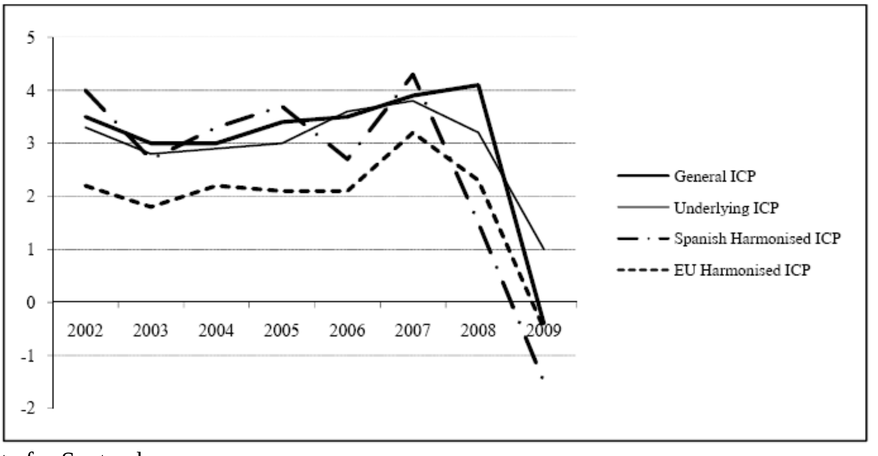
	2008	2009	1st quarter	2nd quarter
Employed (FTE)	-0.6	-6.7	-6.3	-7.1
Working population	3.0	1.2	1.2	0.2
Unemployment rate	11.4	17.8	18.2	18.5
Registered unemployment (in thousands of people)	2538.9	3576.9	3722.1	3812.4

Source: Bank of Spain (2009c).

However, the total national saving rate has been dropping since the beginning of the crisis, from 21% of the GDP in 2007 to the 17% forecast for the end of 2009. This is due to the collapse of public saving which has gone from 7% of the GDP in 2007 to the -5% forecast for 2009.

Lastly, we cannot end this section without analysing the evolution of another of the relevant economic indicators, that being the price variation for goods and services. Traditionally, the inflation rate in Spain has been high (even reaching rates of over 4% in 2008) and always above Euro zone country averages (harmonised index of consumer prices stands at a rate of almost 3% as opposed to 2% in the Euro zone). However, in the present crisis context, an important and surprisingly rapid aspect of Spain's economic adjustment process is the steep reduction in inflation experienced in the months of last year (see Figure 1).

The underlying inflation rate (excluding the prices for energy and perishable goods) stood at rates of around 0% in the second quarter of 2009 and 1% in terms of annual variation (Table 5). That is, inflation in Spain has dropped by approximately 3.5% with respect to 2008. The corresponding moderation in the Euro zone stands at less than 1.6% and, for the first time in Spain's recent economic history, the inflation rate is lower than the Euro zone average.



2009: Data for September

Source: Authors' compilation based on data from the Spanish Statistics Institute –Instituto Nacional de Estadística- and Eurostat (2009). www.ine.es; www.eurostat.eu.

Figure 1. Evolution of the Index of Consumer Prices.

Table 5. Prices and salaries in the Spanish economy

	2008	2009	1st quarter	2nd quarter
Index of consumer prices (ICP)	4.1	-0.4	-0.8	-1.0
Underlying index of consumer prices	3.2	1.0	0.4	0.1
Harmonised ICP differential with the Eurozone	0.9	-0.6	-0.7	-0.5
Industrial price index	6.5	-3.9	-5.5	-5.4
Labour cost per unit of production	4.6	1.2	1.0	1.4

Source: Spanish Statistics Institute –Instituto Nacional de Estadística (2009).

This adjustment in the evolution of prices is a direct consequence of the economic recession and the imbalances that exist in the Spanish economy. A market economy corrects excesses in supply and demand through product pricing and production factors; and the moderation of consumer prices is a natural reaction in the face of a fall in demand and agents' expectations. In the specific case of the Spanish economy, the drop in consumption, rapid job destruction and the excess of installed industrial capacity explain the rapid drop in inflation. The evolution of the world prices for raw materials, especially oil must be added to it.

EXPECTATIONS FOR ECONOMIC RECOVERY

On an international level, data would seem to indicate that the path to economic recovery has begun, and that expectations for global economic activity are improving (IMF, 2009). In the third quarter of 2009, international financial markets maintained the tone of improvement already shown in the previous quarter and the stock markets recorded widespread gains. In the foreign exchange markets it is worth underlining the depreciation of the dollar against the main currencies, of developed as well as emerging economies. And in the raw materials markets the Brent oil price has remained stable at around 70 dollars a barrel, while the prices of the main industrial metals have continued to rise. The improvement in the financial markets coincides, in turn, with the appearance of signs of economic revival in numerous economies and regions: the GDP shrank at a lesser rate, and positive rates, even, in the second quarter (see Table 1). On account of all this, the IMF's latest estimation is for a negative growth of 1.1% for 2009 (which entails an improvement of 0.3% with respect to the previous forecast) and an increase of 3.1% for 2010. Area by area, the developed economies would grow by 1.3%, where the growths of the Japanese and US economies by 1.7% and 1.5%, respectively, for 2010 stand out. The emerging economies are those which are in a more advanced phase, with rates of over 5%, the evolution of China and India the most prominent, with economic growth expectations of 9% and 6%, respectively (see Table 6).

The IMF, however, also warns that the recovery will be slow in developed countries, as the financial systems are still damaged and unemployment will continue to rise in 2010. The unemployment rate will hover around the 10% mark both in the US and in the Euro zone. And at some moment in time it will be necessary to begin to withdraw the economic stimulus measures, households will have to begin to rebuild their savings and increase their purchasing power, and governments will have to begin to reduce the volume of fiscal deficit they have generated in the past two years. Ordered strategies to exit the crisis which ensure that recovery is firmly established will therefore be necessary. In this air of widespread optimism, both the international agencies (IMF, European Commission) as well as Spain's official agencies (Bank of Spain, National Statistics Institute), forecast the recovery of the Spanish economy for the beginning of 2011 in the most optimistic scenario, with a growth of no higher than 1% in that year and a drop in the GDP of over 0.5% in 2010.

If we observe the evolution forecast in the GDP components (Table 7), the majority continue to show a negative variation, although there are signs of moderation, even in the case of construction investment. Only public consumption will continue to grow in the next months. With regard to the external sector, exports are forecast to evolve positively in the final quarter of 2009 in the face of expectations of global economic recovery, especially in the Euro zone (main destination of Spanish exports); imports are also forecast to fall more moderately after the final quarter of the year.

For its part, the shrinkage of the economic activity forecast for the coming months will generate an unemployment rate of around 20% in 2010 and 21% in 2011. The figures mean that the Spanish economy will once again possess the highest unemployment rate in the Eurozone, doubling the average of the other European countries. Therefore, the crisis in Spain will last longer than in the other EU member states. While the majority of these countries have already or are in the process of exiting the recession, in Spain economic growth will take a year longer, until the end of 2010.

Table 6. IMF forecasts

	2009	2010
World economy	-1.1	3.1
Developed economies	-3.4	1.3
USA	-2.7	1.5
Eurozone	-4.2	0.3
Germany	-5.3	0.3
France	-2.4	0.9
United Kingdom	-4.4	0.9
Spain	-3.8	-0.7
Japan	-5.4	1.7
Emerging economies	1.7	5.1
China	8.5	9.0
India	5.4	6.4

Source: International Monetary Fund (2009).

Table 7. Quarterly forecasts for the Spanish economy. GDP components

	3rd quarter 2009	4th quarter 2009	2009	1st quarter 2010	2nd quarter 2010
GDP	-4.0	-3.1	-3.8	-1.6	-0.4
Private consumption	-5.6	-4.8	-5.3	-3.0	-1.7
Public consumption	4.8	4.6	5.2	4.3	4.1
Gross fixed capital formation (GFCF)	-15.9	-13.2	-15.4	-7.6	-3.7
GFCF in capital goods	-28.8	-24.5	-26.6	-12.7	-6.6
GFCF in construction	-10.7	-8.6	-10.7	-5.0	-1.7
GFCF in other products	-14.3	-12.3	-14.1	-9.4	-6.7
Exports	-11.4	3.0	-12.1	0.9	1.4
Imports	-18.4	-10.7	-18.8	-4.5	-1.5

Source: Spanish National Statistics Institute –Instituto Nacional de Estadística (2009).

According to the European Commission, only Latvia, Lithuania and Bulgaria will take as long as Spain to reach positive growth rates.

As well as the slow economic recovery and the imbalances in the employment market, it is necessary to underline that the public deficit will shoot up to 11% of the GDP in 2009 and remain at around 10% in 2010 due to the fall in fiscal revenue, the increase in unemployment benefits and the economic stimulus measures put in place by the Government. The European Commission forecasts that Spain's accumulated debt will rise from 40% in 2008 to 74% of the GDP in 2011, thus exceeding the 60% maximum established in the Stability and Growth Pact. All of this clearly endangers the sustainability of long-term public finance.

CONCLUSION

The Spanish economy experienced rapid growth for more than a decade, clearly above the European average. The marked growth of the GDP was based on an increase in consumption and housing investment, financed by unique credit facilities aimed at the private sector. In this period, infrastructures and human resources have both improved, exports have increased, the public debt has been reduced and Spain has consolidated its leading position in activities such as tourism, renewable energies and bank intermediation.

But this model of development has ended, and the financial and credit conditions which favour such a model are not expected to return. In the same way as the majority of countries which form a part of the global economy, in 2008 Spain entered a deep recession and the successful achievements to modernise the Spanish economy are not currently sufficient to ensure a relatively quick exit from the present economic crisis.

In relative terms, the forecasts for Spain with regard to the year overall are no worse than those for the Eurozone as a whole. However, the situation in which the Spanish economy finds itself is worrying not only because of the way in which the GDP is falling but also because of the imbalances in the employment market, in construction and in the financial position households find themselves in, and the poor perspectives for recovery as a result.

In accordance with the forecasts of most of the international agencies, the Spanish economy will shrink by approximately 4% in 2009, and it will undergo an additional fall of 0.8% in 2010. This fall will be followed by a slight recovery, 1%, in 2011, a year in which the unemployment rate will foreseeably stand at 21% of the working population. Therefore, the crisis will last longer in Spain than in the majority of other developed countries and the recovery will not be enough to solve the current imbalances, basically in the employment market.

It is necessary, then, to begin to restructure production and develop a growth model capable of replacing the buoyancy of the sectors hit hard by the crisis, especially construction. This can be achieved by improving the production structure as it stands, modernising and increasing the quality of the most important economic activities to date in the GDP, such as tourism, but also housing construction. Until then, the imbalances which have built up in the previous expansion stage will continue to exist, at least in the short term.

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