

# The FORUM

Discussing International Affairs and Economics



## Interviews, Essays, Editorials

Viral V. Acharya	Jörg Bibow	Erik Brattberg	Joseph E. Gagnon	Delio E. Gianturco
Terence Guay	Jolyon Howorth	Laurence J. Kotlikoff	Jens F. Laurson	Sally McNamara
Ramon Pacheco Pardo	Claudio A. Pardo	George A. Peiler	Charles Hugh Smith	Karen E. Smith
Joshua B. Spero	Michael Werz		Stephen Williamson	Neil Winn

### *Student Award Winners*

Jan-Ulrich Rothacher Calvin Wong



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## summer 2011

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## ABOUT THE FORUM

The Forum is a publication of the International Affairs Forum online journal. Inside each issue you'll find interviews, editorials, and short essays from academics and practitioners, presenting a wide spectrum of views and from around the globe. In this way, we wish to provide readers with an all-partisan, international look at today's major issues, and tap into the research and views of major thinkers and actors in the field within the 'space' between social science journalism and academic scholarship. That is, we look for carefully considered contributions that can nevertheless be published relatively quickly and which can therefore maintain the impetus of current thinking but which do not require detailed peer review. The extent of our review is therefore largely a matter of informed editorship. We think that this is a valuable approach to extending informed opinion on policy in the international sphere.

Another feature of each issue is recognizing winners of our Student Writing Competition Program by publishing their efforts. As part of our mission, we strive toward providing a platform for students to take next steps toward successful professional careers and as such, believe exceptional work should be recognized, regardless of experience level. The program is open to all college students around the world.

## ABOUT THIS ISSUE

When the Treaty of Maastricht was signed on 7 February 1992, it set the path for the EU to establish a single currency, the Euro, and on its way to form a economic and eventually political union. Joaquín Almunia, Economic and Monetary Affairs Commissioner from 2004 until last year, said: "[Maastricht] put an end to the division of Europe, helped consolidate democracy and brought economic benefits for all EU countries in terms of higher competitiveness, higher economic growth and higher job creation. United, we can shape the solutions to global issues such as climate change or a new international financial governance. Divided we will achieve nothing." He may muddle the eloquence of Aesop's (via John Dickinson) "united we stand, divided we fall" with EU-speak, but the historic sentiment is all in place.

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Twenty years later the question remains whether history matches the sentiment. The EU has made progress in economic and political integration—reducing borders for individuals and commerce alike. But questions on further EU-expansion, missile defense, military action abroad, immigration, and how to treat the errant economic sheep that have caused the current sovereign debt crisis offer potential policy landmines.

This issue of The Forum focuses on two issues: EU Security and Central Banking. It brings together a articles, interviews, and opinion pieces of and with experts from a number of countries, organizations and think-tanks to reflect and discuss these issues from perspectives. In the first section of the issue we present contributions on external security threats to the EU. These range from discussions about the EU involvement in Libya, the war on terror, to the Common European Defense Policy. In the second section of the issue we present interviews and short papers that examine differences between the EU and the Federal Reserve in addressing the financial crisis as well as economic recovery.

We hope you enjoy this issue and encourage feedback about it, as it relates to a specific piece or as a whole. Please send us your comments to [editor@ia-forum.org](mailto:editor@ia-forum.org).

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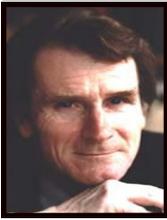


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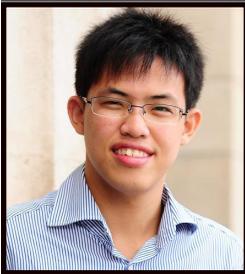
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# EU SECURITY





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# European Union Security Challenges

**Dr. Joshua B. Spero**

Fitchburg State University

**UNITED STATES**

**T**he European Union (EU) confronts the institutional challenges for whether its Common Security and Defense Policy (CSDP) can effectively continue to have influence abroad, while significant economic burdens and dependencies dissipate the EU politically. If the CSDP fails to affect the changes diplomatically, strategically, and operationally it wants to project, then the EU risks delegitimizing its collective crisis management global vision. Going into its second decade with the large majority of its members integrated into an Economic and Monetary Union (EMU), the EU's **strengths exemplify models for democratized integration and cooperative security**. The challenges for the CSDP, however, as part of the larger Common Foreign and Security Policy (CFSP) framework, concern its military force projection internationally and economic dependency on Russia. Both geopolitical areas portend a weakening of the EU's **institutionalization with grave potential for re-nationalization and possible debilitation of required CSDP and CFSP burden sharing**.

A critical juncture for such institutional challenges occurred when key EU members, Great Britain and France, acted with the United States (the latter reluctant to participate outside of NATO) to forge an initial multi-state coalition. This coalition went beyond CSDP and outside of CFSP frameworks. Emerging rapidly to implement the UN- mandated military intervention in Libya, the NATO-led Operation, Unified Protector, quickly overrode EU deliberations. What appeared as an envisioned EU-led mission, Unified Protector fast became the international operation to try to stop the humanitarian disaster arising from Libya's **escalating civil war**. As a result, NATO diplomatically and operationally superseded the EU's **strategic area of interest – and region of crucial importance – North Africa**. Many EU members deliberated and determined within NATO's **North Atlantic Council, not within the EU's CSDP and CFSP processes**, to provide the command and control, assets and manpower, political

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legitimacy and military strategy for this major out-of-area responsibility. Whether NATO's **consensus decision-making and institutional impact last effectively beyond** Operation Unified Protector remains a question beyond this analysis. Clearly, the EU's **consensus failure and reputation remain at stake and its institutional legitimacy**, so long viewed economically as integral to the peaceful coexistence among members, stands at a crossroads.

If the EU fails to confront the institutional challenges for whether its CSDP and CFSP processes can effectively have influence abroad, then history may reveal that Operation Unified Protector signified a serious rejection of such processes. This possible rejection of the EU's **CSDP and larger CFSP frameworks might witness a major turning point** since the EU's **2009 Lisbon Treaty sought to solidify and extend the EU's strategic capabilities, building on the decade-long European Security and Defense Policy (ESDP)**. The Lisbon Treaty generated a conjunction of common EU political, bureaucratic, and foreign policy objectives and restructuring, in the wake of some twenty small-scale overseas political, economic, and military missions from the past decade. Certainly, these missions across several continents, primarily civilian or military monitoring or peacekeeping missions, remain important for the countries where they're deployed. **The key objectives for such missions focused on transitioning from ESDP to CSDP, as the EMU evolved and the CFSP was extended internationally.** Since none of these CSDP missions abroad today deploys more than several thousand European civilian personnel or military forces, their impact remains quite limited. The baseline of US and NATO military reinforcement as the only means to successfully counter the Balkan wars of the 1990s reveals how more globalized twenty-first century security dilemmas disrupt EU political consensus building. Moreover, key EU nation indebtedness exacerbates such political difficulties. Consequently, the EU grapples with realistically transforming its political commitments into impactful military operations. Such operations are jointly intended to reduce proliferation of weapons of mass destruction, prevent conflicts or stabilize post-conflict war zones, or counter terrorism internationally. Warning signs abound, though, over projecting legitimate operations abroad. EU efforts to maintain cohesiveness politically appear hindered at best, as mobilizing larger-scale military requirements to conduct such a regional and global set of objectives seem quite elusive.

### Geo-Economic Security Dilemmas

The indecisiveness of the EU to lead on Libya critically impacts CSDP and CFSP legitimacy, but even more critical long-term decisions made on geo-economic considerations may dilute the EU's **institutionalization**. **Before the EU even attempts to forge large-scale international crisis management missions via CSDP with European manpower, resources, logistics, and equipment to field significant**

combined and joint operations, three key geo-economic challenges already weaken EU effectiveness. Such weaknesses arise primarily from the EU's **27 members and serious dependencies** verging on geo-economic security dilemmas. They center on continued membership, extended trade, and needed energy, all areas impacted by globalization that threatens the EU's **ultimate success from its six decade-old integration**. Indeed, the EU's **energy dependency on Russia** may yet determine the most troublesome geo-economic linkage, tying together key aspects of membership and trade. Even as specific member states' domestic indebtedness- such as Greece, Ireland, and Spain- plagues the EU institutionally, geo-economic energy dependency on Russia may actually damage the CSDP, upending the CFSP and EU institutionally, and descending EU members into re-nationalization.

As Russian national security concentrates increasingly on its energy capabilities to ensnare EU members in an even more extensive dependency, the EU may find itself more encumbered geo-economically on Russia's **western and southwestern periphery**. The Russian threat of military intervention in Ukraine over the past several years and the Russo-Georgian war in 2008 have driven West European political considerations and economic necessities. More than Russian military challenges, political and economic concerns have antagonized relations between the EU's Central-East European leaders, their newer EU members, and their West European counterparts. Subsequently, non-EU states, Ukraine and Georgia, have become geopolitical pivots in Russian military planning for larger Russian national security strategy toward Europe. Given the pivotal Russian energy pipelines that traverse Central-East Europe into West Europe via these non-EU states, and the expanded EU membership of bordering Central-East European nations during the past decade, regional tensions will likely remain high. Therefore, energy security policy figures much more prominently in the EU's **eastern outreach, particularly in the aftermath of the January 2009 Russian-Ukrainian disputes and attendant broader European energy supply cut-offs**.

During 2008-2009, EU energy assistance to non-Russian, non-EU states bordering Russia's **western periphery increasingly antagonized Russo-European ties over energy security**. EU outreach initiatives consisted of and currently focus on financing and politico-economic support for Southern and Southeast European pipelines – **attempting, in some instances, to avoid Russia and de-link from Russian pipelines**. Instead of corroboration with Russia, EU eastern outreach raises EU-Russian tensions and continually provokes disagreement at EU-Russian Summits. Hence, EU enlargement to Central-East Europe in the twenty-first century (aimed at integrating Europe) actually heightens Russo-European tensions, particularly as the EU tries extending security to former Soviet Republics. Russian military anxiety intensifies as the EU increasingly sees its role across Europe and globally to conduct

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not only politico-economic policies, but also security policies with growing military implications. For the Russian military, the EU's **cultivation of its newly forming** Eastern Partnerships may result in an anti-Russian and greater geo-strategic rivalry. Russian energy resources will continue to fuel European security developments as geopolitical struggles, mainly for oil and gas, may give Russia greater sway over European security.

Inherent in Russian national security strategy toward Eastern and Central Europe lies the basis for confrontation in Russo-EU relations. Growing EU development eastward alarms Russia. Since Central-East European leaders consistently point to Europe's needed reinforced commitment to them via NATO, the EU's **drive for pipeline** politics and economic maneuverability may yield higher stakes energy security competition. This geopolitical competition may then put Russian military strategy at a crossroads. The geo-strategic maneuvering among Russia, Central-East European EU and non-EU members, and West Europe, with a declining U.S. European role, signal potential renationalization over these counter-productive nation-state pipeline policies. The increased possibilities for renationalization for EU members may then augur such institutionally disintegrative tendencies and policies. Re-nationalized tendencies could stem from differing national security strategies regarding energy supply networks, resulting in intra-competitive EU regions along Russia's **Western and** Southwestern borders. The consequences for renationalization and EU disintegration then make the challenges for reviving the CSDP and CFSP frameworks pale in comparison. Such regional geo-economic energy security dilemmas foreshadow further corrosive political discord within the EU, endangering the EU's **future** cohesion, its institutionalization, and, ultimately, its survival.

# The European Union's Security Policy: An Attempt to Counterbalance America

**Sally McNamara**

Heritage Foundation

**UNITED STATES**

Since the collapse of the Soviet Union, the United States has emerged as the world's unrivalled military, economic and technological power. But unlike most previous dominant powers, the U.S. has not sought to expand its geographical territory. Since the end of the Second World War, the United States has, in fact, guaranteed Europe's security through a web of bilateral and multilateral alliances—with the North Atlantic Treaty Organization (NATO) at the heart of transatlantic security. It is impossible to imagine Europe's post-War security (and prosperity) in the absence of America's security guarantees.

However, a second European defense identity has gradually emerged, separate to and independent of the very alliance which has guaranteed European security for the past 60 years. The European Union's Common Security and Defense Policy (CSDP) was born in the wake of the Balkans Crises of the 1990s, where Brussels' extraordinary powerlessness had been badly exposed. To this day, Luxembourg's Foreign Minister Jacques Poos must regret his infamous proclamation: "This is the hour of Europe. It is not the hour of the Americans"—which was uttered just before the Americans had to step in and stop ethnic cleansing right on Europe's doorstep. By the war's end in Kosovo in 1999, the U.S. had provided 100 percent of NATO's signal-jamming capability, 90 percent of the air-to-ground surveillance, 80 percent of the air-refueling tankers and U.S. fighters and bombers had delivered 90 percent of the precision-guided munitions against Serbia.

Resentment festered in many European quarters that NATO—and more specifically the United States—had been called in to resolve a quintessentially European conflict. For its part, the United States was frustrated by Europe's unwillingness (and inability) to shoulder a greater share of the defense burden.

British Prime Minister Tony Blair—one of the CSDP’s original architects—saw EU defense integration as a vehicle for increasing European military capabilities through the greater pooling of resources. This reasoning still lingers on the lips of EU elites today, as a way of pushing for further European defense integration. However, the CSDP’s other architect, French President Jacques Chirac, saw it as a way to advance an autonomous EU defense identity that could operate independently of NATO. Chirac had no concern for increasing European military capabilities so as to relieve Continental Europe’s free ride on the U.S. defense bus. Neither did he care about ensuring America’s continued involvement in European security affairs; rather, he wanted to see the exact opposite.

And Chirac ultimately had his way. European military capabilities remain as limited today as they were in 1999. Since 1999, average European defense spending has actually decreased and the EU’s much-touted civilian assets have failed to play a big role in global stability operations—and especially not in EU members’ main theatre of operations in Afghanistan. EUPOL Afghanistan has been derided by both the NATO Parliamentary Assembly and the House of Lords as being all but useless.

All-in-all, despite multiple treaties and resolutions on security, the EU is not a serious military power as a collective entity. However, it would be wrong to say that the EU does not have its own security policy. It does. And that policy is to balance against the United States’ global hegemonic position. The EU has thrown its lot in –lock-stock-and-barrel—with Immanuel Kant’s vision of an international rules-based global order. The CSDP is not about creating a robust European military; it is about frustrating American leadership on the world stage. The EU is attempting to establish itself as a global player in a rules-based system which is undergirded by the United Nations—and not by American power. The Institute for Security Studies’ Alvaro de Vasconcelos neatly describes the EU’s main strategic goal as the “multilateralisation of multipolarity.”

“  
*for Europe, real security  
is about creation of a  
multipolar system where  
decisions are made  
multilaterally...*

“

Brussels overtly rejects America's "over-militarization" of global security challenges, and completely repudiates the concepts of pre-emption and unilateralism. EU security analysts argue that too much military power has in fact made the U.S. less secure—the U.S. President should be concentrating on issues of healthcare and welfare rather than security and defense.

Certainly Europe does not possess the traditional military tools to challenge the United States—but neither does it want to nor need to. For the European Union, security is not a question of soldiers, sailors, guns and tanks; for Europe, real security is about the creation of a multipolar system where decisions are made multilaterally and where no single power can dominate militarily or politically to the exclusion of the others. Whether it is by choice—or because of its inherent weaknesses as Robert Kagan argues—the EU is not trying to compete with America in military terms, but rather, it is trying to constrain U.S. power by balancing it in the international system. Or better still, in another of Kagan's terms, Europeans are from (pacifist) Venus while Americans are from (military) Mars.

It is a lone voice in Brussels that points out that it is only because of NATO's hard power security guarantees that the European Union has been able to indulge itself in this process at all. Former British Prime Minister Margaret Thatcher was one however, when she observed in 2002: "far from serving to strengthen the European contribution to NATO, the EU countries under French inspiration have deliberately embarked upon the creation of at best an alternative and at worst a rival military structure and armed forces."

The EU is attempting to redefine the concept of security by creating an international consensus where the UN is the ultimate arbiter of who does what in the world. That is why the EU is one of the primary promoters of global initiatives such as the Kyoto Protocol, the International Criminal Court, the United Nations Convention on the Law of the Sea and countless other multilateral treaties; they see them as a way to prevent America from exercising its power. It is not for nothing that the EU gives U.S.-based advocacy organizations millions of dollars every year to push its political agenda.

Despite a long tradition of shared values and deep political connections, the U.S. will ultimately remain distinct from the EU, in that it shoulders the burden of global leadership. Unlike the EU, America cannot merely abrogate its role when it pleases. And Brussels should be happy about that ultimately—because the cost of America's failure to lead would be unfathomable.

# What Does the Libyan Crisis Say About EU Defense Policy?

*Interview with* **Dr. Jolyon Howorth**  
Yale University

**UNITED STATES**

**International Affairs Forum: The NATO military intervention in Libya, particularly in light of Germany's refusal to aid in the 'no-fly zone' effort, has caused rifts within the EU member states. In light of this, how do you view current EU security and defense policy?**

**Dr. Jolyon Howorth:** There are several aspects to this which all interconnect. Twenty years after the outbreak of the wars of Yugoslav succession we recall that the then Foreign Minister of Luxembourg, Jacques Santer, said that 'this is the hour of Europe, not the hour of the Americans', which made him something of a laughing stock around the world. Clearly the Europeans were not ready to tackle Yugoslavia in 1991. They gave themselves 20 years to develop institutions, decision-making procedures, and military and civilian capacity. All of that was set in motion over a 20 year period with precisely the purpose of allowing the European Union, if another crisis arose or when the next big crisis broke out abroad, to be ready. What

Libya has demonstrated is that Europe is still not ready.

When we look at it in some more detail, that conclusion must be nuanced with a recognition that certain member states are ready and they're ready to cooperate with each other. Those states which have been involved in the military activity in Libya, largely the UK and France, still have power projection capacity way beyond the immediate European theatre. Then there are serious participants such as Italy, that has offered its airbases for use in the 'no-fly zone' effort, Belgium and Denmark which are hitting targets on the ground. However, Spain, Greece, Sweden and Turkey have caveats which restrict their role to air-air operations only. .

Now, a key question here is why did this become a NATO mission rather an EU mission? That's rather complicated to answer. My sense is that in Washington DC, there was an unspoken assumption that if America was going to take a

'back seat' in this particular operation, then the lead should be taken by the EU, rather than by NATO. There was a window of three or four days during which there was talk of handing over the US command to "another entity". But the Obama administration did not want this to be a NATO mission because NATO is perceived around the world as an American-led alliance. It is awkward, to say the least, for the United States to be saying that it will do the initial heavy hitting and then hand over to a "European entity" which turns out to be NATO, which is of course commanded by an American admiral. So there was an assumption in Washington that this could be the first time we'd see the much vaunted European Security and Defense Policy, now called Common Security and Defense Policy, engaging in this sort of operation in a lead position. The Obama administration didn't want it to be NATO, Turkey didn't want it initially to be NATO, Germany certainly didn't want it to be NATO, and France didn't want it to be NATO, all for rather different reasons.

The fact that it turned out in the end to be a NATO operation was I think due to two circumstances. The first was that NATO is the only organization that has the necessary command and control capacity to organize such as mission. The other was that Turkey changed its mind when it sensed that France might emerge as the leader of this operation. For Turkey, opposition to any French lead proved stronger than opposition to NATO taking over the mission. . Remember, Cameron had signed a Defense Treaty

with Sarkozy back in November 2010. The French hoped that this Franco-British entity could be the lead organization for the Libya operation. But Cameron was determined that it should be a NATO mission. Then the Turks joined forces with him and essentially succeeded in turning it into a NATO mission. So, from almost every angle, we see the Europeans failing yet again to generate the dynamics which could produce European leadership.

One further element is the political element. From the very outset of the Libyan crisis, the European member states were coming at the problem as they used to in the '60s and '70s. When the Germans initially and the British and the French suggested sanctions, the Italians, the Greeks and the Cypriots opposed those sanctions. Even on something as simple as sanctioning the Libyan regime, we find that there is

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*...a key question here is why did this [Libya] become a NATO mission rather than an EU mission?*  
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no agreement or consensus internally within the European Union. When you get to much more significant instruments such as a no fly zone or military action, then there's even less agreement. So the politics of it, the military dimension, the strategic dimension, and the practical economic control dimension all added up to another European defection.

### **Do you think a strong EU defense policy strengthens NATO?**

**Dr. Howorth:** Absolutely. That has been the proposition on which almost all of the European defense developments have been predicated over the last 20 years. It will strengthen the trans-Atlantic alliance because traditionally within NATO there have been far too many European free riders. That free riding has resulted in a sub-optimal European capacity to take on military or civilian/military missions.

From the end of the Cold War - and this was the case throughout the Balkans crisis - the message from Washington to the Europeans was very loud and clear: Europe had to get its act together because the United States did not feel that there was any obligation anymore to send American troops to places like Bosnia-Herzegovina or (now) to Libya. Also, if and when the Europeans got their act together, this would strengthen the trans-Atlantic relationship, which is something bigger than simply NATO. It would strengthen the whole relationship and allow Europe to be a true partner with the United States.

That would obviously have some repercussions for NATO. Both the European Security and Defense Policy *per se*, and also NATO since the end of the Cold War, have been projects in the process of becoming. It's not entirely clear to anybody quite what either of these will eventually become and how they will interact. There have been millions of words written and oceans of ink spilt about the interaction or the relationship or the potential for cooperation between these two entities. Nobody has yet resolved that dilemma.

But there is absolutely no question that the greater the European capacity to engage in this type of crisis management operation, the more it will consolidate the Atlantic Alliance and the more it will be useful to NATO as well as to the Europeans.

### **Turning to Russia, President Medvedev recently said that systems protect Europe from missile attack risk being ineffective and threats to stability if they don't include Russia. What is your reaction?**

**Dr. Howorth:** Since the end of the Cold War, Russia has made a number of overtures to the West, largely to the United States but also through Europe to the United States, to the effect that the interests of all of the countries in the northern hemisphere are shared interests against the potential of terrorist attacks from the south. They have been quite explicit in saying that, in Moscow's

view, that's where the attacks will come from. The underlying proposition is that we have shared interests and therefore we should pool our resources and coordinate our objectives. At the same time, Russia has blown hot and cold over its relationship with NATO, and one can understand this since Russia always saw NATO as the fundamental adversary. For people in the West to expect that Russia will join NATO or will even enjoy an easy relationship with NATO is probably unrealistic. Russians wanted something more general in terms of cooperation.

There's also a geostrategic aspect if we are talking about a missile defense system that will protect both Europe and the United States against any future potential missile attacks from somewhere in the southern parts of Central Asia. Technically, yes, it makes sense for us to make use of resources the Russians have in terms of radar or possibly even intelligence. But that has proven to be very, very sensitive politically within the West and remains an unfulfilled promise.

**Back to Libya and another quote. Sir John Major was recently quoted as saying the EU and NATO would be lost if Qaddafi clung to power. Do you agree with that?**

**Dr. Howorth:** I think that's putting it rather strongly. The United Nations Security Council Resolution 1973 simply calls for military action to protect the civilian population of Libya. To a certain extent, that has been achieved. Yet, in

their joint editorial a few weeks back, President Obama, President Chirac and Prime Minister Cameron upped the ante by explicitly saying that they would not rest, and NATO should not slow down on its efforts, until Gaddafi has left power. In that respect, this might well prove to have been a statement of intent that doesn't provide the means to deliver. If Qaddafi were to succeed in staying on in power and if Libya were de facto divided or partitioned, then in one sense the precise Libyan objectives of the Europeans and of NATO could be said to have failed.

But I do not think that if Qaddafi were to succeed in clinging to power one could say that NATO and the European Union's CSDP would be "lost" as such. Both entities will continue to exist and they will continue to develop their capacity. They will engage in further missions in the future. But failure in Libya would certainly be a major blow, a political blow, to an operation which has gone off in rather ambiguous circumstances in terms of its precise military objectives.

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# The Future of CFSP, CSDP, NATO, and Transatlantic Cooperation

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**T**he European Union (EU) is an emerging actor in the fields of foreign and security policy predicated on mainly soft power values and policies. The EU's policies in the fields of the Common Foreign and Security Policy (CFSP) and the Common Security and Defense Policy (CSDP) are based on unanimity and intergovernmental decision-making preserving the national veto. The Lisbon Treaty of December 2009 largely retains this status quo position and is best described as being a consolidating treaty as opposed to being a revolutionary, reformative treaty.<sup>1</sup> The sovereignty of the member states of the EU in the areas of defence and foreign policy is maintained in those fields due to national interests particularly those of the larger member states. Britain, France and Germany have global diplomatic and economic interests, which transcend the borders of Europe. They collectively determine the shaping of foreign policy objectives in the CFSP/CSDP and have been accused of being a de-facto "directoire" in EU foreign policy-making, which also occasionally includes the likes of Italy and Spain depending on the issue.<sup>2</sup>

European foreign trade policy is perhaps the most integrated of the Union's external policies and arguably has the greatest impact in the global environment.<sup>3</sup> The EU uses its economic and trade prowess in the world as a geopolitical tool to attain compliance in the absence of equivalent military and political power. This is particularly the case in respect of developing countries, which have less bargaining power; the EU also prefers bilateral trade agreements as this gives it more bargaining power.<sup>4</sup> If the EU is anything it is an economic actor, partly because it has developed in this manner since the early 1950s and partly because its member states can see the benefits of external economic integration in the world economy.

The broader transatlantic trade relationship is deeply interconnected and interdependent at the level of trade, banking, goods, services, manufactures and

capital. Each side of the Atlantic depends on the other to a great degree for its economic strength in the globalized system of trade preferences. Indeed:

“The transatlantic mechanisms created in the process of institutionalization [in the post-War period] have led to the creation of dense networks between the EU and the US. These networks, in turn, became transatlantic decision-making forums. Here, communication between EU and US counterparts forms the closest thing there is to a transatlantic ‘policy process’.”<sup>5</sup>

Europe and America account for over half of the world’s Gross Domestic Product (GDP), they have the largest bilateral trade relationship in the world economy, and as such are arguably necessary partners in the global political economy. The EU exports 18 per cent of all its exports to the US (compared to 8.4 per cent for China) and imports 11.4 per cent of all its imports from the US (compared to 18.9 per cent for China).<sup>6</sup> The transatlantic economy also shapes global trade investment flows as both the US and Europe are the primary targets for other countries trade and investment in the world economy. This arguably gives Europe and America the power to structure the world economy, in spite of the rise of China in recent years.

EU policy is somewhat less integrated in diplomatic and broader in foreign policy terms. The EU has engaged in intra-European foreign policy cooperation since European Political Cooperation (EPC) was instituted in 1970.<sup>7</sup> Over the past four decades EU has encouraged its member states to “Europeanise” their national foreign policies and the Union has developed a “coordination reflex” based on the daily practice of cooperation.<sup>8</sup> The member states expect to coordinate and harmonise their national foreign policies in an **Europeanised, multilateral manner through a quasi-European lens** because of decades of cooperation and learned behavior. However, the EU’s decision-making systems for the successor to EPC the so-called CFSP/CSDP are still intergovernmental and are subject to unanimity.<sup>9</sup> In some ways the larger member states – particularly Britain, France and Germany – use CFSP/CSDP to pursue their own national interests. Both Britain and France seek to lead CFSP/CSDP as another avenue to punch above their weight in the realm of international relations beyond their medium sized power status. In this view the EU is just another venue for national foreign policy interests to be projected into the wider world. Britain, France and Germany do not have the global reach in politico-military terms that the United States (US) has. Hence the “big three” in the EU do, to an extent, use the Union as a foreign and **defence policy multiplier to ratchet up their own global presence**. The same point applies even more so to the smaller EU member states as the Union gives them a global platform that they would otherwise lack.<sup>10</sup> Germany seeks to hide its power in the world and pursues a strong trade policy, with no global military policy to speak of apart from peacekeeping, security sector reform and the carrying out

of wider Petersberg Tasks.<sup>11</sup> Berlin is still the civilian power par excellence that can straddle Europe and America and remain friends with both without actually “normalizing” its foreign policy despite being labelled a laggard by the US in military terms. Germany is a product of its history and post-war democratic political culture and finds the use of force a non-issue in its own foreign policy.<sup>12</sup>

In strictly foreign policy and diplomatic terms the EU is a longstanding actor in its own right, based on intergovernmental cooperation between its member states. New capabilities and institutions have been added in an ad-hoc fashion to EU foreign policy since the St.Malo Summit between Britain and France in December 1998, which mainly deal with crisis management, and Petersberg Tasks.<sup>13</sup> The Union today has a High Representative of the Union for Foreign Affairs and Security Policy, its own diplomatic corps called the European External Action Service (EEAS) and a range of European-level institutions to underpin the EU’s foreign external actions. However, EU foreign policy still largely rests on national foundations, despite ongoing efforts to build capabilities for the future.<sup>14</sup> Nevertheless, the new institutions are embryonic in terms of their operation, but the EEAS in particular has the potential to become a supranational diplomatic arm of European foreign policy.<sup>15</sup>

In terms of defence policy the EU is an embryonic actor in comparison to the economic and diplomatic fields. Indeed, the EU does not per se have a defence policy: instead the Union has a defence profile that is largely based on intergovernmental cooperation and predicated on national sovereignty.<sup>16</sup> The EU also suffers from a capabilities-expectations gap in defence terms.<sup>17</sup> The CSDP relates to the field of crisis management and encompasses both civilian and military doctrines. Since 2003 the EU has undertaken over twenty civilian missions and military operations, most of which fall under the civilian heading.<sup>18</sup> Military crisis management operations rely on national funding from the participating countries and are used to underpin civilian missions’ objectives.<sup>19</sup> This explains why the Union has mainly tackled civilian crisis management missions - the Union finds it difficult to collect funds for military missions from the participating member states.<sup>20</sup> The military missions are themselves used for broadly humanitarian purposes confirming the EU’s status as a “soft power”, built upon civilian power foundations.<sup>21</sup> Additionally, the Union lacks a central command structure for force projection. The defence of the

“*EU policy is somewhat less integrated in diplomatic and broader in foreign policy terms.*”

European homeland is actually conceived of in Europe as being under the umbrella of the Atlantic Alliance (even though Europe has no existential threats to its security at present) whereas the EU pursues more autonomy in crisis management missions under CSDP structures that in the end still heavily rely on US assets.<sup>22</sup> National armed forces in Europe are also organized along national lines and the loyalties of élites and masses alike are with the nation-states where **defence is concerned**. Few people would “die for Europe”, their identities are still nationally oriented.<sup>23</sup> Europe also lacks a distinctive, supranational strategic/military culture that could bring together national militaries effectively, but the EU does, and in contradistinction, projects a distinctive political culture to the outside world that is predicated on normative “soft” power and civilian power mechanisms.<sup>24</sup> Additionally, national militaries in Europe have not been making the necessary changes to their armed forces to adapt to the European level and for rapid reaction, although Britain and France will increasingly cooperate in military terms to boost European capabilities and save money.<sup>25</sup> Indeed, European militaries are cooperating more closely together – as in the Lisbon Treaty’s Permanent Structured Cooperation<sup>26</sup> – than ever before.<sup>27</sup> Finally, and perhaps most importantly, the key threats that Europe faces are internal-security related within EU borders and relate to justice and home affairs that have also begun to translate themselves into EU foreign policy objectives externally.<sup>28</sup> This means that the actual need for the EU to have a grand strategy in the world is arguably questionable if internal European threats are the drivers of foreign policy. It also probably means that the Atlantic Alliance is not the best institution to manage these security-related issues as opposed to defense-related problems.<sup>29</sup> The conclusion of EU’s Lisbon Treaty (2009) and the conclusion of the North Atlantic Treaty Organization (NATO) Summit in Lisbon on the renewal of the Strategic Concept in November 2010<sup>30</sup> has seen the emergence of much common ground between the EU and NATO as complementary institutions, particularly in the fields of crisis management and Petersberg Tasks.<sup>31</sup> Others argue that the EU can only pursue successful policies in the fields of freedom, security and justice if the EU has a cohesive sense of internal and external security threats and the policies to address them in the fields of foreign policy, defense, development and external economic policy.<sup>32</sup> Furthermore, the security threats actually facing the EU and its member states today are increasingly complex and arguably require that the Union attempts to shape world events to manage those threats in a cohesive manner and further to influence the structure of global politics to avoid irrelevance in the world.<sup>33</sup> A strong EU-NATO relationship is important in this regard. Additionally, nobody can predict what security threats Europe will face in the future and a comprehensive strategy may be needed to address them or at least to have the option of deploying military forces both regionally and globally. In a slightly different vein, there are those in the Brussels institutions who see CFSP/CSDP as a component part of the broader integration project to build European political union along federal lines.<sup>34</sup> The European federal project has been ongoing since the

early 1950s and is mainly based on the Community method of technical functional integration.<sup>35</sup> Thus far, the areas of **defence and foreign policy have not been subject** to this method and continue to be based on intergovernmental cooperation between member states.

### EU Foreign Policy in the Context of Transatlantic Relations

What does this all mean for transatlantic relations? In particular, what does the forgoing mean for EU-US relations and EU- NATO relations?

Washington's primary security focus in the past decade has been the "war on terror". Most EU member states have not followed the US lead and have tended in the main to follow legal soft power approaches whereas the US has utilized a mixture of soft and hard power.<sup>36</sup> Indeed, most European states would not define counter-terrorism as fighting a war. Instead, they prefer to utilize legal means to curb the al-Qaeda threat. Why is this? The majority of EU member states lack military capabilities. The Union is not a state and lacks the legitimate monopoly of the means of violence. Therefore, even if the EU wanted to treat the post-9/11 period as a "war" it could not. As Zielonka has stated:

The Union has no effective monopoly over the legitimate means of coercion. It has no clearly defined centre of authority. Its territory is not fixed. Its geographical, administrative, economic and cultural borders diverge. It is a polity without coherent demos, a power without identifiable purpose, a geopolitical entity without defined territorial limits.<sup>37</sup>

Additionally, the EU has developed as a soft power legal actor since its inception in the 1950s. There is also the empirical fact that America was attacked on September 11 and therefore feels itself as being under attack and at war, whereas Europe does not. Furthermore, the Obama Presidency has been lukewarm towards Europe, focusing on Asia-Pacific and Latin America in US foreign policy.<sup>38</sup> In the President's worldview Europe needs to shape up, take responsibility for some of the world's problems and stop "free-riding" on the US for its parochial security needs in order to avoid decline as a global actor.<sup>39</sup> There have also been transatlantic disagreements in recent years on how to respond to the global economic downturn, trade reform and climate change.<sup>40</sup> Then there is the lack of Europe-wide support for the American led International Security Assistance Force (ISAF) counter-insurgency operation in Afghanistan and for out-of-area operations more generally.<sup>41</sup> This led the US Secretary of Defense Robert Gates to criticise several European states – particularly Germany – for not doing enough to assist the US in the Afghan operation.<sup>42</sup> The implication is that Washington will gradually withdraw resources from Europe as it perceives that

the European states are incapable of helping the US broader strategy in the world. This is further compounded by the fact that the recession has negatively impacted on defence spending in Europe<sup>43</sup> sending a message to Washington that the Europeans do not intend to increase capabilities and hence commitments to transatlantic and global defense.<sup>44</sup> The Europeans also lack key military capabilities such as intelligence, heavy-lift, command and control and sea power.<sup>45</sup> This also makes the Europeans less useful to America in the context of NATO-led operations throughout the world. However, Washington does regard CSDP as having some utility under a NATO umbrella for operations in Europe and the region in the context of executing crisis management and Petersburg Tasks.<sup>46</sup> This is where the EU can have an impact by niche marketing its limited military capabilities under CSDP within the context of humanitarian operations thereby making the EU-NATO relationship complementary in this area at least. Furthermore, as is mentioned above, Britain and France have also renewed military cooperation to boost European defense capabilities in areas such as rapid reaction working alongside NATO and CSDP as in Libya in early 2011.<sup>47</sup>

## Conclusion

As is mentioned above, Europe and America are deeply intertwined in the world economy; this in itself necessarily keeps both sides of the Atlantic in a state of close cooperation. Interests and values are seemingly aligned in the economic field. On the surface Europe and America seem to diverge more seriously in the **defence and security** fields. Post 9/11 the EU and its member states individually have broadly supported the US in its “war on terror”. However, whereas Washington has used a mixture soft and hard power, the Europeans have tended to use almost exclusively soft power instruments. Indeed, many European states do not see the utility of using force to combat the threat of terrorism and instead **favour the use legal and economic** means to address with the problem. It must also be said that the EU and its member states lack world-class military capabilities (save Britain and France) and this exasperates American foreign policy élites and both political parties in Washington. There is a feeling in the US that Europe is in decline and cannot add anything to American capabilities around the world.<sup>48</sup> Secretary of Defense Robert Gates has hinted that Europe will become less relevant in the American grand strategy because it has not grasped the nettle of making itself more useful in the management of international security. Indeed, Secretary Gates has stated that European demilitarization is a threat to world peace.<sup>49</sup> This view arguably underplays Europe’s role in the world through civilian power tools. As Wallace has argued the EU plays an important role in the management of global security via its aid, trade, and development policies and well as being a good multilateral friend to the US.<sup>50</sup> The EU and NATO have also reached some degree of complementarity on crisis management and the Petersburg Tasks working together for the greater European and transatlantic

good. Additionally, the bilateral relationship in trade between the EU and US is the cornerstone of the global economy. Collectively, at European and transatlantic levels all the behind the scenes diplomacy contributes much to the stability of the international system. Indeed, as Calleo points out, both sides of the Atlantic seem parochial and adrift without each other in a political, economic and military sense.

<sup>51</sup> Perhaps European soft and normative power has a role to play in the transatlantic relationships of the future alongside European and American “hard” power, as do the CFSP, CSDP and NATO as part of that broader core transatlantic relationship.

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# The Travails of the European Union at the United Nations

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Since the Lisbon Treaty entered into force on 1 December 2009, representatives from European Union member states and institutions have spent a considerable amount of time and energy trying to create the European External Action Service (EAS) and the office of the new High Representative of the Union for Foreign Affairs and Security Policy. The appointment of Baroness Ashton as High Representative, her rocky period in office, and the bureaucratic and institutional battles over the EAS have made headlines across Europe. The fiercest battles are over, and the EAS is up and running (if not yet at full steam). But one area where the implementation of the Lisbon Treaty is still in flux is the European Union's relations with the United Nations. Indeed, it is still not clear how the Lisbon Treaty's provisions will be applied in this case, and the situation is further complicated in that the battles are not only 'internal' – within the EU – but external, with other members of the UN. A dramatic illustration of this came on 14 September 2010, when a majority in the UN General Assembly defeated an EU resolution to create an 'enhanced observer status' for the EU at the UN. EU member states had argued that such a status was necessary because they had to comply with the Lisbon Treaty; other UN members did not accept that the EU should have such a privileged position within the General Assembly.

How has this situation come about? Under the Lisbon Treaty, the High Representative is to organise the coordination of EU member states' actions in international organisations, and to express the Union's position in international organisations. In practice, the coordination is done by new 'EU delegations' to the international organisations, which replace the old delegations of the European Commission, and EU delegation officials are to speak on the EU's behalf in organisations such as the UN.

Why have these provisions created problems for the EU at the UN? First of all, the member states remain full members of the United Nations; they are not being replaced by an EU seat. Indeed, all EU member states value their roles at the UN – as a cursory examination of any of their foreign ministry websites would show. They have long agreed, however, that they will coordinate their positions within the UN. Before the Lisbon Treaty entered into force, the rotating presidency (held by each member state in turn for six months) organised the coordination; now the High Representative is to do so. The key issue here is that member states may not always agree. A recent example of this is the vote in the UN Security Council on 17 March 2011, when Germany abstained on Resolution 1973, which allowed limited military action against Libya, while France and the UK pushed heavily for it. In another part of the UN, the Human Rights Council, the member states have regularly been divided in votes on Israeli actions. If the member states are divided, then it is obvious that there is no EU position to be expressed in the UN.

Secondly, the Lisbon Treaty indicates that if the EU member states do agree a common position, then it is to be expressed by the High Representative. This is quite a change, in that the rotating presidency would no longer be the ‘voice’ of the EU in UN bodies. This creates several dilemmas for the EU: before 2009, the European Commission occasionally spoke for the European Union in the UN, and it had ‘observer status’ at the UN. Observers speak after all other UN states speak, and are granted less speaking time than states. In contrast, the EU presidency, because it represented a grouping of states, often spoke at the beginning of debates (along with states representing groupings such as the African or Arab states). The new EU delegation, inheriting the observer status, would also inherit the limitations on its ‘voice’. In replacing the presidency with the EU delegation, the EU loses out – and even more so if the EU member states do not speak in their capacities as UN members, as 27 voices would be reduced to only one.

For these reasons, in New York the EU and its member states decided to push for a new ‘enhanced status’ which would give the EU delegation more privileges during debates in the General Assembly. Yet other UN members had their reasons for objecting to this. If the EU demands a special status,

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*A larger question here is whether the UN should be divided into regional blocs*  
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then why can't other groupings? The United States, for one, is concerned that the EU's request would spark similar moves by other groups. Other groups have exactly the opposite concern, in that the enhanced observer status should not be exclusively for the EU.

A larger question here is whether the UN should be divided into regional blocs. There are ideas floating around for the membership of the UN Security Council to be based on regional seats, for example. This would be a radical shift in the practice of multilateralism – and for that reason, is unlikely to happen. But it would be wise for the EU to think about the wider implications of its attempt to force the rest of the UN to make special arrangements for it.

In the Human Rights Council, the EU is often outvoted and isolated. Why? Because there are strong blocs functioning there, who will always be able to win debates and pass resolutions because their members outnumber the EU member states (and EU 'allies') in the Human Rights Council. For example, the Organisation of the Islamic Conference calls upon its member states to vote together, and oppose measures that run counter to OIC objectives and values. The OIC is a voting bloc of 57 states, and has successfully pushed its own resolutions (often focusing on Israeli violations of human rights) and blocked initiatives (often supported by EU member states) that it doesn't like. Given that EU member states are in a minority at the Human Rights Council, it is imperative that the EU reaches out to the wider HRC membership, to build support for its positions. But building cross-cutting coalitions is difficult if blocs are united against the EU. In a UN dominated by blocs, the EU loses out. It is hard to see how in such a situation the EU can push for the 'effective multilateralism' it so often declares is one of its core strategic objectives.

Paradoxically, then, to maximise its influence in multilateral bodies such as the UN, the EU may have to minimise its "actorness". This is the uncomfortable position of a Union that is clearly not yet a state, but is more than just a loose regional group. The EU may find it has to be more flexible in terms of the exact extent to which the Lisbon Treaty provisions are to be implemented in international organisations.

# Turkey, the Libyan Crisis and Climate Change: Impacts on EU Security Policy

Interview with **Dr. Michael Werz**  
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**UNITED STATES**

**International Affairs Forum:** In light of Turkey's current problems with EU accession and their increased economic ties with Iran and Syria, how do you view Turkey's current place as a security partner with the EU?

**Dr. Michael Werz:** Turkey's place is one of great importance. It is not only in the immediate vicinity of the European Union but it also has historical ties for to Europe like no other country. This is true even though we are witnessing the establishment of a new geopolitical space: The new Levant, the region encompassing Turkey, Syria, Lebanon, and Jordan is becoming a reality. And that has greatly enhanced Turkey's reach as well as its geopolitical weight.

It's also important to recognize that Turkey has been long married to Europe, so to speak—mainly because it was one of the most important contributors to NATO in military terms and its migrants played a pivotal role in reconstruction Europe after the devastation of WWII.

With regard to NATO it is often overlooked that during the Cold War, Turkish society at large has provided more to guarantee European security than many of the core European countries themselves. Turkey has also participated in European security defense policy missions such as in Macedonia, Congo, Bosnia, and Kosovo.

This all indicates that Turkey is of great strategic importance to the European Union. And the fact that with the end of the Cold War, the country with steady demographic and economic growth has become interconnected with a much broader region once again and that has only increased its importance.

**How would you view their importance in a peace-making role with Muslim countries in the Middle East?**

**Dr. Werz:** There are different answers to that question. Turkey has the ability to be an effective actor, but does not always

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## Turkey has a lot of potential to play an important role [as a security partner] and be an effective actor

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live up to its potential. One problem that is hampering Turkish efforts and undermining the country's standing in the region and also within the Western community is that the governing AKP's policy towards Israel has basically frozen a formerly stable relationship. It also seems sometimes that Ankara has a bias towards Hamas that is ultimately counterproductive and not serving Turkey's own interest. If Turkey wants to be a honest and relevant broker in the region it has to pass the litmus test of the most difficult problem in the region, which is of course the conflict of Palestine.

Having said that, one also has to acknowledge that the current Israeli government did not make managing this relationship easy for Turkey. One might think about the flotilla incident where Islamist activists wanted to send several boats towards the Palestinian territories and when Israeli commandos boarded those boats, eight Turkish citizens and one Turkish-American citizen were killed.

Despite these tensions, Turkey's importance for the United States was reflected by the fact that President Obama tagged on a visit to Turkey in his first trip to Europe in April 2009. Turkey is an important strategic partner not only for the U.S., but also for Europe because it is a point of reference for

many of the aspirations of many people in the Middle East and Near East region. One could say that Turkey is the West of the East -- a society that is fairly open, fairly democratic, and it is very lively in cultural, economic and political terms. That makes it a point of identification not only for people in northern Africa and the eastern Mediterranean, but also in the Arab world.

So the twofold answer to the question is: Turkey has a lot of potential to play an important role and be an effective actor. It certainly has a geopolitical position and the bandwidth and the way to do so. But it also depends on how Turkish foreign policy will evolve in years to come and if Turkish society manages a difficult but necessary constitutional reform process that is likely to be after the elections in June.

**Internal issues within the EU states have sprouted during the recent military intervention in Libya. In light of this, what do you think these issues bode for EU security policy and their ability to address potential future actions in the future?**

**Dr. Werz:** A difficult question. It is not only that the counterproductive German decision to reject the implementation of a no fly zone was one that might have

been influenced by domestic political considerations. It would also be fair to say that, to a certain degree, the opposite of the equation represented by the governments of France and Italy, which massively argued in favor of an intervention, also was influenced by domestic considerations.

At the same time it is important to acknowledge that historically the European Union has never been a monolithic foreign policy actor because foreign policy is still determined by the member states. And there has been a lack of European coordination before—for example, during the first Balkan crisis and the major divisions over the second Iraq war. So this is nothing new.

Even though the European countries are currently attempting to develop a Common Foreign and Security Policy, this is not really going to be a game changer because power still has a national origin. Political power in the European Union is still established and consolidated within the realm of national politics and not within the realm of European policy. That is also reflected by the fact that recently appointed High Representative of the European Union for Foreign Affairs and Security Policy is not really a major political figure in her own country.

So, this is not an entirely new development. But given that in the immediate European neighborhood Turkey is becoming a regional player, the Palestinian conflict is continuing without

any solution, and in light of the massive transformations in Northern Africa, there is increasing need for a more consistent EU foreign policy.

**Climate change concerns are, in turn, increasing security concerns around the world. What steps is the EU taking towards addressing this security area?**

**Dr. Werz:** The European Union is doing quite a bit in this field. It has established the EU Climate Action Commission that identifies climate security as a challenge—similar to the last Quadrennial Defense Review of the Pentagon. The consequences of climate change obviously include rising food prices, health issues, rising sea levels, and migration. Here again, Europe's proximity to Northern Africa is of importance because the fact that climate change has an impact that is speeding up migration patterns on the African continent is clearly bringing Europe into the mix.

It is also clear that the EU traditionally, especially Germany for historical reasons, have a fairly elaborate development policy over a number of years and the Europeans have fairly large development agencies comparable to what the USAID does here in the United States. These are certainly institutional conditions which allow the Europeans to become players in this emerging field of security and climate issues.

In addition, the European climate

initiatives have been much more far reaching than here in the United States. In 2008, the Europe Climate and Energy Package said that by 2020 there should be a 20% carbon dioxide reduction, 20% use of renewable energy, and 20% improvement in energy efficiency. Then, of course, there is talk about a cap and trade system.

So, overall Europe is in a good position to be a strong partner for the United States in discussing how to interconnect security, development and climate policies. As a matter of fact, the German mission and the Portuguese mission at the United Nations have made this a core issue in their two year Security Council term. In May they started with their first event in New York, where the nexus of security and climate issues are being discussed. This is a perfect fit for ongoing discussion in the United States. Last year, for the first time, the Quadrennial Defense Review mentioned climate change as a threat enhancer. The Quadrennial Diplomacy and Development Review, that has been pushed by Hillary Clinton and the State Department, is a document that is discussing these issues.

So there are interesting debates going on in Europe and in the United States that's allowed us to evaluate the security issues tied to climate change and look at future possibilities of foreign policy cooperation in different parts of the world.

# The EU and the War on Terror: More Than Meets the Eye

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**T**he EU is keen to use its military power. This is a line that many outside of Europe would be surprised to read. It is also a line that more than a few officials in Brussels would rather not publicly acknowledge. Yet, when it comes to the war on terror the EU is willing to roll up its sleeves, flex its muscles, and use all means necessary to prevent terrorist attacks similar to the 2004 Madrid and 2005 London bombings.

Often portrayed as a normative power that prefers to use international norms and institutions to achieve its foreign policy goals, the EU has showed that when it comes to its own security all options are on the table. In the specific case of the war on terror, international norms do not apply. Terrorist networks and sympathetic governments targeting the EU do not abide by international law. Therefore, EU officials do not feel it is sufficient to resort to international norms and institutions to strengthen security. Normative power Europe might be a nice buzzword, but it does always not apply in practice.

## Counter terrorism or the unfinished business

Counter terrorism is one of the areas of greater activity of the EU in the war on terror. The attacks on New York and Washington in 2001 were a wakeup call for Americans. The bombings in Madrid and London had a similar effect on Europeans. Certainly, EU officials had been aware that Europe was a target for Islamic terrorists for a long time. But many European citizens still believed that they were safe and that once autochthonous terrorist groups were under control the EU would be spared from terrorist attacks. After this belief was shattered in the worst possible way, the EU stepped up its game.

The European Security Strategy of 2003 had already identified terrorism as one of the five key threats to European security. The Strategy also identified different ways to fight this threat using intelligence, judicial, police and military measures and was further developed in the Counter-Terrorism Strategy, finalized in 2005. Published only four months after the

London attacks, the document made clear that the EU would use all available means and act in as many places around the world as necessary to combat terrorism. To an extent, the EU has acted on its promise.

Several EU member states have their armies fighting in Afghanistan and Iraq. Even though the EU per se does not have an army, member states involved in these wars cooperate with each other and in some cases even operate together. Moreover, the EU does have a EU Police mission in Afghanistan (EUPOL) to train the country's police forces. Military intelligence gathering is a central component of Brussels' counter terrorism strategy, showing the EU's willingness to use military tools in this field.

Police and judicial cooperation among EU member states has been strengthened since the publication of the 2005 Strategy. Thanks to the coordination work carried out by Europol and Eurojust, it is increasingly difficult for terrorist suspects to move from one member state to another to escape police investigation, something that was surprisingly easy only fifteen years ago. Since the establishment of Europol in 1999 and Eurojust in 2002 police forces and prosecutors from EU member states have had a common legal framework within which to fight terrorism. However, some member states are unwilling to channel resources into these areas, preferring to concentrate on issues such as tackling illegal immigration or enhancing energy security.

Intelligence is the area in which cooperation among EU member states has been weakest, and as a result the EU has been unable to fulfil its potential. The EU's equivalent of the CIA is the Joint Situation Centre, which has been home to a Counter-Terrorism Group since the 2001 terrorist attacks in America. However, the Centre's human and financial resources have been extremely limited when compared to those allocated to Europol and Eurojust. This might change following the entry into force of the Treaty of Lisbon, since the Centre is now integrated into the European

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*Intelligence is the area in which cooperation among EU member states has been weakest*  
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External Action Service that will institutionalise EU foreign policy. To date, however, the Centre's record has been poor.

Another problem with the EU's counter terrorism strategy is the alleged unwillingness of member states, which are less threatened by terrorist networks to take a larger share of the burden of terrorism prevention. France, Germany, Italy, the Netherlands, Spain and the UK have been very active in shaping and implementing a common EU counter terrorism policy. They have also been the largest providers of funding and intelligence to Europol, Eurojust and the Joint Situation Centre, along with Sweden. But other member states have been unwilling to date to treat terrorism as a central threat to European security.

Counter proliferation or an integration success

Counter proliferation, or non-proliferation in Brussels' jargon, is the second area of greatest activity of the EU in the war on terror. But differently from counter terrorism, the EU's counter proliferation policy is much better defined and more effectively implemented. Crucially, the proliferation of WMD is an issue of concern to all EU member states, making cooperation easier. This is an area in which normative power Europe definitely does not exist. The EU is comfortable using its military muscle to ensure that WMD do not reach the hands of terrorist groups and so-called rogue regimes.

Proliferation has been a major concern for European countries since the 1980s. Indeed, the 2003 European Security Strategy called it "potentially the greatest threat" to the security of the EU. The Strategy against Proliferation of Weapons of Mass Destruction, published two days before the Security Strategy, along with two other documents published earlier in 2003, enunciated the pillars of the EU's counter proliferation policy: action against proliferators, stable international environment, cooperation with key partners, and development of EU internal structures.

Building on its diplomatic and technical capabilities, the EU has been working with Armenia, Kazakhstan, Russia and Ukraine through political dialogue and technical support programmes to manage and, when possible, dismantle the nuclear programmes of these former Soviet republics. Putting its money where its key security interests are, the technical support programme has been generously funded since it began, shortly after the collapse of the Soviet Union. The EU has been successful in helping these countries manage their nuclear power plants and ensuring that no technology is transferred to unreliable third parties.

At the international level, the EU is one of the most active actors in the Nuclear Non-

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Proliferation (NPT) regime. Brussels presented a common position of all EU member states at the 2005 and 2010 review conferences. Baroness Catherine Ashton, the EU's High Representative for Foreign Affairs and Security Policy, spoke for the EU at the 2010 conference, providing Brussels with a seat at the table and a common voice. The EU has been publishing working papers on NPT safeguards since 2007, all of them jointly agreed by all member states. If there is a matter on which all EU countries agree it is their position with regards to the NPT.

The willingness of the EU to use coercive tools to control the proliferation of WMD has been most clearly demonstrated through the Proliferation Security Initiative. Initially conceived by the George W. Bush administration to intercept transfers of WMD and related materials, the initiative has been most successful in intercepting shipments going to or coming from the Middle East. The EU and all its member states participate in the initiative and several of them have deployed their navies to give military support to interception activities.

In addition, the EU and its member states have been closely involved in drafting and implementing UN Security Council and bilateral sanctions on Iran. Tellingly, EU sanctions have been even tougher, showing Brussels' willingness to go beyond what the international community deems proper action. Given that the EU is Iran's largest trading partner and oil export market, its sanctions have had a real economic impact on the Iranian regime.

Thinking about the future

The counter terrorism and counter proliferation policies of the EU are well developed. Nonetheless, there is certainly scope for Brussels to improve its role in both areas.

To begin with, counter terrorism policy coordination among member states is still limited. Asking all member states to agree to send their troops to war, as some have done in Afghanistan and Iraq, might be a step too far. But the fact that police and judicial cooperation and intelligence sharing are still not a priority for many member states hinders EU efforts to implement a coherent policy. The recently created area of freedom, security and justice should ensure better coordination and, in theory, strengthen the capabilities of those member states weaker in these areas. However, as discussed, political will is still lacking in many member states. The recent financial crisis and European sovereign debt crisis have not helped in this regard.

Intelligence gathering is a second area in which Brussels must also work harder. Some member states have modern and well-resourced intelligence services. The

British MI6 and the French DCRI are two examples. However, other member states have not shown much commitment to surveillance of terrorism suspects and WMD shipments. Top notch human resources exist, but political commitment to equip them with sufficient material resources does not. The work of the Joint Situation Centre depends heavily on the material provided by five or six member states. This has led some of them to develop stronger ties with the intelligence services of other countries, most notably the CIA. Differences between the intelligence services of Eastern and Western Europe is to be expected, given that most of their high ranking directors were recruited during the Cold War or shortly afterwards. But differences among Western Europe's intelligence communities do exist, and are unlikely to disappear any time soon.

Finally, the EU needs to become more involved outside of its immediate borders. Brussels has often been accused of focusing too much on its neighbouring regions. This is counterproductive for an EU that wants to be treated as a superpower and which claims to be a central player in global governance. The bilateral dialogue with India on nuclear issues initiated in 2005 was a step in the right direction. However, this has not been followed up with more activities elsewhere. Technical training and intelligence gathering outside of the EU neighbourhood have been especially weak. Given the transnational and globalised nature of today's security threats, it is not possible for the EU to protect itself effectively without improving its work in other regions of the world, never mind be considered a leading power. The European Security Strategy recognized this. The Treaty of Lisbon is a step in the right direction. Now it is up to the member states to allow Brussels to become a global player.

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# The European Union: a Quietly Rising Global Smart Power in the 21st Century?

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**S**ixty years after the birth of the European integration project, which was aimed at creating a peaceful and prosperous European continent in the aftermath of World War II, it has become a popular exercise for political pundits to assess Europe's standing in the world.

One of the most noticeable fads is the declaring of the impending end of the EU's global ambitions. Pointing to the rise of China, the decline of America, and the seeming inability of Europe to keep its own affairs in order, commentators have found it easy to at best ignore the EU, or even discount it entirely. Such arguments are headline grabbing, but flawed for at least three reasons.

First, these arguments are premised on a massive shift in global wealth and power to the South and the East. This shift is taking place, to be sure, and the old international order is giving way to one shared by non-Western rising states. The current international order – made up of open and rule-based relations embedded in institutions such as the United Nations and the so-called Bretton Woods institutions – must learn sooner rather than later how to accommodate new global players in meaningful ways. Decades of talk about reform of these institutions must lead to action today.

Yet the international order isn't really under threat. As John Ikenberry has pointed out, today's power transition is taking place within – not in contradiction to – the existing international order. China, for instance, needs that system and the rights and protections it affords. It's the hierarchies within that system, once dominated by the U.S. and Europe, that are changing – not the system itself. The old powers must make room, but they aren't being pushed to the sidelines. Paraphrasing Ikenberry, the United States and Europe will no longer dominate the international order as

they have been doing for decades, but they will still need to uphold it. This system requires maintenance, protection and support. Often seen as a more credible player than the United States, Europe, with its long commitment to multilateralism, is well-placed to lead this reform drive.

Second, overly negative predictions of the EU's role in the world are rooted in assumptions about shifting levels of economic power. The BRICs (Brazil, Russia, India and China) we are told, are rising in economic strength and will soon leave Europe behind. Europe, on the other hand, isn't in a position to stop this, since its periphery is in economic flames and its center is preoccupied with crisis management.

And on top of the current economic and financial crisis, lingering structural problems, ranging from an aging population to chronic unemployment to growing government deficits, suggest that European countries will stand little chance of competing against the booming economies in the global South and East. This crude generalization, however, presupposes a future based on the status quo, where Europe is doomed to inaction.

Yet Europe isn't doomed to inaction, although it does indeed face a pressing need to rebuild its financial system and boost competitiveness. With half a billion citizens, a fourth of the world's economy and almost a fifth of global trade, Europe remains an economic giant. Although the euro is currently facing serious problems, the financial crisis is also likely to prompt new powers at the European level to increase political coordination. There's a very real possibility that a stronger Europe will rise from the ashes of the current euro crisis. Moreover, the EU's services sectors, the last of the internal market initiatives requiring implementation, is an untapped source of economic strength, accounting for over 70% of the EU's aggregate GDP, but only a fifth of its global exports. So Europe can still keep up with other global players, and as others falter (even China certainly will at some point), Europe's economic assets will remind the world that economic fluctuations are a relative, not absolute, question.

Third, these arguments rely heavily on the belief that military might will remain a fundamental source of political strength in the years ahead. Few can dispute the fact that capability to project power requires a strong military presence, and that the EU's efforts to build a military capability have faltered of late. Although Europe isn't likely to become a full-fledged hard power, at least not in the foreseeable future, it still needs to continue developing its military capacities.

Despite attempts since the mid-1990s to bolster the EU's hard power capabilities, European countries still spend less than half of what the U.S. does on defense. Furthermore, the so-called "Helsinki Headline Goals", stipulating that the EU

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is to have 60,000 troops on stand-by for overseas crisis management missions, remain unfulfilled. Moreover, as the recent military operation in Libya has once again reminded us, European countries still have a long way to go before having the unilateral capacity to project power anywhere close to that of the U.S. These shortcomings are further compounded by the spending cuts on defense in the wake of the economic and financial crisis. France and the UK, which together constitute two thirds of the EU's overall defense capabilities, have already taken concrete measures toward further reductions in their respective defense expenditures. But inadequate capabilities aren't the only problem for the EU's ability to project hard power; lacking political will is an equally salient factor. As seen during the Libya crisis, some EU member states (notably Germany) are still opposed to the EU playing any sort of military role during crises, even in response to a humanitarian crisis.

Nevertheless, Europe still has a critical role to play in global security. Modern security problems will continue to be divided between clear crises and more disparate threats stemming from the forces of globalization. To rehearse an important but oft-forgotten adage, guns do not solve all of the world's security problems. Rebuilding states, deterring cyber-sabotage, suppressing terrorism and strengthening critical infrastructures are equally important tasks in today's complex multidimensional security landscape as the ability to launch military operations. To succeed in the long term, with reconstruction and with promoting sustainable peace in fragile societies, a mix of civilian means such as police and judicial support, security sector reform and development assistance is required. Here, the EU's wide array of civilian instruments gives it a critical, even leading, role in addressing complex, transboundary security threats. As a global "soft power", Europe accounts for roughly half of the world's total development assistance (whereas the U.S. only accounts for a fifth), and it's a leading actor when it comes to environment and human rights issues. With the Lisbon Treaty, the EU has also beefed up its diplomatic presence around the globe. The new EU "State Department", the European External Action Service (EEAS), now exists side by side with the national representations. Taken together, some 94,000 European diplomats are today stationed across the world, giving the EU unsurpassed diplomatic clout.

So, let us not discount the future of Europe quite yet. Europe still has the potential to play a strong and meaningful role in the international order, global economy and multidimensional security environment in the years ahead. In a world where both hard and soft power matter, the EU can leverage what it has of both to fulfill the prescription for "smart power". But to do so requires action now to take steps that will enable it to fulfill these functions. We outline three areas where urgent reform is needed:

- Take ownership over its role as a reformer of international institutions. The EU should encourage reform of international institutions such as the UN and the IMF and the World Bank, even at the cost of a receiving a declining say within these same organizations. In particular, the EU could create task forces to lead reform in these organizations with the ambition that they should better reflect the broader global leadership, while also strengthening the principles of good governance and effectiveness in their programs. While a single EU seat at the UN Security Council is unlikely, consolidating European representation at the IMF is a realistic option. This would enable rising powers to assume more responsibility, while also strengthening European power in regards to promoting a Europe that's a more united and effective partner in the global economy.
- Place economic competitiveness first on its global agenda. This would include both unlocking the internal market and boosting free trade deals internationally.

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*...the EU can leverage what it has ... to fulfill the prescription for ‘smart power’. But to do so requires action now...*

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It's estimated that completing the single market could produce growth in Europe of about 4% of GDP over the next 10 years. This would bestow EU countries and companies a stronger geo-economic base in a world of other continental-sized players. Moreover, the EU must do more to make itself a focal point for the global exchange of ideas, people, capital, goods and services through encouraging entrepreneurship and innovation at home, and strengthening its innovation networks around the globe. Finally, the EU must also continue promoting free trade deals with countries both in its neighborhood and beyond. The recent success in setting up a Transatlantic Economic Council and reaching a single sky aviation

agreement with the U.S. should create the impetus to revive the idea of a Transatlantic Free Trade Area.

- Provide value added for its member states by supplementing and helping the creation of stronger crisis management capacities. This would include working towards economies of scale in procurement and joint deployment of military

capabilities. The agency in charge of improving European defense capabilities in the field of crisis management, the European Defence Agency (EDA), has been widely criticized for its lack of success in encouraging greater collaboration. More efforts should therefore be put in toward boosting the EDA, including strengthening the agency's ability to monitor national defense budgets. In addition to hard power capabilities, the EU also needs to add more value in terms of "early warning capacities", assisting the member states with intelligence, analysis and assessment of today's security problems. Finally, to bolster its ability to mobilize its hard tools in a joint fashion in the midst of crises, EU countries should also seek to develop a stronger strategic culture. A new strategic process in Europe, for example aimed at revising the European Security Strategy (ESS) from 2003, could certainly be helpful in this regard.

Ultimately, rumors about the Europe's death are greatly exaggerated. The European Union still has great potential to play the role of an important global player as the challenges of the 21<sup>st</sup> century require access to both hard and soft power resources. The EU already has plenty of both, but should devote attention to continuing to strengthen its power recourses while also enhancing its ability to put these into efficient use in a smart way.

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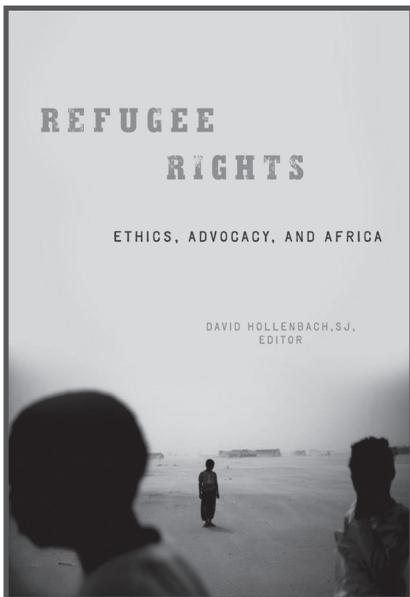
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# Not Your Mother's Central Bank

**George A. Peiler & Jens F. Laurson**

**UNITED STATES, GERMANY**

**W**hat is a central bank? The term conveys a state-controlled, usually or at least nominally independent of partisan politics, supplier of money and credit: The lubricator and back-stop for a nation's financial system, the "lender of last resort". The honorable tradition of central banking in the 20<sup>th</sup> century posited central banks as a stabilizing force, managing economic conditions with disinterested objectivity while warding off avoid inflation and currency debasement.

Not an easy job, and met only with limited success by the Federal Reserve in the US. Low points were stagflation in the 1970's after floating the dollar and the 2000's tech-bubble bust-boom. The European Central Bank (ECB) and its national predecessors have a more consistent reputation for sticking to business despite varying economic fortunes of the European Union and despite considerable political pressure in the 2007-2008 crisis to 'do something'. Through ups and downs, the central banking template has retained its reputation as a defender of confidence in a nation's currency and thus economic stability.

In recent years the Fed and the ECB have evolved into more political entities, indeed into major economic players in the political process. At the heart of this is the very explicit addition of a new goal for central banks: the facilitation of economic growth. This underlies a process that may have been under way for a long time, but the 2008-2009 meltdown-and-recovery of western economies has changed the nature of central banking. Forever? Hopefully not.

United States Federal Reserve

This transformation is particularly notable in the United States. Never entirely free of

a political function, the Fed has been commanded to report to Congress its goals and projections on inflation, growth, and unemployment. It has been one of the principal regulators of the financial system (including banks with state-granted, rather than federal, charters, and holding companies of banks which may also offer diversified financial services). In 1977 it was additionally tasked with monitoring ‘redlining’, the (alleged) denial of or allocation of credit away from low-income areas, often with a suggestion of racial bias, and various other miscellaneous consumer protection laws.

These regulatory functions are very much at odds with its monetary policy responsibilities and, at a minimum, should be separated by a ‘Chinese wall’. Better yet, they should be relocated to a separate consumer protection agency or divided among existing financial regulators not tasked with monetary duties. Unfortunately, the newly ramped-up Consumer Financial Protection Bureau has made matters worse, being housed in the Fed itself, funded by the Fed, and thoroughly insulated from political accountability. Somehow this regulatory baggage hasn’t yet undermined the Fed’s traditional central banking mission of maintaining financial stability through regulating the money supply—at least in most public and political minds.

Three striking developments might change this yet, and may make the Fed a ripe (or rather: riper) target for criticism:

- The Fed’s role in TARP and the bailouts of US companies since 2008
- Its decision to explicitly and directly purchase US public debt to hold down costs of government financing
- The enactment of the Dodd-Frank legislation overhauling financial regulation

In 2008, when financial companies, and eventually manufacturers (like the automakers), faced their own financial meltdown, no one questioned that the Fed would and should stand ready to provide credit as the lender-of-last-resort. But instead of limiting itself to that role, the Fed, in cooperation (or collusion) with the US Treasury, bailed out individual firms and participated in political decisions as to who would fail and who would be rescued. The Fed made loans to support the sale of Bear Stearn’s assets when that investment bank failed, for example, and it bailed out AIG (“too big to fail”), while letting Lehman Brothers go to the dogs.

The Fed’s role in TARP was (and remains) less explicit and more subtle: the Fed provided emergency cash and credit to many financial institutions, several of which also got TARP funds, and helped facilitate the AIG bailout. The Fed has also regulated payback of TARP funds, for example by bank holding companies, deciding when and whether they could pay back their TARP debts. Of course, many of those debts were

pushed at financial institutions at the peak of the financial crisis, when investment banks and other nonbank financial firms converted to holding companies, even at institutions that wanted nothing to do with TARP. Ironic, then, that the Fed now sets financial standards for certifying institutions to be 'sound enough' to get off the TARP welfare rolls.

It would be foolish to think that TARP would have happened if the Fed had not backed the Treasury at every juncture; in consultations as well as by using its lending powers to support marginal firms (not all of which survived). Most important of all, the Fed has supplied and continues to supply money to the faltering US economy by buying Treasury bills, keeping Fed funds rate low and real interest rates as close to zero as possible, setting aside any concern about inflation and commodity price surges—not to mention the value of the dollar—in favor of heading off, at all costs, a theoretical threat of deflation. In all of this, the White Houses (first George W. Bush's, now Barack Obama's) and their respective Treasury officials were intimately involved, even calling the shots. None of which seems very 'independent' for an independent central bank.

This brings us to "Quantitative Easing", "QE" and "QE2", as they're abbreviated, with "QE3" already rearing its head. They constitute the Fed's determination to buy enough US government debt and other securities to keep pressure off interest rates and restrain the cost of unprecedented levels of US borrowing. The Fed essentially compensates for the failures of US fiscal policy and its actions increasingly blur the line between its steady-as-you-go responsibilities and the assumption of an inappropriately political role.

There is more—and likely worse—to come: The Dodd-Frank financial regulation law institutionalizes the Fed as a direct actor in the political arena. Under Dodd-Frank, the Fed—in conjunction with the Federal Deposit Insurance Corporation (FDIC)—is responsible for interpreting that law's "too-big-to-fail" rules and definitions. In short, the financial regulators, including the Fed, are to identify in advance which financial firms (very broadly defined, by the way) are so large that their failure would damage the US economy. They are then supposed to manage and structure reforms of those firms (including the option of liquidation) to prevent a potentially catastrophic failure. The problem, of course, is that once you list such firms, they become magnets for investors seeking low risk (since we know the government will guarantee them, one way or the other), to the detriment of equally or more important firms that don't make the cut. The result will be a sea of moral hazard that will make the Fannie Mae/Freddie Mac cases—pushing subprime lending with implicit taxpayer guarantees, one of the main ingredients of the last crisis—look like child's play.

## The European Central Bank

The case of the ECB is less dramatic and (so far) less severe than the politicization of the Fed, but it is headed in the same direction. The ECB has held a more consistent line on monetary policy and can't be accused of buying up EU member states' debt as the Fed does with the US. But it has been successfully pressured to purchase Irish, Greek, and Portuguese debt as part of the 'save the euro' campaign. Given that Europe has also agreed on a permanent bailout facility for European states at risk of sovereign debt default, an agenda heavily promoted by Nicolas Sarkozy and Angela Merkel, the ECB's bailout role may be difficult to unwind. The reluctant participant in these debt purchases is the outgoing ECB head Jean-Claude Trichet, and no obvious successor has the reputation of being nearly so firm in defense of pure central banking. With the office being a political appointment (ensuing heavy EU political horse-trading), it is reasonable to assume the ECB will take on a more explicitly political role henceforth, similar in kind, if not degree, to that of the Fed.

While TARP and the Fed's bailouts of financial firms were taking shape in the States, the ECB did not object to these policies but chose not to follow the Fed's lead. Where the principled difference lies, though, between bailing out firms directly, as in the US, and bailing out nations that can't service their debts (partly because so many non-bailout firms themselves fail), is hard to see.

### Consequences

There have been and will be consequences for this evolution (ECB) and incipient revolution (Fed) of the central banking function. The Fed's commitment to monetizing debt has already lead to calls for supplements to the dollar as a world-reserve currency, if not its wholesale replacement. As part of Dodd-Frank, the Fed now houses and funds, independent of any direct control by Congress, a consumer financial protection bureau with a near-unlimited mandate to probe the actions of financial firms. Congressional calls for direct and constant oversight of the Fed are reaching

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banking function.*

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record levels as it becomes increasingly apparent that the Fed is the most critical player in the American political economy without direct accountability to either the legislative or executive branch— ultimately to the voters. Whether the subsequent politicization of the Fed would be desirable is another matter altogether. ‘Democratic control’ of central banking is in many ways a fiscal nightmare. But the fault lies with the Fed for moving so far away from pure central banking in the first place: To be a political player demands – sooner or later – playing by political rules, however ugly they be. At this increasing rate of political-economic activism without accountability, it’s not just the likes of Ron Paul demanding an end to the Fed.

In Europe, meanwhile, the ECB is constantly being brought into the public debate over a Euro-stabilization regime, including a permanent revolving fund to ‘resolve’ the fiscal problems of Eurozone nations on the brink of insolvency. It is hard to see how the ECB will stay out of Euro-politics in circumstances where the next bailout (Portugal, most imminently) seems always just around the corner.

Some of this damage could possibly be avoided by reverting to original central bank principles. One such principle is that central banks should not have the power to regulate the very entities they bail out, no matter what regulatory powers they hold. If the US wants the Fed to be the premier financial regulator, it cannot also have it function as Bailout Central. If Europe wants the ECB to provide liquidity to at-risk states to bolster the Euro, it must understand that the credibility of the ECB as defender of fiscal soundness will be put at risk which could ultimately result in more at-risk states across Europe. Crises like the 2007-2009 financial meltdown can certainly produce necessary innovations in policy. They can also produce quick-and-dirty solutions with disturbing long term consequences. The recent history of the Fed and ECB shows more of the latter than the former.

# Fed Taking Right Steps Forward

*Interview with* **Dr. Joseph E. Gagnon**

Peterson Institute for International Economics

**UNITED STATES**

**International Affairs Forum:** Would you compare and critique the response of the major Central Banks to the economic crisis to date?

**Dr. Joseph E. Gagnon:** The Federal Reserve and the Bank of England were much more aggressive than the Bank of Japan and ECB. The Bank of England actually was a little hesitant at first but then, a few months into the crisis, it really changed gears. Now of course you might say the crisis was more centered in the United States and the United Kingdom but there were huge problems in Europe: Spain, Ireland, and Germany. Japan was less affected in many ways financially, although they did suffer a huge loss of exports and a big drop in GDP. All four economies were hit with a very big macro shock to their economies but the financial sectors were hurt more in the United States and the United Kingdom than in Europe, and not as much in Japan.

On the macro side, the Federal Reserve

and the Bank of England reacted more and faster than the other two banks. In fact, the European Central Bank never cut its rates in the first stages of the crisis. Even in the summer of 2008, because oil prices were high, they raised rates and people here (in the U.S.) were surprised at and wondered what they were thinking. But finally the ECB did also ease and the Bank of Japan even eased a little bit, although not much. The Bank of Japan is clearly the most timid of these and has never really given Japan the monetary policy that the economy needs.

I think aggressive action by the Fed and Bank of England was good. Moreover, once they got to a zero interest rate, the Bank of England and the Fed did more, and started buying long term bonds and trying to push down the longer term interest rates, which the ECB never did. It's amazing that the effect on output in this crisis was less in the United States than in Europe or Japan, despite the fact that it was more centered in the United States than it was in Europe or Japan. I

Timeline of Central Bank Responses to the Financial Crisis				
Japan	United States		United Kingdom	Euro Area
	increased liquidity and expanded term loans to banks, narrowed spread on discount window loans	Aug 2007		increased liquidity and expanded term loans to banks
	increased term liquidity to banks, lowered policy rate 100 b.p.	Sep 2007 through Dec 2007	frontloaded bank reserves, widened reserve target range, increased term liquidity to banks, loan to Northern Rock, lowered policy rate 25 b.p.	frontloaded bank reserves, increased term liquidity to banks, provided dollar liquidity through Fed swaps
	increased term liquidity to banks, began term loans to primary dealers, established term securities lending, loan for Bear Stearns, lowered policy rate 225 b.p.	Jan 2008 through Apr 2008	established term securities lending, lowered policy rate 50 b.p.	increased dollar liquidity through Fed swaps
		May 2008 through Aug 2008		raised policy rate 25 b.p.
increased term liquidity to banks, supported CP market, provided dollar liquidity through Fed swaps, increased JGE purchases, lowered fee on security lending, lowered policy rate 40 b.p.	increased term liquidity to banks, supported CP market, broadened collateral accepted, began outright purchases of agency securities, loans for AIG, Bank of America, and Citigroup, lowered policy rate 185 b.p. and guided down future expectations	Sep 2008 through Dec 2008	increased term liquidity to banks, provided dollar liquidity through Fed swaps, broadened collateral accepted, lowered policy rate 250 b.p.	increased term liquidity to banks, increased dollar liquidity through Fed swaps and provided swiss franc liquidity through SNB swaps, broadened collateral accepted, narrowed corridor between standing facilities, lowered policy rate 125 b.p.
began outright purchases of CP and short-term corporate bonds	began purchasing longer-term Treasury securities and expanded purchases of agency securities, began to support ABS market	Jan 2009 through Aug 2009	began purchasing longer-term gilts, corporate bonds, and CP, suspended reserve targets, lowered policy rate 150 b.p.	increased term liquidity to banks, began purchasing covered bonds, lowered policy rate 150 b.p.

From *Central Bank Responses to the Financial Crisis of 2007-2008: The Case for Further Action*, p. 102 By Joseph E. Gagnon, Peterson Institute for International Economics

attribute that to a more aggressive, better policy.

### **What about their efforts in the financial bailout and dealing with troubled banks?**

**Dr. Gagnon:** There again, Japan was not really affected but the United States, Europe and the United Kingdom were affected a lot. Banks in all those regions, and other financial institutions in all those regions, had serious trouble and some failed. In all three cases, the central banks behaved roughly similarly. Here you have to combine the central banks with the governments. It's not just about the central banks, it's about the whole government--central banks working with government finance ministries together. In each region, I think they did what they needed to do to keep the system from collapsing.

### **Do you think the U.S. should have stepped in to save Lehman?**

**Dr. Gagnon:** What Chairman Bernanke has said is that because of the framework that we had in the United States at the time, it was not strictly legally possible for them to save Lehman Brothers. The Federal Reserve can lend in emergencies only if the lenders put up collateral realistically valued at more than the loan. In the case of Bear Stearns and AIG, that was just barely possible. To this day, the collateral that Bear Stearns and AIG put up is actually more than the value of the loans. In fact, the Fed has made money

on those loans.

Lehman just didn't have any collateral. If you look at the Lehman bankruptcy proceedings as they've gone forward, the bond holders of Lehman Brothers are getting pennies on the dollar. Lehman didn't have underlying assets that it could put up for the Fed. They thought they could basically fool someone into buying them. Lehman thought that they had some people lined up in the UK to buy them, and the UK regulators said no. People in Korea looked at them and the Korean regulators said no. They couldn't get anyone to buy them because anyone who looked at their books ran away scared. They knew this company had a huge hole in its balance sheet.

If the Fed had bailed out Lehman, maybe things would have gone better, but the Fed would have lost money and it really would have been violating the law because they wouldn't have had collateral. Perhaps the Treasury could have done it somehow. Perhaps the Fed could have pretended there was collateral--that's what many people think they did with Bear Stearns and AIG--but they didn't. They took those rules seriously and Bernanke was not about to do this without strong support from Treasury. At this point, I think Paulson was angry with Lehman and didn't want to. So between Paulson's anger and Bernanke's law abiding caution, there was no bailout for Lehman. You can argue whether that was the right thing or the wrong thing to do. Lehman Brothers was not a commercial bank, it was not

in a framework with examiners the way commercial banks are. But yet it turned out to be every bit as important. Who knew?

What you want to do in a crisis is lend freely to banks that have good collateral, that are fundamentally solvent, or that would be solvent in a more healthy economy. The solvency of banks is closely tied to the health of the economy and so, if you have a sick enough economy, almost every bank will be insolvent. If you have a strong enough economy, almost every bank will be solvent. The rule is you lend to solvent banks. The trick of it is though, how do you define what a solvent bank is? I think that Lehman turned out to be insolvent under any definition, although Bear Stearns and AIG may have been, at least under an optimistic good case outcome, solvent. In fact, this can be proven because the Fed is not losing money. So, I think this is what they all did and I think it was good.

### How do you view the situation today?

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The US certainly has problems fiscally but there is something fundamentally fragile about the way the euro area is set up

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**Dr. Gagnon:** In the US, it seems that we've dealt with the problems of the sub-prime mortgages and the aftermath of that. The Dodd-Frank legislation last

year pushed things in the right direction but I'm not convinced it's nearly enough. Ideally, there should be much more robust systems and triple layers of fail-safe mechanisms so that banks don't get into these kinds of troubles again. So, I think Dodd Frank goes in that direction but I think we could go a lot more.

### Dealing with Fannie and Freddie --

**Dr. Gagnon:** Exactly. We haven't decided what we're going to do with Fannie and Freddie and how we're going to deal with the mortgage issue going forward. We have other decisions to make and, even to the extent that we have made them in Dodd Frank, it could be more. There are international negotiations on capital standards for banks that are decided at a more international level, which I think are not aggressive enough but they're a step in the right direction and maybe there'll be more.

That's common around the world and there's not much difference in the US

and Europe, except for the Swiss, who are going a very different route. The EU, and Japan to some extent, are holding back what I think should be even tougher capital standards for banks; to make sure

they have enough capital, to buffer, to cushion against a loss. What you want is that banks have their own money and stockholders should have their own money at stake so that bond holders are protected and the first person to lose is the stockholder. Banks didn't have enough of that; it was only 4% before the crisis, that's just not much at all. The fiction was that bank loans are safe and they have a margin that's good enough. That's just wrong. Banking is a fairly risky business.

The Swiss are going for almost 20% capital, including something that's contingent capital, where it's a bond that if the bank gets in crisis, it turns into stock. That's good because the Swiss can't afford to bail out their banks, they're too big for their country. For anyone to deal with the Swiss banks, they have to have a substantial amount of capital. The Germans and others don't want to do this because they think it would be hard for their banks to raise that much capital. I think that's a big mistake. We should all be aiming for banks with 20% capital. People say that would raise the costs of doing business for banks but it would only be a little bit. It's probably a price worth paying for a safer system. 20% is still not a huge amount. In the early days of US banking, that was actually quite normal, and even higher ratios for smaller and riskier banks could have been 30 – 40% capital. But that's a decision that's done internationally and that's where we're going.

Of course, there's also the European sovereign debt crisis where the macro slow down and the bursting of some housing bubbles, especially in Spain, has exposed their economies to a lot of weakness, and caused their governments to have to bail out some banks at great expense and threatened their physical solvency.

### Is the US next?

**Dr. Gagnon:** The US certainly has problems fiscally but there is something fundamentally fragile about the way the Euro area is set up, in which there is no central fiscal authority, and no sense in which the ECB works hand in hand with a central fiscal authority and buys its bonds and regulates its interest rates for everybody. Each country in the Euro area has to sell its bonds on its own terms. There's not a unified bond market because each bond is actually paid off by someone different and there's no centralization.

It's like state governments in the United States where each state actually pays a different interest rate, and they vary across states depending on the solvency of the state. There can be a state bankruptcy, if you can imagine. In the Euro area, each country is like a state in the US. So the Fed doesn't buy state bonds in the US and it doesn't regulate and maintain their interest rates. Neither does the ECB in Europe, so the European countries have greater fragility in the way that US states have greater fragility.

In other words, any one state could get into trouble and people might stop buying its bonds, its bond rating might be lowered, and its interest rates might go up. Then its fiscal situation gets worse because now it can't really afford to pay the interest on its bonds. It gets into this escalating crisis when interest rates go through the roof. That can happen to a US state and it can also happen to a country in the Euro zone. It cannot happen to the United States as a whole because the Fed will always step in and buy treasury bonds to keep interest rates where they want them.

Now, at some point there could be a fight between the Fed and the Federal government because, even in our system, if the Fed wants to control inflation it may have to let interest rates go up at some point and the federal government may not like that. The Fed has ultimate authority on what the interest rate's going to be to get inflation down, but Congress could always change that law. I think a lot of investors think that if Congress really ran away with spending and couldn't raise the taxes to pay off the debt, they might take over the Fed and have us print money. That would be inflationary, and that would not be good. But it would not be a default the way Greece would default. It would not be a sudden non-payment, it would be a gradual inflating away of it. We could have a fiscal crisis in the US but it wouldn't be as urgent, it wouldn't be as dramatic, it wouldn't be as sudden as it was for the Europeans.

It's really much less about their monetary policy than it is about fiscal policy. The governments in Europe are negotiating, they're setting up a mechanism, and they're setting up rules. I think it's long overdue and they're always coming in the last moment. It's understandable that this kind of thing is difficult to do; it takes a crisis to make people do it. So far, they have managed to keep it together, but just barely. It's sort of a close run thing, you would like to see it planned out in advance better but it is hard to do that.

I think the euro area needs a much more centralized fiscal system where taxes are raised across the whole area and spending is set more centrally. But that would require giving up sovereignty. They're not there yet, but they're taking steps. Their approach has been to set up rules, set up a mechanism that lends in emergencies, but under strict conditions. It still tries to keep each country sovereign but it tries to force it to behave in a way that the group wants it to behave.

### **What about on the macro side?**

**Dr. Gagnon:** It is amazing to me that the US unemployment rate rose so high so quickly compared to these other countries. It's still a puzzle, people are still studying it. We know in Germany and a couple other countries in Europe, the government actually subsidized employers to keep employees on short time so they wouldn't be unemployed. I think that was a good thing and we

probably could have had a bit more of it here. But that doesn't explain the difference between the two countries. Employers are quicker to fire and hire in the US than they are in Europe but that difference has just been magnified in the past few years, and that is surprising. US employers were too quick to lay people off and have been too slow to hire them back in an unusual way. Compared to Europe the difference has been wider this time than it has before.

Now if you then look at just inflation and GDP or output, the US has had better outcomes and I think it reflects a better policy. We've been more aggressive at fighting this recession than the other countries. The Bank of England may be up there with us but the ECB has been more reluctant, and the Bank of Japan, very reluctant. If you can imagine, a sort of a spectrum with the US Federal Reserve and the Bank of England at the top and most aggressive and having the best results. Europe is having a slower recovery than the US, and had a deeper recession. I don't think inflation is really an issue for any of these economies.

**What effect has the crisis had on major countries outside of the areas you've discussed?**

**Dr. Gagnon:** Advanced economies like Canada and Australia weren't hurt as much, and the developing economies such as China, India, and Brazil weren't hurt at all, or very little. They're growing strongly again and, outside the big three-

-US, Europe and Japan--the world is growing strongly, and that's a little over half the world economically. They are putting upward pressure on commodity prices and production of commodities is just not keeping up. I think a lot of it is that these rapidly growing countries have a particularly strong demand for commodities. They are in a stage of their development where people really do want more cars, houses, other things with commodities in them, and of course, they need more energy. Contrast that to the US and Europe where, when we grow, we don't need more cars. We might have a better car but it doesn't have more commodities in it. However, China actually wants cars which it never had. That's very demanding on the world's commodity resources. Their growth is very commodity intensive at this stage of development. They're growing rapidly and they're putting upward pressure on commodity prices.

As we saw three years ago in 2008, the Europeans are very worried about the effect this has on inflation. These commodity price increases are very large, 20-50%. Big numbers. They are a small share of inflation, say 10%, but if that raises the inflation rate by 1 percent or a half a percent, that's enough to get the Europeans concerned, and they've been responding by raising rates.

This is a very different philosophy than what the Federal Reserve has, and to date, what the Bank of England has. The Federal Reserve cares more about the underlying inflation rate, which is dominated by wage pressures because

wages are the vast bulk of costs. They're 70% of costs or more, where commodities are 5 or 10% of costs. The Fed tends to ignore commodity prices unless they're expected to continue significantly over several years. But if you look at a futures curve for oil prices recently, they are actually perfectly flat, all the way out for the next 9 years. We had a big run up, but the futures market does not expect any further increases from where they are now. The Federal Reserve looks at that and says, we had the inflation already and the market's not expecting any more. If we were to raise rates now, it would not make sense because there's nothing we can do about the price increase we already had. The way monetary policy works is not through commodity prices, but really through wages. We basically have to throw people out of work and get them to accept lower wages and then that part of inflation would go down, to offset the higher oil prices, and the Fed does not want to do that.

But in Europe, they seem willing to do that. It's a different philosophy. I don't understand why they do it but I think the Fed is right not to think that they need to slow the recovery down and keep people unemployed longer when the cause of the blip in inflation is something that is outside their control and is not expected to continue. This is the big issue now, how to respond to commodity price increases. There are very different strategies on both sides of the ocean. I've talked to Europeans about this and what I've heard as a defense of this approach

is, well, we have a history in Europe that when overall inflation increases, which includes commodities, workers demand bigger pay increases, and we have to fight that. There's been some work, before the Euro was created, showing that in a lot of European countries in the past, the overall inflation rate, which includes commodities, was actually a better predictor of future inflation than the so-called underlying rate that strips them out. I've never fully understood why that is, but people claim it's true and I've seen some evidence that supports it.

In the US, that was not true. So there's a difference in how our economies behave to some extent. I suspect the euro area has changed and has become more like the US. If you look at the last five years, it has definitely not been the case that overall inflation has been a better predictor of future inflation. In fact, underlying inflation has been a better predictor because there was this big run up in overall inflation in 2008 in the euro area, which was followed by a collapse in 2009. In other words, underlying inflation did not respond to the runup in overall inflation caused by commodity prices. The underlying inflation rate actually cut through that swing. It was a better measure of future inflation. Even if the euro area behaved differently in the past, it is not behaving like that now, and therefore I would urge them to not worry so much about commodity prices.

**Any other thoughts on how the Fed and ECB are positioned towards addressing**

### the economic recovery in the future?

**Dr. Gagnon:** I would say that the Fed explicitly cares about unemployment in a way that the ECB does not, and that's written into the charters of both institutions. The Fed is actually told that its objectives are to maximize employment and have stable prices. The ECB is told that stable prices are its objective, end of story. Consequently, that can be pointed to as a big difference. A lot of people say in practice the ECB seems as if it does care somewhat about unemployment, but not as much as the Fed. In many periods, you'd say they behaved similarly. They respond to movements in the economy and try to stabilize inflation.

We're now in a period where they seem to differ a lot on commodity price. Commodity prices were rising back in 2008, and to me that explains some of their slowness to react to the gathering crisis, because they were looking at it as a gathering crisis on one hand, but on the other hand commodity prices were very high, so they were sort of torn, and the Fed was less torn and basically responded to the crisis. That was why they behaved differently then, and once again now it's coming up again, the commodity prices are important. Again, that difference is showing up.

# High Inflation Risk From Economic Recovery Policies

Interview with **Dr. Laurence J. Kotlikoff**

Boston University

**UNITED STATES**

**International Affairs Forum: What do you view as the successes and shortcomings of the Fed and ECB's policies in addressing the economic recovery?**

**Dr. Laurence J. Kotlikoff:** The ECB and the Fed have created a huge amount of money to stabilize their economies and the financial sector. In the process, they've also created the potential for very high inflation if not hyper inflation. I think they've succeeded so far in restoring economic growth, although it's not yet very significant, and they've also succeeded in stopping the failure of major financial institutions. So this can be judged to be a success.

But, as I said, the ECB and Fed have created a lot of money. In the case of the U.S., by the end of 2011, we will have more than tripled the base money supply compared to 2007. That lays the foundation for more than tripling the price level. There is a real danger from these banks that are now holding all this

money that's been printed, as a large part of their holdings are in the form of excess reserves. If the banks begin to lend out those excess reserves, which are massive, we could see prices take off quickly.

The other major concern is that the financial problems that were there and caused the crash in 2008 haven't really been addressed. We still have a highly leveraged "trust-me" banking system, providing no real disclosure as to what the financial intermediaries are doing with our money. For all we know, they may be investing in assets that are even more toxic than those they fraudulently produced prior to the crash of 2008. When people got a whiff of that fraud, they quickly ran on these institutions and they would have kept running had the Fed and ECB not stepped in. You're talking about a situation where only a handful of people at the top of these huge institutions have access to the true financial picture of those companies. In the case of Bear Stearns, there was Jimmy Cayne (a college dropout, who sold

Xerox machines and scrap metal), who got a job at Bear Stearns on the basis of his excellent bridge game and then ended up being the head of the firm. At some point, when the public looks at someone like that, who's purported to be smoking dope and was off playing bridge or playing golf during critical times when the bank needed supervision, they say forget it and all withdraw their money in a rush. Then, when you're highly leveraged, the bank doesn't have the equity to cover the run. You could have a 10%, 20%, 30%,... capital ratio -- it still wouldn't be enough if there's a fraud run.

We need to move from "trust-me" banking to "show me" banking and take the leverage out of the financial intermediaries. That's where my limited purpose banking proposal discussed in [Jimmy Stewart is Dead](#) comes in.

**Turning back to the ECB, what are your thoughts on their steps towards addressing the sovereign debt crisis?**

severe than those of Greece, Portugal, Ireland, Spain, and Italy, because we have an out-of-control healthcare spending problem. We have a sovereign debt problem as well. But the vast majority of our debt is implicit. It's in the form of unofficial IOUs, obligations to pay Social Security, Medicare, and Medicaid benefits as well as the new health exchange benefits. We also need to make defense spending and other discretionary expenditures. While the Europeans also have a lot of implicit debt, I think it's smaller as a share of GDP than ours, in large part because they have more control of healthcare spending than we do.

Whether here or in Europe, there is a real risk that fiscal problems could lead to another major meltdown of the financial sector. If countries start to default on the bonds they've issued, the banks holding these bonds may go under water. In this case, the countries will have to print money to try and shore up these banks on top of the money they've already printed. Then people will become worried that there will be very

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We need to move from "trust me" banking to "show me" banking and take the leverage out of the financial intermediaries

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**Dr. Kotlikoff:** The US and Europe both have major long term fiscal problems. I think the US fiscal ones are much more

high inflation or even hyperinflation. If you expect to see high inflation or hyperinflation and you're holding

deposits in the bank, what you want to do is take your money out of as soon as possible and buy something real, like a new sofa or television or car. So money becomes a hot potato when people get the idea in their head that there's going to be inflation.

My concern about the sovereign debt [issue] in these European peripheral countries is that if they do formally default, the banks will be forced to take explicit write downs. Then these banks could be formally declared insolvent and need to be bailed out. That could just trigger further expectation of inflation.

I think very shortly we're going to see something happen. I think the Germans' appetite for printing a lot of money to bail out Greece and these other countries is limited, and I think they're likely to say no more. In this case, Greece is likely to formally default or restructure its debt. If that happens, Greece could decide to go off the euro but then everybody who had money in Greek banks would run and try to get their euros out because they won't know what will happen with their euro accounts. That in itself, could trigger a run on the Greek banks. And a default could put the German and French banks holding Greek sovereign debt, under water. So you have risks either way. I think there is a way for Greece to proceed, but it's more likely they're going to do one of two things: go off the euro and, in effect, default; or just default directly and stay on the euro.

# The Issue of Insolvency

*Interview with* **Dr. Claudio A. Pardo**  
Washington International Finance Corp

**UNITED STATES**

**International Affairs Forum: The ECB and Fed have taken different approaches to address the economic crisis. How would you grade their results?**

**Dr. Claudio Pardo:** First, it's important to understand there are significant institutional, political, and historical role differences between the institutions. Both institutions start from a different perspective. The Fed, as the main monetary policy institution in the United States, has three simultaneous goals in its mandate. One is the pursuit of maximum employment. Another is stable prices, which is not stated very clearly but is presumed to be an inflation target in the CPI of about two percent. The last objective is moderate long-term interest rates. In the case of the ECB, the goal is very singular. It's only focused on consumer price stability, controlling inflation. They have set it clearly, below but close to two percent per year and have even defined a harmonized CPI for the Euro area. All this implies important differences between the two institutions

because the Fed really has three, sometimes conflicting, interests. So, which one of these competing mandates is going to be favored, and what does it mean when it comes to applying their monetary policy? As an example, the Fed is much less concerned about inflation than depression at this time; which is probably the right decision. That dilemma is not present in the ECB.

Another important difference is that the European Central Bank tries to stay clear of mixing monetary policy with specific fiscal policy actions by its euro-members. On the other hand, the Fed policies allow for little separation of its monetary policy actions from fiscal policy choices by the US Treasury. For example, the Fed has been very willing to buy Treasury paper directly in the marketplace and, by doing that, they are clearly supporting the US Treasury in financing a big fiscal deficit. Monetary policy instruments differ considerably between the Fed and the ECB precisely because they have different objectives

in maintaining separation of monetary and fiscal policy. The ECB prefers to buy paper issued within the financial sector, which is by and large private debt. They only get government paper indirectly as collateral to give liquidity to the banks that have these government securities in their portfolios; they discount them. That route is a more indirect way of supporting fiscal policy. This is not true of the Fed, which is acting much more directly on the government paper market.

However, all these things in the end are probably not that important when you look at what's happening in the real world marketplace. The results from the action of these two institutions have been practically the same. Both have inundated financial markets with liquidity. They have been very successful doing that and were able to mitigate the impact of the 2008-2009 financial collapse, avoiding another big depression like the 1930s. They did it by using different instruments and within the restriction of their own mandate, but they did it very well. Central banks in Europe and in the United States have been very good at providing the necessary liquidity to the market without causing a big leap in inflation—at least so far.

However, the problem for these institutions, and for the U.S. and European financial systems as a whole, is that there are big unresolved solvency problems in these economies and the financial system in particular. The question is, what do you do when some big institution becomes insolvent? You

can keep it from collapsing by providing it with sufficient liquidity as was done in the case of Freddie Mac and Fannie Mae. However, you cannot solve their solvency issues the same way—unless you are willing to own them for good and thus socialize the losses with the taxpayer taking the hit. In the non-financial business sector things tend to be simpler since in cases of distress it is easier to avoid the chain reaction normally associated with the collapse of a large financial player. The restructurings of General Motors or Chrysler were successful in part because there was much less contagion among other companies in the sector, and banks and other private creditors took most of the loss and reduced their claims on these two companies. More generally, the Fed and the ECB have contributed by creating the space and liquidity to make it possible for the financial system to support an orderly restructuring of companies which were otherwise healthy from an operational viewpoint. However, they have not really been able to be of much help to those—including many home mortgage debtors—facing much deeper solvency issues.

Even though central banks have been able to do much less with respect to solvency shortcomings in the banking system, they have helped by dropping funding rates for financial institutions. This has been particularly true in the United States where interest rates for financial institutions have stayed close to zero for an extended period now. That has helped with banks' solvency

because lending rates have not dropped as much as their funding rates, helping to boost profits nicely in the financial system. Whenever banks are given a good spread, they are able to recover fast. So many banks have been able to recapitalize in the past couple of years. In fact, the current bonanza of cheap funding has been appropriated mostly by the financial sector.

Contrary to the experience of past recessions, this time there has been much less refinancing of mortgage loans by homeowners. One of the main reasons is that the price of homes has gone down dramatically and many people are “under water”, holding negative equity. This illustrates the big problem being faced by the transmission mechanism of monetary policy, making this a very peculiar recession since much less of the benefits of a soft monetary stance by the Fed and ECB have trickled down to the final consumer.

Getting back to your question, when you ask how do we grade the approaches of the ECB and the Fed, my answer would be that the final outcome of their actions is still to be known. The game is still being played. We’re not out of the woods yet. Fiscal issues in the United States and the sovereign risk problems in the eurozone are significant. These are certainly going to have a decisive impact on the financial system. To give some examples, what is going to happen when the QE2 Treasury bond purchases are stopped at the end of June? Are we going to see the same enthusiasm for

Treasury paper we see today? That might cause hardship if we see rapid increases in interest rates. What happens if the increase in the debt ceiling in the United States gets delayed by political trouble? Plus, passing the 2012 fiscal budget in the US might face a real ordeal-- not to mention the financial problems faced by many state and municipal governments.

### **What are your thoughts on ECB effectiveness in addressing the sovereign debt crisis?**

**Dr. Pardo:** To a large extent the monetary stimulus of the ECB has have been effective in buying additional time, but overall, sovereign troubles in Southern Europe are primarily fiscal, and not necessarily financial system troubles. Very forcefully, the ECB wants to keep them that way.

The ECB continued to increase rates until 2008, when they rapidly dropped them until its reference rate reached one percent. However, contrary to the Fed, the ECB already started to raise its reference rate again. In fact, the ECB very recently raised its interest rate by 0.25%, and it is likely to increase it again soon. All this is an indication that they’re very nervous about inflation in the eurozone. Should they be so concerned? Probably more so than the Fed in the United States. Currently, inflation seems to be a little bit higher in Europe, and since price stability is the single mandate of the ECB, it makes sense for them to be very focused and concerned.

But, as I said earlier, the sovereign troubles in Europe originate and derive mainly from fiscal largesse—which has lasted for many years now. The ECB is fighting against a creditors’ haircut on sovereign debt since that would create major solvency issues in the banking sector of member countries, transforming a fiscal problem into a financial nightmare for the ECB. In fact, fiscal deficits in the Euro zone are likely to evolve into extremely serious financial/monetary policy tribulations if the resolution of current fiscal problems in Southern Europe and Ireland require going beyond a drastic fiscal structural adjustment in those countries. In particular, major Greek banks clearly would become insolvent overnight, and there is no easy solution to that problem or clarity about how to go about addressing the collateral damage. Mr.

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Trichet, the head of the ECB, has just pointed out the urgent need they all face of putting in place a greatly enhanced toolkit to address an eventual problem of insolvency of financial institutions in the eurozone. More to the point, I feel that an uncontrolled sovereign default in the eurozone would be the worst of all scenarios for everybody, including the U.S. Key decisions on the Greek fiscal package have to be taken very soon by the E.U. The risk of conditions deteriorating fast is very high—let’s hope there is some sort of a contingency plan in place if these risks eventually materialize.

**Some people believe that the institutions could stand to be reformed. Do you think either one of them would benefit from that?**

**Dr. Pardo:** Well, they actually have been reformed. For me the real question really is whether we need further financial and fiscal reforms in the developed world. From my experience in emerging economies, the pursuit of sound and in-depth financial and fiscal reform in the U.S. and Europe is an imperative today. This is not a new issue. From an international perspective, structural reform has been going on for a long time in the developing world. For example, my perception is that nations in Asia have been doing much better this time because they did their homework during the years following the onset of the Asian crisis.

As for particular reforms, new and enhanced capital requirements for banks in the new Basel III proposal are a good step forward. More has to be done to reduce funding risk and improve management of asset/liability imbalances – particularly for those banks using wholesale international financial markets to fund their operations. Also, ‘too big to fail’ was not resolved by recent legislation in the U.S. or Europe. The threat of high levels of potential moral hazard remains intact; that is, we still see a serious threat of a socialization of future losses incurred by large banks and key financial players. The taxpayer ends up paying while profits remain private, including high returns for management in Wall Street.

However, there is tremendous reluctance in any society for structural reform because it is painful. There is no substitute for that, though. When you really start looking at what is necessary to be restructured in the US and in Europe, you see that it is not only a question of institutional restructuring; it’s also that you have to change basic financial laws and regulations and fiscal conduct, adopt new and creative ways of conducting social policy and providing incentives to businesses. In the developed world at the technical level, experts will agree on basic things that have to be done. The main crisis is at the political level, mustering the political will to bite the bullet in order to make necessary changes. That’s not to say there aren’t some problems with professionals in the financial sector. For example, there are

too many regulators and supervisors in the financial arena in the United States and in Europe who are often competing and covering the same turf. There should be a consolidation of financial regulation and supervision at the national level as well as better integration and coordination on the international front. All this is likely to involve much work and really take a long time. The question is whether politicians and financial agencies are willing to take this long and arduous road and make the necessary compromises. I don’t know.

# Monetary Policy in the United States and the ECB: The Institutional Context and Recent Policy Issues

**Dr. Stephen Williamson**  
Washington University in St. Louis

**UNITED STATES**

**T**he Federal Reserve System (the Fed) and the European Central Bank (ECB) are of course both central banks. As such, they have a lot in common, but there are some striking differences, in terms of their operational approach to monetary policy, their relationships to the fiscal authorities in their jurisdictions, and in the policy problems they currently face.

## Monetary Policy

As is the case with central banks in most countries, in “normal” times, for example pre-financial crisis, the Fed intervenes in financial markets by targeting an overnight interest rate: the federal funds rate. The fed funds market is somewhat unusual, in that it has thousands of participants, including commercial banks (small and large), credit card companies (e.g. American Express), and government-sponsored institutions (the GSEs are FNMA and FHLMC: Fannie Mae and Freddie Mac). Since late 2008, the Fed also pays interest on reserve deposits held overnight with the Fed, and the Fed also lends to financial institutions at the discount rate, which is set above the fed funds rate. Thus, with the Fed now paying interest on reserves, it essentially operates on a channel system, where the overnight fed funds rate is bounded above by the rate at which the Fed lends short-term, and bounded below by the rate the Fed pays on deposits (reserves).

In normal times, the Fed’s role is, principally, to act as a financial intermediary that issues liquid liabilities – primarily currency, since reserves are normally essentially zero – to finance a portfolio of US Treasury securities. The Treasury securities are typically a mix of short-term Treasury Bills (T-bills) and long-maturity Treasury bonds (T-bonds), with open market operations (and repurchase agreements) in T-bills being the primary means for achieving a daily fed funds rate target. In late 2008 however,

this approach changed dramatically.

In response to the events of the financial crisis, the Fed ultimately dropped its fed funds rate target to a range of 0-0.25%, and began paying interest on reserves at 0.25% in late 2008. Further, it embarked on a massive intervention in financial markets, including a large quantity of discount window lending to financial institutions, lending in the commercial paper market, and lending to American International Group (an insurance company) among other things. Most of those interventions have now been unwound, but the Fed's balance sheet currently reflects two other large, important, and unprecedented interventions, often referred to as "quantitative easing" programs.

Quantitative easing is something of a misnomer, as the actions of a central bank must necessarily always involve the manipulation of quantities on its balance sheet. However, the key idea is that the fed funds rate is currently essentially at its zero lower bound. If the Fed wishes to be more accommodative under these circumstances, it certainly is not feasible to do this by lowering the fed funds rate target. Thus, beginning in early 2009 and continuing until mid-2010, the Fed executed what is now referred to as QE1, the purchase of about \$1.2 trillion in mortgage-backed securities (MBS), and about \$165 billion in agency securities, i.e. debt issued by the GSEs. While buying GSE debt is not much different than the purchase of T-bonds, since the GSEs were put under government "conservatorship" in fall 2008 anyway, the massive purchases of MBS was an unprecedented intervention by the Fed in private credit markets, in this case the mortgage market. By mid-2010, the Fed's balance sheet had increased to about \$2.4 trillion from about \$940 billion in August 2008.

Next, in August 2010, the Fed decided that it would begin replacing MBS and agency securities that were "running off" (due primarily to prepayments on the underlying mortgages in the MBS and maturing agency securities) with T-bonds. Then, in November 2010, the Fed embarked on QE2, a planned purchase of \$600 billion in T-bonds with an average duration of about 7 years, to take place over an 8-month period. At this time (mid-April, 2011), it appears that the QE2 program will conclude as planned. The Fed's balance sheet has expanded to about \$2.6 trillion in assets, supported by about \$1 trillion in currency and \$1.5 trillion in reserves on the liabilities side.

A key feature of the current operating environment of the Fed is that – as in any channel system for monetary policy when the quantity of excess reserves in the system is positive – short term interest rates are determined by the interest rate on reserves (IROR). A complication, which may or may not ultimately matter, is that the

IROR is currently set by the Board of Governors of the Fed, but the decision-making arm of the Fed is the Federal Open Market Committee (FOMC) which includes as members the Presidents of the regional Federal Reserve Banks. However, these Fed Presidents have no say in setting the IROR.

One way in which the ECB differs fundamentally from the Fed is that its primary avenue for intervention is not in the overnight market, and it does not seek to target an overnight interest rate. The key tool for the ECB is its main refinancing operations, i.e. the ECB manipulates the total quantity of ECB liabilities primarily by lending to commercial banks in the Euro area through a weekly auction of ECB funds. There are also longer-term refinancing operations, and overnight intervention through the marginal lending facility. The key interest rates set by the ECB are the interest rate on the deposit facility (the counterpart of the IROR in the US), the main refinancing rate, and the marginal financing rate (similar to the discount rate). The main refinancing rate is typically the mid-point in the “channel” formed by the deposit interest rate and the marginal financing rate. The overnight interest rate in the Euro zone is then bounded by the deposit rate and the marginal financing rate, though it tends to fluctuate in that channel substantially. Thus, this is a much different system than Canada’s channel system, for example, where the overnight market interest rate typically deviates little from its target.

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*The Fed’s key problem will be reducing its very large balance sheet to more normal size while ultimately increasing the IROR to contain inflation*  
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As the ECB is the central bank in a currency union, its relationship with the member governments in the Euro zone is quite different from the relationship between the Fed and the US federal government. The ECB holds some debt of the member countries on its balance sheet, but in normal times the composition of that debt by country is determined by a pre-specified formula, and the assets just sit on the balance sheet and are not actively traded in the way the Fed actively trades Treasury debt. Recently however, due to sovereign debt problems, particularly in Greece, Ireland, and Portugal, the ECB has come under pressure to purchase the debt of these countries. Making use of the ECB to monetize the debt of member countries is akin to making use of the Fed to

monetize the debt of California or Illinois, for example. While the ECB is secretive about the composition of its security holdings of member-country debt, it appears that the ECB has indeed intervened by purchasing the debt of Greece, Ireland, and Portugal, out of proportion to their sizes.

In terms of monetary policy actions since the onset of the financial crisis, the ECB acted to reduce its policy rates, and narrowed the width of the channel. In August of 2008, the margin between the deposit rate and the marginal financing rate was two percentage points, and the main refinancing rate was set at 4.25%. In May 2009 the width of the channel was set to 1.5 percentage points, with the main refinancing rate at 1%. Recently, the ECB tightened slightly by moving the main refinancing rate to 1.25%. The ECB has certainly not engaged in quantitative easing on the order of what the Fed has. Total ECB assets grew a relatively modest amount from 1.4 trillion Euros in August 2008 to 1.8 trillion Euros in April 2011. Further, the ECB is not holding a large stock of reserves, as is the case with the Fed. In August 2008, the quantity of deposits with the ECB was 90 billion Euros, and this grew to 30 billion Euros in April 2011, again a very modest amount relative to what has happened in the US.

### Looking Ahead

In the United States, the Fed faces some very difficult problems. The first quantitative easing program, QE1, was an unprecedented and large-scale intervention in private credit markets. Nothing currently prevents the Fed from, for example, purchasing the debt of General Motors, Chrysler, or any other private corporation, and circumstances could arise where pressure to do so could come from Congress, threatening the Fed's independence.

With respect to QE2, it is not clear whether this intervention is having any effect, and there is really no solid economic theory to support the notion that the Fed can in fact lower long-term interest rates through QE2, as Fed officials claim. By engaging in QE2, the Fed is effectively transferring interest rate risk from the private sector to itself. Most of the Fed's assets are now long-maturity, and it is very much in the business of borrowing short and lending long. Should the Fed have to tighten by increasing the IROR, this would cause capital losses on its asset portfolio, which would have to be made up somehow. The Fed could need a capital infusion from taxpayers, or would have to print more money, thus increasing inflation.

The Fed's key problem will be reducing its very large balance sheet to more normal size while ultimately increasing the IROR to contain inflation. Given the large quantity of reserves outstanding, the potential exists for a large inflation if alternative assets become much more attractive to banks relative to reserves. In its drive to

unload reserves to acquire other assets, prices will be driven up, unless the Fed has the resolve to increase the IROR sufficiently quickly. In this respect, the Fed is more constrained than is the ECB. The Humphrey Hawkins Act in the US specifies a dual mandate for the Fed, i.e. Congress dictates that the Fed conduct monetary policy so as to stabilize prices, but the central bank is also supposed to care about real economic activity. The Fed may not have the resolve to contain inflation if the economy is still recovering and if it cares sufficiently about the second part of the dual mandate.

The ECB does not have the Fed's problems, in that it does not have an inflated balance sheet, and it has already commenced the move to getting its policy interest rates back to normal levels. However, the ECB has a different set of problems, which indeed threaten its existence. There is considerable conflict within the Euro zone concerning the role of the ECB in solving the sovereign debt problems of the member countries, and this conflict seems to have put a smooth transition of power in the ECB in jeopardy.

# The Fed and ECB: A Study in Contrasts

*Interview with* **Hon. Delio E. Gianturco**  
George Mason University  
**UNITED STATES**

**International Affairs Forum:** As you see it, what have been the major differences over the last few years between the monetary policies of the Federal Reserve and the European Central Bank?

**Prof. Delio Gianturco:** While there have been significant differences, both organizations have shared the common objectives of long-term price stability, high employment, economic growth, interest rate stability and foreign exchange market stability. However, it would appear that the Fed has placed greater emphasis on employment and growth in the short term, while the ECB has particularly emphasized price and foreign exchange stability. In seeking to achieve these objectives, the two organizations have followed different approaches, most notably with regard to interest rates. The differences in circumstances of the Fed and ECB have contributed to the inherent strength of the U.S. economy, more certainty of support for its mission by major

economic and political players in the system, and appreciation of the basic homogeneity of the 50 states, which reduces concern about the differing effects of policy on its constituent units. In contrast, the ECB has been more heavily influenced by inflationary concerns because, unlike the Fed, price stability has been enshrined in founding documents and subsequent decisions as the primary objective of the organization. The secondary objectives of the ECB are to define and implement general monetary policy, to conduct orderly foreign exchange operations, to hold and manage the official foreign reserves of the EU, and to promote the smooth operation of payment systems within the Union.

**Do you perceive a major difference in Fed and ECB policies of helping non-member countries address their monetary and credit problems and, if so, why?**

**Prof. Gianturco:** Yes, I do. The U.S. Federal Reserve Board has been much more active in shoring up the finances of other governments and foreign financial institutions in the belief that their health and soundness are essential to American economic interests. As one example, the Fed has lent trillions of dollars in swaps to foreign-owned commercial banks operating in the U.S. One bank alone, Dexia Credit of Belgium, borrowed over \$2 trillion from the Fed. While sharing an appreciation for the interconnectedness of world finance, the ECB has not involved itself with non-member countries to the same extent as the Fed; so it has been heavily challenged by problems affecting the weaker members of the EU, which have required the extension of massive amounts of assistance to countries like Greece, Portugal and Ireland.

**How would you evaluate the success or failure of both Fed and ECB policies in addressing economic recovery?**

**Prof. Gianturco:** In answering this question, I will focus on the most recent data available, but bearing in mind that recent developments are not necessarily indicative of future success or failure and that unexpected events both within and outside of North America and Europe may be decisive in concluding whether current policies are appropriate. As of the end of the first quarter of 2011, the U.S. led the European Union in GDP growth, employment rates, retail sales growth, consumer and producer prices,

and wages and earnings increases. In contrast, the European Union led the U.S. in strengthening of its exchange rates, industrial production growth, international trade and current account balances, and government budget balances. However, both areas faced serious uncertainties which could upset these initial 2011 results: the U.S. faced a budget, national debt and balance of payments crisis which threatened to undo the progress of previous months and the EU was grappling with the myriad financial problems of its weaker members which could have the same effect. Early in the second quarter of 2011 the ECB raised its discount rate while the Fed publicly announced that it would keep the credit spigots open and cheap. Both policies have deep dangers: the Fed's expansionary policy, intended to revive American production and investment, has resulted in massive transfers of cheap credit to the rest of the world with accompanying global inflationary pressures while the EDB's tighter money policy has provided less stimulus to regional and global recovery and poses the danger of reversing progress in the area.

**It sounds as if some of the biggest differences revolve around the contrasting perceptions of current and future economic problems which can and should be affected by Fed and ECB policies, and the priority and timing of attacking the problem.**

**Prof. Gianturco:** I think that's correct

and believe the Fed has been basically more optimistic about economic recovery and growth than the ECB. The Fed appears to have placed top priority on maintaining low short-term interest rates and restoring a more normal and long-term yield curve so

and technological skills, wise and effective governance, and exogenous factors like commodity prices, war, famine, etc. Considering all these factors together, the International Monetary Fund estimated at the end of the first quarter of 2011 that the US would

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## the Fed has been basically more optimistic about economic recovery and growth than the ECB

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that investors would not withhold their money from more extended investment opportunities. The Fed has definitely been less concerned about inflation than the ECB, believing that rising commodity prices and other inflationary pressures can be brought under control by tighter monetary policy in the future and that deflation was a greater danger to recovery. Recent developments in world energy, food and metals prices, however, may change perceptions in this area.

have GDP growth of 3.0% in 2011 and 2.7% in 2012. At the same time, the IMF estimated that the EU would have growth of 1.5% in 2011 and 1.7% in 2012. If that indeed becomes the reality, most people would probably conclude that the Fed's approach was superior, conveniently forgetting that the ECB had fewer resources, less control, and a much harder job to do.

### **What do you think these differences in approach by the Fed and ECB augur for the future of economic recovery of the United States and Europe, and which organization has done the better job?**

**Prof. Gianturco:** The future of economic recovery is, of course, determined not only by monetary policy, but also importantly by fiscal policy, social factors and political harmony, the quantity and quality of natural and human resources, the encouragement of entrepreneurial

# The ECB's Telling Price Stability Fixation

Interview with **Dr. Jörg Bibow**

Skidmore College

**UNITED STATES**

**International Affairs Forum: Would you provide a comparison of Fed and ECB monetary policies since the economic crisis? And how you think each have fared?**

**Dr. Jörg Bibow:** From the beginning of the crisis, the ECB tried to completely separate the needs of providing liquidity to the markets and their monetary policy stance. If you look at the last hike in July 2008, which was about a year after the crisis became very severe, the ECB responded fairly flexibly by making more liquidity available, first through fine-tuning operations then by reforming their operating procedures. But as far as their monetary policy focus and stance was concerned, they remained preoccupied with inflation rates, a perception of them, that is. They even hiked interest rates in the summer of 2008, just a couple of months before Lehman. Actually, it seemed clear to me at the time it was a blunder. But at that point, there were some voices arguing that the ECB should be careful about inflation rates.

In retrospect however, few people would deny that that was a major blunder.

The ECB only started easing it in the fall, after Lehman, and in coordination with other Central Banks. In view of their past record, they eased relatively quickly. That is, if you would compare it to the slowdown after 2001 when they were extremely slow to ease. This time they were somewhat faster but still responded very late.

The Federal Reserve's response was very different. They realized much earlier that the situation was rather critical and cut interest rates much faster. As far as the provision of liquidity was concerned though, since August 2007, they perhaps took a little longer to reform their measures and procedures. So, in both regards, there were significant differences.

**So, do you think the Fed is better positioned to tackle the economic**

## recovery?

**Dr. Bibow:** Yes. First of all, it's related to the mandate. Secondly, to their different mindsets and approaches to monetary policy.

The Fed has a clear mandate to not just maintain price stability but also to aim at maximum employment. Given the labor market situation in the US, the Fed does not shy away from that responsibility. The crisis has left a huge problem in the labor market. We have delightfully seen some minor decline in the headline unemployment rate but the damage that has been done is better reflected in the employment population ratio, which is down very sharply. Boosting employment is the key task for policymakers in general, and for the Federal Reserve in particular. For that reason, I think the Fed will remain very accommodative, for quite some time.

Whereas the ECB has already started to hike again. Some people were surprised by their recent announcement that the next hike will come in July, not June. But that doesn't change the overall picture much. The point remains that the ECB believes it's trying to normalize monetary policy and they are, once again, exclusively preoccupied with inflation rates that they perceive, from somewhere. I can't see them, but they seem to see them. What have been their key mistakes, from the beginning, is they fear headline inflation. This has been pushed up somewhat over the last year, due to energy and food prices and also,

less well-known, increases in indirect taxes and industry prices, that make a very sizable contribution to headline inflation.

This is, of course, due to government policies. Almost all of the Euro governments are under extreme pressure due to the so-called Stability and Growth Pact (which today could be termed the 'Instability and Stagnation Pact'). They are under pressure to balance the budget. In order to do so, they hike indirect taxes and that pushes up inflation. This effect is very sizable. It's adding, at the moment, more than half a percentage point. That's very significant. It's also not new. It happened over 2002 and 2005, where the contribution of what I call tax-push inflation was, again, very sizable. This was because, very similarly at that time, governments were under pressure to balance their budgets, and so they did the same kind of thing. That's what the ECB is responding to, when it's quite clear that there actually zero inflationary pressures in the Eurozone economy.

The only economy that is booming, as far as exports are concerned, is the German economy. But even in Germany, wages are rising at the rate of roughly 2%. Now, if in the only part of the Eurozone that is growing, wages are rising at 2%, how can you get inflation? Then look at the problems Greece, Portugal, Spain, Ireland...where it's clear what is going on there. The ECB must be daydreaming to think about inflationary pressures.

Their mindset is focused on trend stability

only. They do not really feel responsible for the economy, for managing domestic demand, and it really shows in the way they come at monetary policy.

# Europe, the United States, Central Banks, and “the Great Recession”

**Dr. Terrence Guay**

Pennsylvania State University

**UNITED STATES**

**T**he global financial crisis has strained both the economies of Europe and the United States, as well as the abilities of the central bankers seeking to mitigate its impact. Absent a playbook for a crisis of such proportions, the European Central Bank (ECB) and the US Federal Reserve (Fed) have tried different approaches to reverse the effects of the crisis within their respective jurisdictions. The differences reflect less any philosophical differences between opposite sides of the Atlantic Ocean, as it does the unique characteristics of the US versus the European Union (EU).

One of the Fed’s primary strategies at the onset of the crisis in 2008 was to sharply cut interest rates. The federal funds rate dropped from 4.25% at the beginning of 2008, to a target rate of between zero and 0.25% at the end of that year. The rate has remained there ever since, and shows little likelihood of increasing any time soon. Conversely, the ECB’s rate was 4.25% as recently as October 2008, and dropped quickly to 1% within seven months. ECB president Jean-Claude Trichet is opposed to matching the zero interest rates of the Fed, for fear that it will be difficult to raise them to slow inflation at a later date. Now, after almost two years at this level, the ECB is considering raising rates to thwart inflationary pressures.

One area of difference is the extent to which the Fed and ECB have bought government and corporate bonds, commercial paper, and mortgage-backed securities. The Fed has been very active in these markets (known as quantitative easing), to increase liquidity in US financial markets and to encourage banks to lend. The ECB is not permitted to purchase bonds directly from governments, although it can intervene in bond markets. But even here, it has done so only on a modest level, in large part because of its philosophy of independence from national governments. In fact, the ECB waited until May 2010 to do so.

These differences underscore institutional variations that both central banks operate within. In the US, both the Fed and the national government (particularly the Treasury Department) have a similar and coordinated mission: to end the recession and spur economic growth. This has been accomplished with the Fed policies described here, and through stimulus programs and deficit spending. In Europe, the ECB handles monetary policy. But each member country of the EU is responsible for deciding its own fiscal policy. Some countries, such as Germany and France, resisted US pressure to implement massive stimulus programs. Others, such as Greece and Ireland, had spending cuts thrust upon them by EU members as a condition for their 2010 bailouts. But the point is that the ECB controls only the monetary policy tool, and that for only 17 EU countries.

Another important difference is that the ECB's sole directive is to control inflation (“below, but close to, 2% over the medium term”). The US Fed also must take the wider economy into consideration, particularly the labor market. This wider mandate requires the Fed to accept trade-offs, such as a little more inflation if unemployment is reduced. However, a rise in ECB rates will have diverse consequences for Europe. It may be beneficial for Germany, whose economy has done rather well over the past two years. But higher rates will raise borrowing costs for governments with high levels of debt, and slow economic growth in countries like Portugal and Spain still struggling with the recession.

Despite their differences, the efforts of both the Fed and ECB can only do so much to end the recession in the US and Europe. As powerful as markets regard them to be, they can only influence part of the economic environment. It is necessary then for companies, workers, and other economic actors to undertake the everyday decisions that will spur real growth.

# US Trumps Europe in Crisis Response

*Interview with* **Dr. Viral V. Acharya**  
New York University

**UNITED STATES**

**International Affairs Forum: What do you view as the major differences between monetary policies of the ECB and the Fed since the start of the global economic crisis?**

**Dr. Viral V. Acharya:** In the first phase of the crisis, the Fed was a lot more aggressive in lowering interest rates and adopting an expansionary monetary policy compared to the ECB, and even the Bank of England. I think one of the reasons was that the commodity price inflation of 2008 was so substantial that perhaps both the ECB and the Bank of England were caught off-guard and leaned on the side of not adopting an expansionary policy right away in order to tackle inflation. However, since we had the problems of August and September 2008, and especially since the bankruptcy of Lehman Brothers, central banks across the world started adopting highly expansionary monetary policies. There have, however, been a few significant differences between the exact kind of policy the Fed adopted and

the kind of policy the ECB adopted. This has been especially true since 2009. In the first year after Lehman Brothers, the Federal Reserve grew its balance sheet quite substantially (Quantitative Easing I or QE1). This was essentially between the agency debt, which is Fannie Mae and Freddie Mac debt (implicitly backed by the United States government), and Fannie and Freddie-guaranteed mortgage-backed securities. The Fed built a portfolio of over a trillion dollars this way, which reduced the supply of these securities in the market. But the second round of easing that the Federal Reserve engaged in since August 2010 (QEII) was primarily through purchase of relatively safe Treasury securities.

Now, when you compare that to what the European Central Bank has done since Fall of 2008, from all accounts it seems that the ECB was by and large fairly aggressive, providing liquidity to the banking system against relatively illiquid mortgage-backed securities.

But more importantly, its problem got especially complicated a year later in 2009 when sovereign creditors faced a very significant issue, starting with the problems in Greece then eventually in Spain, Portugal, and quite severely in Ireland too.

It might look as though the ECB's policies were to buy back some of the government debt on the market, just as the Federal Reserve has, but the kind of government debt that we're talking about is of a substantially lower quality in the case of the ECB than the Federal Reserve. To the extent that some of the European sovereign debtors are reasonably credit risky right now, I would say the ECB's operations represented essentially a quasi-fiscal action of the type that perhaps the Federal Reserve's operations with Bear Stearns or AIG or Citigroup were, where it was directly taking on

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*in terms of outcomes, the United States is certainly in a better situation than Europe is right now*  
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significant credit risk on some of the assets it backed in the process.

The circumstances have been such that the lack of a direct and decisive fiscal response from the Euro zone, that is, the stronger Euro zone countries and the European Union as a whole, has meant that unfortunately the ECB has had to start playing the quasi-fiscal role. And now it risks taking some haircuts on its exposure of close to 100 billion euros of sovereign debt that would require recapitalization.

**Do you think either has done a better job of positioning themselves towards moving forward?**

**Dr. Acharya:** I would say that, at least in terms of outcomes, the United States is certainly in a better situation than Europe is right now. One striking difference between the United States and the Euro zone has been that the recapitalization of the financial sector in the United States was quite decisive and quite transparent to the markets. Once stress tests were conducted and recapitalization (largely a private recapitalization) was undertaken in the summer of 2009, the health of the U.S. financial sector became far less of a worry. The main worry in the United States right now is whether aggregate demand in the household spending picks up or not. But I think the United States is perhaps in as good a condition as it has been in the last several years, even though recovery has been bumpy. In Europe however, it is unclear if banks really took write-downs up to

the extent that they needed to take. This meant that they were not recapitalized adequately in time. And because this did not happen, when the eventual sovereign creditors problems surfaced in 2009 and 2010, any prospect of debt restructuring of Greece, Portugal, Spain and Ireland, got deeply intertwined with the question of, who's holding the bonds of these countries and their banks? Is it French and German banks, or other banks of leading countries in Europe? Another point is whether they need their own restructuring to contain knock-on contagion effects onto these banks in other countries.

Effectively therefore, the lack of adequate capitalization of the banking sector in the Euro zone or at least lack of any conviction from the regulators that the capitalization is good, the market has experienced what I would call a sort of generalized uncertainty or the threat of a panic. The main problem this has created is that we can't really make progress with any restructuring of sovereign debt because if we do it we don't know what's going to happen next, and that is because we don't know which banks might deteriorate as a result and how the losses might actually spread from one country to the next. This has happened partly because the European stress tests were not just done by one entity, as there's home country supervision and home country regulation in Europe. Some of the efforts underway in the Euro zone right now are to harmonize these processes a lot more.

But the bottom line is that, in terms of ensuring that the recapitalization of the financial sector was good enough to deal with the next shock that hits the markets after the fall of 2008, the U.S. authorities and regulators have done a much better job than in Europe. To the extent that the Fed and ECB are involved in these exercises I would give higher marks to the Fed than to the ECB.

# Monetary Policy in the EU and the US: The Colonizing Forces of Financialization

**Charles Hugh Smith**

**UNITED STATES**

I am not an economist and I have no institutional or ideological loyalties to defend, and as a result my views are highly anachronistic.

I have been asked to discuss the monetary policies of the European Central Bank as compared to those pursued by the Federal Reserve in the U.S. To do so with any insight, we need to establish some basic characteristics of the Eurozone system.

The European Union established a single currency and trading zone for the classical Capitalist benefits this offered: a reduction in the cost of conducting business between the member nations and a freer flow of capital and labor.

From a Neoliberal Capitalist perspective, such a union consolidated power in a Central State proxy (The E.U.) and provided large State-approved cartels and quasi-monopolies easier access to new markets.

From the point of view of the citizenry, it offered the benefit of breaking down barriers to employment in other Eurozone nations. On the face of it, it was a “win-win” structure for everyone, with the only downside being a sentimental loss of national currencies.

But there was a flaw in the structure that is now painfully apparent. The Union consolidated power over the shared currency (euro) and trade but not over the member states’ current-account (trade) deficits and budget deficits. While lip-service was paid to fiscal rectitude via caps on deficit spending, in the real world there were no meaningful controls on the creation of private or state credit or on sovereign borrowing and spending.

Thus the expansion of the united economy via the classical Capitalist advantages of freely flowing capital and labor were piggy-backed on the expansion of credit enabled by the Neoliberal Capitalist structure of the union.

The alliance of the Central State and its intrinsic desire to centrally manage the economy to benefit its fiefdoms and Elites and classical free-market Capitalism has always been uneasy. On the surface, the E.U. squared the circle, enabling stability, plentiful credit creation and easier access to new markets for all.

But, beneath this beneficent surface, lurked impossible-to-resist opportunities for exploitation and arbitrage. In effect, the importing nations within the union were given the solid credit ratings and expansive credit limits of their exporting cousins, Germany and France. In a real-world analogy, it's as if a sibling prone to financing life's expenses with credit was handed a no-limit credit card with a low interest rate, backed by a guarantee from a sober, cash-rich and credit-averse brother/sister. Needless to say, it is highly profitable for banks to expand lending to credit-worthy borrowers.

Credit at very low rates of interest is treated as "free money," for that's what it is in essence. Recipients of free money quickly become dependent on that flow of credit to pay their expenses, which magically rise in tandem with the access to free money. Thus when access to free money is suddenly withdrawn, the recipient experiences the same painful withdrawal symptoms as a drug addict who goes cold turkey.

Even worse—if that is possible—free money soon flows to malinvestments as fiscally sound investments are quickly cornered by State-cartel partnerships and favored quasi-monopolies. The malinvestments are masked by the asset bubble which inevitably results from massive quantities of free money seeking a speculative return.

The E.U.'s implicit guarantee to mitigate any losses at the State-sanctioned large banks—the Eurozone's equivalent of "too big to fail" banks—enabled a financial exploitation that is best understood in a neocolonial model. In effect, the big Eurozone banks "colonized" member states such as Ireland, following a blueprint similar to the one which has long been deployed in developing countries such as Thailand.

This is a colonialism based on the financialization of the smaller economies to the benefit of the big banks and their partners- the Member States governments- which realize huge increases in tax revenues as credit-based assets bubbles expand.

As with what we might call the Neoliberal Colonial Model (NCM) as practiced in the

developing world, credit-poor economies are suddenly offered unlimited credit at very low or even negative interest rates. It is “an offer that’s too good to refuse” and the resultant explosion of private credit feeds what appears to be a “virtuous cycle” of rampant consumption and rapidly rising assets such as equities, land and housing.

Essential to the appeal of this colonialist model is the broad-based access to credit: everyone and his sister can suddenly afford to speculate in housing, stocks, commodities, etc., and to live a consumption-based lifestyle that was once the exclusive preserve of the upper class and State Elites (in developing nations, often the same group of people).

In the 19<sup>th</sup> century colonialist model, the immensely profitable consumables being marketed by global cartels were sugar (rum), tea, coffee and tobacco—all highly addictive, and all complementary: tea goes with sugar, and so on. (For more, please refer to Sidney Mintz’s book, *Sweetness and Power*.)

In the Neoliberal Colonial Model, the addictive substance is credit and the speculative and consumerist fever it fosters.

In the E.U., the opportunities to exploit captive markets were even better than those found abroad, for the simple reason that the E.U. itself stood ready to guarantee there would be no messy expropriations of capital by local authorities who decided to throw off the yokes of European capital colonization.

The “too big to fail” Eurozone banks were offered a double bonanza by this implicit guarantee by the E.U. to make everything right: not only could they leverage to the hilt to fund a private housing and equities bubble, but they could loan virtually unlimited sums to the weaker sovereign states or their proxies. This led to over-consumption by the importing States and staggering profits for the TBTF Eurozone banks. And all the while, the citizens enjoyed the consumerist paradise of borrow and spend today, and pay the debts tomorrow.

Tomorrow arrived, but the capital foundation of the principal—housing and the crippled budgets of post-bubble Member States—has eroded to the point of mass insolvency. Faced with rising interest rates resulting from the now inescapable heightened risk, the citizenry of the colonized states are rebelling against the loss of their credit-dependent lifestyles and against the steep costs of servicing their debts to the big Eurozone banks.

Now the losses resulting from these excesses of rampant exploitation and colonization by the forces of financialization are being unmasked, and a blizzard of

simulacrum reforms have been implemented, none of which address the underlying causes of this arbitrage, exploitation and financialization.

Understood in this manner, it is clear there is no real difference between the monetary policies of the European Central Bank and the Federal Reserve: each seeks to preserve and protect the “too big to fail” banks which are integral to the Neoliberal State-cartel partnership.

Both are attempting to rectify an intrinsically unstable private-capital/State arrangement—profits are private but losses are public—by shoving the costs of the bad debt and rising interest rates onto the backs of the home-country taxpayers. The profits from this vast arbitrage and Neoliberal colonialist exploitation were private, but the costs are being borne by the taxpaying public.

Any policy maker or pundit who is confident this is a stable arrangement will find his/her confidence was misplaced.

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*a blizzard of simulacrum reforms have been implemented, none of which address the underlying causes of this arbitrage, exploitation and financialization.*  
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# GUARANTEED TO FAIL



**FANNIE MAE, FREDDIE MAC**  
and the Debacle of Mortgage Finance

VIRAL V. ACHARYA  
MATTHEW RICHARDSON  
STIJN VAN NIEUWERBURGH  
LAWRENCE J. WHITE

## Guaranteed to Fail

Fannie Mae, Freddie Mac, and the  
Debacle of Mortgage Finance

*Viral V. Acharya, Matthew Richardson,  
Stijn Van Nieuwerburgh &  
Lawrence J. White*

*“Guaranteed to Fail* is a comprehensive and well-written study of the role played by Fannie and Freddie in the events leading up to the financial crisis. It also suggests the way forward. This book is both timely as well as insightful, and will be an influential contribution to the debate on the role of government-sponsored enterprises.”

—**Raghuram G. Rajan**, author of *Fault Lines: How Hidden Fractures Still Threaten the World Economy*

“This is an excellent book. *Guaranteed to Fail* presents a cogent proposal for the resolution of the current conservatorship of Fannie Mae and Freddie Mac. It documents the historical, economic, political, and financial issues that led to the current crisis, and presents all the issues in a fair and informative manner.”

—**Dwight Jaffee**, University of California, Berkeley

*“Guaranteed to Fail* is a down-to-earth analysis of why Fannie Mae and Freddie Mac collapsed and why housing finance is broken. The authors provide clear solutions to fixing this complex problem. This is a timely and important book.”

—**Nouriel Roubini**, coauthor of *Crisis Economics: A Crash Course in the Future of Finance*

The Center for International Relations holds student writing competitions for collegiate students where winners are eligible for publication in The Forum. The following two editorials are winners of the Spring 2011 Contest. The topic for this award:

Experts on both sides of the water have been observing the changing attitudes towards the Euro and the strength of the Euro-zone - both of its longevity and the seemingly current downturn - and how the current global climate (politically and economically), is having a direct impact on the strength of it as a major currency and of those economies within the Euro-zone. Some have stated that the internal relationship between countries within the Euro-zone are starting to unravel as countries begin to look towards domestic interests and stability first and above 'collective interests'. Experts have argued that relationships with other countries like China, the US, and India - have ensured that the Euro-zone is facing its first serious challenge and raises questions about the regulations ruling the Euro-zone and its future expansion. Others have suggested that failure is obviously not an option, so pulling together through the good and bad times, doing everything possible, is a necessity.

Select a national or global perspective and, using supporting facts and evidence, discuss what path respective policymakers should take to address this issue.

## ***Student Writing Competition Winner***

# Should Germany be the Pillar of the Euro-Zone to Save Europe?

**Jan-Ulrich Rothacher**

University of Heidelberg

**GERMANY**

In Germany, a broad consensus exists between the political parties that there is no alternative to these costly measures.<sup>1</sup> The nightmare scenario which has been conveyed to the public is an unraveling of the whole project "Europe".

Realistic projections of the inflating levels of sovereign debt suggest that lowering borrowing costs can only be considered as a mere attempt to buy some breathing space. European leaders have also assured that the drastic fiscal austerity packages are bringing down the level of debt. The empirical evidence however shows us, that an external debt exceeding 90% of the GDP gravely affects economic growth (Reinhart & Rogoff, 2010). A recession exacerbated by cuts in public spending is hardly going to help since tax revenues are bound to drop.

<sup>1</sup> The European Council has decided to raise the guarantees for government bonds to effectively 440 billion Euros in its latest proposal (Mussler, 2011). This would mean that the involvement of Germany of currently 174 billion would again have to rise significantly (Brüderle, 2011).

These robust findings clarify that a restructuring or even a default of some members of the euro area is inevitable. By claiming the opposite the Heads of State are diverting attention from the weakness of European banks, which are heavily involved in the peripheral countries such as Greece, Portugal, Spain and Ireland. In the event of a default, the bonds will suffer a sharp drop in value. It is eminent that public funds are then used, to support the troubled banks in restructuring their balance sheets. If those funds are instead used to supply almost-default nations with financial liquidity, they ensure that the persisting recession will be deepened in the countries affected.<sup>2</sup> The more sensible alternative is to suspend struggling countries from the Euro-zone during a certain amount of time, letting them depreciate their national currency and regain their competitiveness. The argument that European solidarity is at stake is therefore misleading.

It is often suggested that the benefits of the current Euro-zone, through the export opportunities, outweigh the costs, resulting from the “rescue”-packages. This is at least debatable. Economists have identified domestic investments as the main driver of economic growth in the past quarters in Germany. This points to the fact that capital is being rechanneled back to Germany, which is profiting from the new risk-evaluation within the Euro-zone. The rise of exports is now being outweighed by the rise in imports (plus 5.7%). A sufficiently large interest spread could therefore help to limit the trade imbalances between Germany and its European neighbors (Carstensen, 2010).

It is insightful what damage the rescue packages have inflicted upon European and National institutions. The first thing that was swept away was the Stability and Growth Pact. The misgivings feared by economists before the introduction of the Euro, have turned out to be justified. Nations that are considered financially sound are now liable for debts of the peripheral countries. Deliberations on reforms now ought to focus on automatic sanctions that are implemented prior to excessive deficits (Starbatty, 1997).

The reputation and credibility of the European Central Bank (ECB) has also seen better days. The Central Bank is struck with the dilemma of finding a common monetary policy in a more and more heterogeneous currency area. An increase of interest rates which is pressing for example in Germany, to prevent further asset bubbles, is poison for a recovery in the peripheral countries. Every intervention of the ECB is now being scrutinized about possible political motives. The ECB has to deal with its recently purchased government bonds, worth 77.5 billion €. This has shed a new light on the heavily advocated ESM (European Central Bank, 2011). This “financial Stability mechanism” could help to bailout the ECB, which has obviously

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<sup>2</sup> Kenneth Rogoff has estimated that if the austerity measures were all being implemented in Greece, the recession would last about 4 to 5 years.

miscalculated the default-risks of its peripheral members.

The infamous stroll of Angela Merkel and Nicolas Sarkozy along the seaside resorts of Deauville was conceived as though the two heavyweights wanted to impose their plan upon the existing institutions.<sup>3</sup> While the other heads of state felt themselves rushed, the MEPs are now complaining about the lack of democratic legitimization on the European level. On the national level, countries that have received bail-outs are in political turmoil because of widespread fears about the loss of national sovereignty. The landslide election victory of the opposition in Ireland is due to their campaign promise, to renegotiate the lending terms with the EU and the IMF and not to raise the tax rate for corporations (Murray Brown, 2011).

The measures undertaken to save the Euro-zone seem to have caused serious collateral damage and give rise to distrust between the members. The public's affirmation of the EU has reached an all-time low in the past few months.<sup>4</sup> The Euro has become a liability. The much needed common "European identity" seems to vanish in the course of vain attempts to keep unfit countries in the Euro-area. It is in the collective interest of all the members of the EU, to tackle the underlying problems in the balance sheets of their banks. This will prevent the debt-burdened countries to be choked by the payment of interests, protect the German taxpayer from incalculable risks and restore faith in the European integration.

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3 The tough stance of Angela Merkel, regarding the involvement of private creditors, when offering rescue packages to Euro area countries, had to be abandoned a month later, when Ireland requested a bailout.

4 The percentage of those declaring of having „no confidence in the EU“ has risen from 51% to 63% according to a survey conducted by the Allensbach-Institute.

## ***Student Writing Competition Winner***

# Getting the PIIGS (and Europe) off the Ground

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**UNITED STATES**

**T**he Euro-zone crisis had similar underpinnings to the global financial crisis unleashed in the United States, with substantially high sovereign debt levels in the PIIGS (Portugal, Ireland, Italy, Greece and Spain) leading to a crisis of confidence, widening sovereign credit spreads in the five countries.

Easy access to financing, ensured by membership in the Euro-zone, appeared to systematically induce overspending amongst Euro-zone government in order to stimulate their economies. The result was nothing less than jaw-dropping high government debt. In a report at the beginning of 2010, analysts at Danske Bank paraphrased Barack Obama, saying “You can’t put lipstick on a PIIG,” referring to the unsustainable and non-credible action of postponing debt repayment via lower consumption and income.

True enough, the combined foreign debt of the PIIGS (amounting to US\$2.5 trillion – almost equivalent to their combined GDP) proved far too much for creditors to handle, resulting in a dramatic showdown centered in Greece, where sovereign bonds were downgraded to junk status, and the country came within a hair’s length of default. The EU responded in May 2010 with the creation of the European Financial Stability Facility (EFSF), with a financial safety net of 750 billion Euros aimed at stabilizing monetary fluctuations in the Euro-zone. While the EU successfully averted crisis in 2010, both long and short-term questions remain for policymakers in 2011.

The first is no doubt the question of the euro’s very existence. Fortunately, this does not seem to be in much doubt. Policymakers have taken a fairly united stance on this issue, despite a few alarmist comments from Germany’s Angela Merkel, with Klaus Regling, chief of the EFSF, reiterating just last November that “there is zero danger”, and that “it is inconceivable that the euro fails”. Moreover, the prohibitively

high costs of exiting the Euro-zone (such as in formulating a new currency, and in replacing local bank assets from the European Central Bank) as well as the legal grey areas (there are no provisions in the Lisbon Treaty for leaving the European Monetary Union) mean that in the short term at least, policymakers can realistically and safely defend the continued existence of the euro.

The most urgent task at hand for policymakers, then, is to restore fiscal stability in the Euro-zone. While the Chinese creditor may seem like an attractive unilateral option to multi-lateral action within the Euro-zone to reduce budget deficits and trade surpluses/deficits, it is worth noting that China is increasingly looking towards its own hinterland in Asia for investment opportunities. Asian countries were fairly unscathed during the crisis, and have been increasingly interested in fostering intra-Asian trade, such as via the China-ASEAN Free Trade Agreement. Europe arguably pales in comparison with the vast opportunities available in Asia. European policymakers will thus have to convince its public of the necessity of tightening the fiscal belt, which means reaching out to groups which have been disproportionately affected, such as youth in France and Italy. Talk of austerity or tax reform will prove insufficient; Europe must structurally reform her social and financial institutions. For example, while Article 126 of the Lisbon Treaty already obliges member states to avoid excessive deficits, budgetary rules and financing could be further tightened. The German slogan *Geiz ist geil* – “Stinginess is cool” – proves more than applicable to this situation.

In the longer term, policymakers need to address the issue of a monetary union that is simply not yet complete. Consider the fact, for example, that countries cannot even lend money to Greece without bending the rules, since the Lisbon Treaty forbids countries from lending except in the event of natural disasters or circumstances beyond a country’s control. New legislation will have to be implemented to address these shortcomings. Also, greater political integration will be necessary to overcome the moral hazard of easy financing that the PIIGS indiscriminately exploited. The existence of the EFSF definitely represents one step towards such integration, and the Euro-zone would be well-placed for the future if its policymakers continue to investigate the possibility for greater integration in the form of common fiscal policy or even in EU-approved national budgets.

All in all, policymakers need to address the short-term fiscal ramifications of their debt-ridden economies, but also consider the possibilities for greater political unity in the Euro-zone. While the Euro-zone survived its first test in 2010, there is little doubt that the next crisis will make this one look like a walk in the park if the Euro-zone stagnates in its current form.

## OTHER RESOURCES

### ORGANIZATIONS

European Central Bank

Board of Governors of the Federal Reserve System

### REPORTS AND ARTICLES

The Monetary Policy of the ECB, European Central Bank

[Interpreting the Bank Stress Tests](#), Douglas J. Elliott, Brookings Institute

Greece's Debt Crisis: Overview, Policy Responses, and Implications, Congressional Research Service

The World Needs Further Monetary Ease, Not an Early Exit, Peterson Institute for International Economics, Joseph Gagnon

The Eurosystem, The US Federal Reserve, and The Bank of Japan; Similarities and Differences, Dieter Gerdesmeier Francesco Paolo Mongelli and Barbara Roffia, ECB,

From Financial Crash to Debt Crisis, Carmen M. Reinhart and Kenneth S. Rogoff

### VIDEO

The Future of the Fed, Joseph Gagnon, Joseph Stieglitz, Joerg Bibow, Matthew Yglesias, and others discuss at Roosevelt Institute event.

Regulating Systemically Important Financial Firms, Daniel K. Tarullo, Federal Reserve Board, Peterson Institute for International Economics

### BLOGS

Stephen Williamson: New Monetarist Economics

Laurence J. Kotlikoff

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