



The Bologna Center Journal of International Affairs

Vol. 1, No. 1 - Inaugural Issue.

EUROPA 1998

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Special Feature:

European Monetary Union

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and

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Spring, 1998

The Bologna Center Journal of International Affairs



Published at the Bologna Center
The Johns Hopkins University
Paul H. Nitze School of Advanced International Studies

The Bologna Center Journal of International Affairs was established by Bologna Center students to serve the students and faculty of the Center and the larger academic community of which they are a part. The journal is designed to provide a forum for discussion and dissemination of ideas about the issues and events of interest to the Bologna Center community. As a publication conceived and founded by students, it is meant to be primarily based on student contributions. These works are to be complemented by contributions from notable scholars as well as non-academic professionals; as the editors believe that an academic dialogue is strongest and most comprehensive when it is inclusive.

Published at:

The Bologna Center
Via Belmeloro 11
40126 Bologna (BO) Italy

Fax: 39-51-228505
Phone: 39-51-232185
E-mail: bcjournal@jhubc.it

Printed by:

Baiesi snc
Via Broccaindosso, 2/b
40125 Bologna (BO) Italy

The opinions expressed herein are solely and explicitly those of the authors and do not reflect the views of the Journal staff or the Bologna Center.

March, 1998

Dear Editors,

I want to commend you for the exceptional work you have done in launching a journal of international affairs at the Bologna Center. At a time of historic change in Europe, as well as dramatic developments in other parts of the world, you have recognized the importance of creating new channels for the exchange of ideas. Your initiative in publishing this new journal will allow both students and professors to contribute to the critical dialogue that illuminates and helps us understand the complexities of world events. I am certain that those of you who have participated in this new project share in the excitement of creating something that is both innovative and needed. You have added a new dimension to the Bologna experience that will have an impact for years to come.

I congratulate you on the inaugural issue of The Bologna Center Journal of International Affairs. In the tradition of the best SAIS students, you have done honor to our school.

Sincerely,

A handwritten signature in cursive script, appearing to read "Paul Wolfowitz".

Paul Wolfowitz

Dean, Paul H. Nitze School of
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March 1998

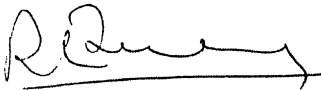
Dear Readers:

A group of talented students at the Johns Hopkins SAIS Bologna Center have taken a daring initiative this year by launching The Bologna Center Journal of International Affairs. Their hope, and mine, is that this issue, now in your hands, will be the first in a series - to be continued next year and beyond.

There is an abundance of imagination and talent to be found among our students and faculty. The impetus for this journal is to make public the results of their research - whether it be in the form of a term paper or the basis for a book - into the various facets and issues relevant to the study of international affairs.

I am confident that this endeavor will be a great success, and I hope you enjoy this new publication.

Sincerely,

A handwritten signature in dark ink, appearing to read 'R. Evans', with a horizontal line drawn underneath the signature.

Robert H. Evans

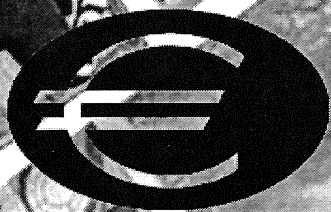
Director of the Bologna Center

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European Monetary Union



Introduction

Welcome to the feature section on European Economic and Monetary Union (EMU). The launching of the *Bologna Center Journal of International Affairs* coincides with the momentous drive to complete the preparation for the launch of the single European currency, the Euro. It is our pleasure to offer some vantage points from various sources both within Europe and from abroad.

EMU has a particular resonance because it is an awesome undertaking both in and of itself and as the foundation of a larger, longer-term project. The continent, that for four centuries was best described by its notable and destructive wars and their aftermaths, may now be carried forward towards an end-state of economic, political, security and defense union.

There has been notable political philosophy and international debates over just how far Europe, the cradle of the idea and the practice of the "nation-state," will go towards evolving toward a new type of organization with new institutions and inter-relationships very much apart from the classical nation-state. Whether supranational federalism or inter-governmentalism, based on reasoned, bargained transfers of power both above and below the state level, one aspect of the process is clear: EMU represents a fundamental, qualitative change that immediately and over time will decisively alter the economic relations between states totaling more than 300 million citizens. Evidently, there will be, whether for good or ill, collateral effects in the social and political realms, and more broadly in terms of Europe's international relations with the rest of the world.

In a way, the launch of the Euro, with more than the superficial levels of integration and collective co-determination, marks the re-launching of a European "power." To be sure, there are as many new questions raised as there are others answered. But, there is an unmistakable dynamic that has been building and is being amplified by the successful fulfillment of the Maastricht Stage III of EMU "at the latest by 1 January 1999." The rhetoric attending this step has been expectant: Commission President Jacques Santer suggested that the European Union (EU) has "opened the path to the peaceful unification of our continent," while German Chancellor Helmut Kohl noted the vast change in the entire milieu by reminding leaders that "ten years ago we were still talking about Euro-missiles." EMU is occurring within the sea-changes of the international landscape; it also has the potential to feedback into this framework and define its future arrangement.

The EU is at a pivot-point in its development. It is on the threshold of a historic opportunity but it is also faced with critical challenges to its eventual success. Often in the past, the margin between success and failure has been razor-thin. Finally, with the concomitant launching of the process of the Union's eastward enlargement into Central and Eastern Europe and the Eastern Mediterranean, the EU will again be critically tested. If EMU goes well and promotes positive externalities in terms of increased political co-operation, policy harmonization, and institutional reform this will act as a motivating and gravitational force for the new aspirants and the five other Central and East European Countries (CEECs) still waiting to begin negotiations for accession.

At some point the EU will have to confront serious institutional reform. It would be better to begin addressing the issues of budget, agricultural, structural and cohesion funding reform as soon and as thoroughly as possible. The July 1997 publication of the Commission's Agenda 2000 is but a beginning. The Luxembourg presidency of the Council clearly illustrated how much at odds the Commission and the Council are, not to mention the European Parliament, when it comes to eastward enlargement, and institutional and policy reform. Perhaps the run-up to Stage III of EMU clouded the collective perspective. Whatever the explanation, the EU has put itself on a faster track with increasing expectations and higher stakes for the success and failure, than even its most ambitious previous endeavors. It must prepare itself structurally - and especially its citizenry - psychologically for these challenges.

On another front, the development of a European Security and Defense Identity within the Western Alliance - particularly through the Combined Joint Task Force, the greater scope and maneuverability of the Union's Common Foreign and Security Policy (CFSP), the continuing resuscitation of the Western European Union - all together represent provocative introductory steps towards realizing the goal of "an ever closer union" with multiple independent capabilities in every sphere.

Clearly, we have entered a defining period for Europe. It is for the first time in almost a century, truly at peace - free from World Wars and the Cold War - fully sovereign, yet never more interdependent. The results of these efforts today will be judged beyond 1 January 1999, beyond 2002 (when the coins and notes of the Euro will become tangible, legal currency), and even beyond 2006 (the end of the prospectus of the Commission's Agenda 2000). It will require at least a generation. But the tests that EMU and other initiatives face will be decisive in determining the type of "Europe" of which that generation will find itself a member. In this way it is much like the generation that faced the challenges of re-building Europe after World War II. The work before the EU today, of which EMU is and will continue to be the core, is the last link to the legacy of a divided past, and the first step towards a truly united European future.

The contributors that follow all offer unique vantage points on the path leading up to and beyond EMU and its implications, whether it be from a micro-perspective based on very specific elements, or from a macro-perspective based on the effects for the international system. In sum, these articles present the themes that affect and are affected by the project of Economic and Monetary Union.

Brendan C. Fitzsimmons

What makes a Great International Currency?

Robert A. Mundell

An Epoch-Making Event

The introduction of the Euro in 1999 promises to be one of the greatest events in modern history. It will certainly be the most important change in the international monetary system since President Richard M. Nixon took the dollar off gold in August, 1971, and the system gravitated to flexible exchange rates. But in fact it goes still deeper. The collapse of the Bretton Woods arrangements altered the *modus operandus* of the international monetary system but it did not change its power configuration. Both before and after the breakdown, the dollar was the dominant currency in the system. The introduction of the Euro, on the other hand, will challenge the status of the dollar in the international monetary system and change the power configuration. For this reason the introduction of the Euro may be the most important development since the dollar replaced the pound sterling as the dominant international currency in World War I.

A decade from now, the international monetary system will look very different. Exactly how different will depend on the importance of the pecking order of currencies and how well the Euro stacks up against the dollar. This article will try to make an assessment.

What makes a currency important internationally? Obviously, confidence in its stability is the key characteristic. But stability is a vector that depends on at least four factors: size of transactions domain; stability of monetary policy; strength of the issuing state; and fallback value. I shall comment on each of these elements before making a general assessment.

Size of Transactions Domain

Size in the sense depth and breadth of the market is a measure of the degree to which a currency can exploit the economies of scale and scope inherent in money as a public good. Size feeds on itself. The larger is the transactions domain, the more liquid the currency. The simplest surrogate for transactions domain is GDP; an alternative measure

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is the size of the capital market. The size of a single currency area determines its liquidity. Obviously a currency that is money for 100 million people is much more liquid than a currency that is money for one million. Size is also important for a different reason. The larger the single currency area, the better it can act as a cushion against shocks. If you consider a shock such as German unification, manifested in a debt-financed increase in annual government spending and transfers East of more than 150 billion D-marks, close to destabilizing the German economy, then think of the effect of the same shock on a smaller economy. Alternatively, think how much more easily the shock would have been handled had there been in 1992 a stable European currency!

Size is relative. How the Euro will survive depends on the competition. Its two rivals are obviously the dollar and the yen. How such a tri-currency world would work out depends importantly on relative market sizes.

From the standpoint of size, the outlook for the Euro is very favorable. The EU-15 has a population of 375 million, and the EU-11, which includes those countries slated to enter EMU in the first round, contains 292 million, somewhat larger than the United States; by comparison, Japan has 125 million. At current exchange rates, the GDP of the EU 15 is running at the rate of \$8.4 trillion, that of the EU-11, at \$6.6 trillion. These compare to US GDP running at \$8.5 trillion and Japanese GDP \$4.1 trillion. All of a sudden, with or without the four countries that will not proceed to the first round, the EU becomes a player on the same scale as the United States and Japan. Over time, as the other countries join, as the per capital incomes of the poorer members of the EU catch up, and as the EU expands into the rest of Central and Eastern Europe, the EU will have a substantially larger GDP than the United States.

Openness also plays a role because it affects dependence. The less open, the more self-sufficient. As measured by the ratios of exports or imports to GDP, the "G-3" economies are about equally open. Of course the percentage of current exports to GDP in Europe is now around 30%, but when intra-European exports and imports are netted out, the openness figures are remarkably similar. It makes a difference of course whether openness is measured by exports or imports; economies with trade deficits will have higher import than export ratios. The US ratio of imports to GDP is the highest at nearly 11%; the EU 15 and Japan's import ratios are substantially lower at around 8%. With openness measured by exports, on the other hand, Japan's and the EU-15's ratios are around 9%, while the US's is a little over 8%. What emerges from these numbers is a significant fact that the three giant economies are all relatively closed, creating the risk that the monetary authorities may tend to underestimate the importance of the exchange rate and lead to more volatility of exchange rates.

ECB Monetary Policy

The importance of the monetary policy stance scheduled for the EMU countries can hardly be underestimated. No currency has ever survived as an international currency with a high rate of inflation. The lower the rate of inflation, the lower the cost of holding money balances, and the more of them will be held. In addition to a low rate of inflation a *stable* rate is also desirable; because, however, inflation and variance go hand-in-hand, much of the problem is avoided if inflation is kept low.

Additional considerations are predictability and consistency in monetary policy. In a democracy both are abetted by *transparency*. If the monetary authorities openly state their targets and their strategies for achieving them, the market and the critical public will be able to make its own judgement about inflation outcomes.

From the standpoint of sound monetary policy, the outlook for the Euro is also very favorable. The Maastricht Treaty is unambiguous in making price stability the target of monetary policy; while the ECB can and should assist the monetary union in carrying out its other objectives, it is forbidden to do so if such assistance would conflict with price stability. Monetary policy will not be used to reduce unemployment by "surprise inflation" or to inflate away embarrassing public debts.

There remains considerable discretion for the independent ECB. They will have to determine how price stability can best be achieved. The problem is complicated by lags in the effect of monetary policy. The best approach for a large economy like the EU is to target the inflation rate, formulating monetary policy actions on forecasts of inflationary pressures. Leading indicators that should always be taken into account include gold prices, other commodity prices, rates of change in the different monetary aggregates, the growth rate and bond prices. The most successful central bankers have been pragmatists. But there is no reason why an independent ECB, modeled partly after the Bundesbank, cannot be as effective a body as the Federal Reserve System in the United States or the Bank of Japan. As Otto Pohl once said, "credibility is the capital stock of any central bank," and you can be sure that the management of the ECB will do its best to establish credibility at the outset.

The Security Factor

Monetary stability of course depends on monetary policy. But monetary policy is in turn affected by its *sine qua non*, political stability. Strong international currencies have always been linked to strong central states in their ascendancy. The reason is not far to seek. When a state collapses, the currency goes up in smoke. Examples include the hyperinflation of Germany and a few other countries after World War I; the collapse of the ruble after the October 1917 Revolution; the hyperinflation of Kuomintang China after the communist forces of Mao Tse-Tung crossed the Yang-Tse; and the hyperinflation in the former Yugoslavia in the 1990s. It does not bode well for its currency if a state is not powerful enough to defend itself against enemies from outside and within.

What about the Euro and the EU? Is the EU a strong central state? It is here that one can see a *potential* weakness of the Euro. Of course we could simply assume universal peace and go on to the next syllogism! If our assumption proved to be correct, the EU would not have to worry about enemies from without. It would be sufficient to hold itself together. Yet even here, nothing can be completely taken for granted. Monetary union is supposed to be irrevocable. But it might not be in the face of a violent economic crisis. A real test would be its ability to hold itself together in the face of a drastic terms-of-trade shock such as that experienced in the 1970s when oil prices quadrupled.

The problems arising from the weakness of the central state cannot be swept under the rug. However, there are strong mitigating factors. The Cold War ended, putting aside what was in the post-war years the most dangerous threat to European security. A closely connected factor is NATO, probably the most successful alliance in history. As long as the EU is tied to NATO and the military alliance with the United States, the EU will be

able to fend off enemies from without even if it is not a strong central state. At the same time, the process of monetary union will itself be a catalyst for political union, quickly bringing to common attention the most fissiparous issues. These factors greatly mitigate what would otherwise be a fatal defect.

The Fall-Back Factor

Historical analogies can be treacherous. Modern currencies differ from the great currencies of the past, which were all either gold or silver, or convertible into one or both of those metals. Unlike paper currencies, they had a fall-back value if the state collapsed. If any of the Italian city-states coining the sequins, florins or ducats of the Middle Ages collapsed, the 3.5 gram gold content would always have a fall-back value in metal. Metallic currencies frequently outlive the state issuing them, as the flourishing of Macedonian states in the centuries after Alexander's death clearly attest. A more recent example is the Maria Theresa thaler which continued to circulate in Eastern Africa long after that lady and the Austro-Hungarian empire was no more. That does not hold for a paper currency. After the Battle of Gettysburg in the United States, Confederate notes became worthless.

Until the advent of the dollar, there is no historical record of any fiat currency achieving great international significance. Before the twentieth century all the great international currencies were metallic. The predecessor of the dollar, the pound sterling, achieved its great distinction as a metallic currency. Even the dollar achieved international importance as a gold currency, selected unofficially as the anchor at Bretton Woods; if the dollar is now fiat currency, as a "ghost of gold" it is the exception that makes the rule.

The introduction of the SDR provides an illustration of the fall-back factor. When first distributed in 1970, it had a gold weight guarantee confirmed in the Second Amendment to the Articles of Agreement of the IMF. The gold guarantee made it a substitute for gold rather than the dollar and, at a time when gold was under-priced, a coveted asset that was in great demand. After the dollar was taken off gold, however, the international monetary authorities reneged on the gold guarantee, and the SDR went through a series of transformations, ultimately turning into a five-currency basket. When the Euro comes into existence and the mark and franc and perhaps also the pound are scrapped, the SDR will have to be changed again. Had its gold guarantee been maintained, however, the SDR would have been much more important in the international monetary system and perhaps qualified as a useful supra-national unit of account. Lacking both a commodity fall-back value and the backing of a strong state, the SDR fell by the wayside on the scrap-heap of forgotten dreams.

There is in this a lesson for the Euro. In any great political emergency, and especially one that threatened the durability of the EU, there would be a run on the Euro that would not be mitigated by any fall-back value. A run or even the risk of a run would make it difficult to float long-term securities in Euros.

It might be argued against this, that economies like Germany's thrived even when it was on the front-line of the Cold War. Yet two factors need to be understood. The first was the existence of NATO which kept Germany under the security umbrella of the United States. The second was that Germany, like most of the other countries on the European

continent, did not - or only rarely - issued debt exceeding 10-15 years. The substantial issues of long-term securities have been a phenomenon of the post-Cold War world.

Such an emergency of course might also weaken the dollar. Total political and military security can never be assumed. Nevertheless, the US situation differs in that the dollar has an established reputation; the US, though a federation, has a strong central government; and it is a military superpower. The lesson in this for the Euro is that the ECSB will need larger holdings of external reserves than otherwise or than the United States. Fortunately, the EU countries have dollars and gold in abundance and will therefore be able to meet any foreseeable contingency.

General Assessment

All things considered, the Euro should stand up very well. It has two great strengths: a large and expanding transactions size and a culture of stability surrounding the ECB in Frankfurt. Initially, the EU-11 will be smaller than the dollar area, but as other members enter, as the EU expands, and as the poorer countries catch up, the Euro area will eventually be larger than the dollar area. From the standpoint of monetary policies, there is also not much to choose between the two areas. Information is globally mobile and there is no reason why the ECB should not become as efficient as the Federal Reserve System in the United States.

The Euro also has two weaknesses: it is not backed by a central state and it has no fall-back value. These weaknesses would be enormously important in an unstable world. At present, however, we are in a period of remarkable stability. The *Pax Americana* backed up by NATO has been just as efficient in preventing major conflicts as the *Pax Britannica* of the last century. For the foreseeable future, we should bet on stability rather than the opposite and that tends to neutralize the absence of political union in the EU. At the same time, the more than substantial EU gold and currency reserves will compensate for the fact that the Euro starts out with no fall-back commodity value. Together, membership in NATO and large reserves suffice to neutralize what would otherwise be fatal defects. ●

Prospects in EMU

Reimut Jochimsen

Just a few days after the signing of the Maastricht Treaty, David Marsh, who has in-depth knowledge of the European economic and financial scene, summed up his impression in a gloomy forecast published in the Financial Times (December 24, 1991): "The Mark was disappeared and the Age of Stability would be no more." This prophecy went to the heart of the matter. Then, as now, the general public was calling for a clear and unequivocal prospect of stability; for the abolition of their currency not to be a political end in itself, and for the Euro to give us not just a new single currency by also a *good* one. People, particularly in Germany, are sceptical because all the efforts to create additional pillars of support for stability in the Maastricht structure (such as the stability pact, ERM II, the informal "Euro-x" council, etc.) do not, by themselves, imply anything about the *long-term* preconditions for the success of this ambitious epoch-making project. How sustainable and durable will the economic, institutional and political basis of monetary union be? And what additional efforts will be needed to create the preconditions for long-term success?

If it is created in the right way, the Euro undoubtedly has the potential to be as stable as the Deutsche mark. But how soundly this project is tackled will be pivotal for the Euro's success - and, in that respect, one must regrettably entertain quite considerable doubts. Let us briefly recall: before any data on the state of convergence had been made available, the word was being spread by many interested parties that a definitive decision had already been taken on the start of EMU and on which countries would be members. Thus, the entire process of examining convergence was downgraded to a show-event having a token character and made fun of, which is certainly not an advertisement for the credibility of the decision.

A further example of the doubts about the sound design of the project: senior politicians of the governing coalition in Germany have converted to the firm opinion that the abolition of the D-mark is not only the political "morning gift" that had been promised as an exchange for European integration. They believe it will also break the stalemate over reform in Germany and in Europe in economic terms, and even inevitably bring about all the necessary adjustments and changes geared toward European solidarity, as well as economic, political and social convergence and political projection. In other words, they

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see the Euro as a fail-safe remedy for everything and anything - for more growth, more jobs, a closer political union, etc. However, it would certainly be asking too much of the Euro to serve as a "prime mover," to act as a magic lever for all future problems in Europe, or to be the only project of integration which is still capable of achieving a consensus at present in an environment of growing neo-nationalism in a Europe of national states (without a common foreign, security or domestic policy).

Therefore, my concern is all the greater that 1998, the "year of the final spurt" and the "year of decisions," will become the year of "carrying on regardless," in which the preconditions that are not in place, the "soft" conditions and unresolved differences and contradictions of that ambitious political project will simply be swept under the table and ignored for reasons of sheer "political correctness." To say that price movements are all right, that inflation is dead, that the market's judgement speaks for itself in terms of interest and exchange rates, and that we shall then manage somehow or other to get indebtedness under control in monetary union is, in my opinion, extremely dangerous and a very risky bet on financial policy indolence.

There can be no doubt about the fact that the degree of price stability achieved in Europe was hardly deemed possible even just a few years ago. In terms of convergence in the capital market interest rates and exchange rate stability, things look different, however. Here, the progress made is undoubtedly based on inflation rates that have been lowered considerably; but this does not explain everything. In addition, as a kind of self-fulfilling prophecy, there is the expectation of the markets that policymakers will make sure EMU starts on time and with a large group of member states. I can only warn urgently against overestimating markets' ability to function as a referee on the success and failure of national economic policies. Markets can err, too, as history has shown in many cases.

Promises must be kept - therefore, the criteria must be completely and strictly complied with in every respect and by each country. With regard to the financial criteria, the focus is on sustainability. One-off compliance with the target values is not enough here, and even less so if creative accounting ("cooking the books") and other tricks are involved.

Much more important than the wrangling over decimal places in terms of the deficit is the correct medium-term trend. Particularly in this field, however, the facts so far have had little or no connection with the sustainability that is called for. And if government debt far exceeds the reference value, the country concerned will have to have demonstrated over a number of years that debt has been reduced at a satisfactory pace. A country, such as Germany, which has exceeded the reference value only recently but with an unstoppable upward trend, faces a very special problem, as this eventuality is not considered in the Treaty at all.

Political convergence in economic policymakers' minds, attitudes and actions is just as important as the convergence of nominal data required by the Treaty. European monetary policy would soon be overstrained if it had to do without the support of management and labor and of national financial policies.

In addition, there is a further legacy burdening monetary union: unemployment in Europe, which is far too high. Those who praise the single currency, of all things, as a prerequisite for solving the employment problem are arousing completely false hopes. One market, one currency - that implies raising efficiency as a result of even fiercer

competition. Some people even hope that we would be able to attain a competitive advantage and spare ourselves internal reforms by means of a cheap Euro that is undervalued against the US dollar and the yen. This will not work, either: a Euro with a weak external value and a strong internal one are incompatible, too.

Solving the problem of employment and reforming the labor markets are, in fact, indispensable conditions for monetary union to have any chance at all of developing into a durable and lasting community of stability that is capable of bearing strains. The more pressing the problems of employment, the more likely the European Central Bank is to run the risk of being called upon by other economic policymakers to introduce an easy money policy or depreciation strategies rather than gradual reforms.

To rely merely on hope is not enough - neither in labor market policy nor in respect of the other preconditions for monetary union's success. A premature start by immature partners would not only gamble away the opportunities which the single currency offers, but would even harbor substantial additional risks, particularly political and social ones. That is because, in the final stage, everyone is liable for everyone else, even if there were no formal bail-out. The resulting political tensions can easily be imagined. And it is also obvious that, under such auspices as a lack of agreement but great needs for adjustment, EMU is hardly likely to accelerate the future process of integration.

To start the final stage on time will in any case be mere child's play compared with the enormous and persistent challenge of keeping the Euro durably stable after that date. We still have some way to go before we arrive at a new Age of Stability. ●

EMU: Path to European Political Integration

Gianni Bonvicini

Only a few years ago no one would have bet on a single European currency.¹ Nevertheless the idea of a unified European money has a long history which can be traced back to the political philosophy that in only forty years has brought us from the European Coal and Steel Community (ECSC) and the European Economic Community (EEC) to the European Union (EU). The Euro can be considered the final point of the neo-functional project inspired by Jean Monnet. Through a progressive integration of national economic factors, from agriculture to steel, from trade to structural funds, it has finally arrived to the 'spill-over' point where integration in the economic field forces the Europeans to deal with the central question of how to govern the economy within the context of broader political cooperation. The currency, the Euro, is only a symbol, the 'veil' of classical economics texts, over a structural reality which requires real governing capacities.

Actually, the date 1 January 1999 does not represent anything more than the most recent attempt of European governments in this direction. As early as 1970 the Werner Plan (meant to 'defend' Europe from the dollar) tried to further develop along the neo-functional path of the old Community to the end of monetary union. Yet this very brief attempt and the 'snake' (the first experiment in cooperative monetary policy) were undermined by the dollar crisis. The exchange-rate volatility soon put an end to this experiment.

The later and less ambitious European Monetary System (EMS), which lacked both specific dates and objectives, was much criticized by the member states' central banks. Nevertheless, the EMS, once launched, made it possible to experiment with the monetary mechanisms necessary to understand the macroeconomic variables indispensable to initiate much broader projects in the field of economic integration.

The real premise for the Euro was the decision to complete the internal market through the first revision of the Rome Treaty, the Single European Act (SEA) of 1986, and its objective of completing this by 1 January 1993.

This set the real basis for developing the plan for the Euro launched by the Delors Committee, made up of members of the member states' central banks, in 1988. The first

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phase started in 1990, on the eve of the Intergovernmental Conference (IGC), which led to the Maastricht Treaty and to the inclusion within it of the subsequent steps. The last phase is now at hand. The Maastricht Treaty fixed the dates, the exact procedures, and the institutional mechanisms, but was more vague with regard to its aftermath. As a consequence, the 'Pact for Stability and Growth' had to be approved in Amsterdam in July 1997. Nevertheless, the institutional framework of the Euro can be considered to be very effective and sophisticated in as much as we are now on the eve of the final decision.

These brief considerations of history demonstrate the conceptual strength and the technical seriousness by which the whole single currency project has been carried out. Comparing, for example, the specific section of the Maastricht Treaty and the annexed Protocol related to the European Central Bank (ECB) with the section relative to the Common Foreign and Security Policy (CFSP) and the annexed Declaration on the Western European Union (WEU), one notes, however, the abyss which lies between the launch of the Euro and the CFSP, in terms of both the maturation of their ideas and their institutionalization.

Clearly, in the end, the decision taken between the end of March and the end of May is again an essentially political decision, as it has been in the past (as with the EMS in 1979). But this time there is less room for maneuvering because there are the 'objective' criteria on which the decision is being made, as well as the qualified majority voting that must be respected (i.e. one country voting in the negative cannot block the decision). Finally, because the project has gained inertia from the preceding two stages of Economic and Monetary Union (EMU) it is difficult to alter or rethink the mechanism. As a result, all countries have tacitly suggested that if the launching of the Euro were set back it would mean abandoning the project altogether.

Despite this there are still numerous forces working against the Euro. On few previous occasions have the decisions of the European governing 'elite' met with so little enthusiasm among the people. The lack of an ideal, long-term end-state in contrast to the concrete short-term advantages which have been focused upon by member governments has rendered the whole project barren: thus it has been suggested that the Euro is being born without a 'soul'. This is most unfortunate, however, because this project has such a great historical importance.

The macroeconomic convergence criteria of Maastricht have become, in the rhetorical arguments of many European leaders - especially the Germans, an 'ideological substitute' as against the deep values of European integration. As such, the Euro comes to be seen as a result of the plans of merchants and bankers, as a technocratic project: by definition a project distant from the interests of the normal citizen.

Added to this, the idea that Europe does not function well in other sectors of activity has been gaining ground, starting from the CFSP area which was once seen in the collective imagination as a tool for bringing peace to the crisis areas nearest to Europe. Instead, from Bosnia to Algeria, there remain signs of internal division and impotence. This is the horizontal link between the Euro and CFSP, which further weakens the perception of the former project.

How is it possible, then, to allay fears and sway ambivalent public opinion?

This is a matter which the governments have paid little attention to and repeatedly delayed addressing. They have been, instead, more engaged in the race to participate, at

all costs, in the 'club', rather than finding the political and economic reasons by which they might justify the move to the Euro to their populations. This enthusiastic race to join the club is another paradoxical aspect of the Euro affair, especially when contrasted to the cool public reception. Even countries that have opted out of the first round, particularly Britain, have used all available pressure in order to take part in and define the participatory roles within the Euro council (or Euro-X) established through Article 109k..

This evident wish of not losing contact with or influence over the leading group is contradictory to the hostile attitude of those states towards the Euro. Nevertheless, this is an important sign of the deep political meaning of the introduction of the Euro. Based on this a complete re-evaluation of the economic and monetary integration should start. One not based on 'technical' criteria but which, on the contrary, examines the 'spill-over' into political integration.

In helping to confuse the question of 'technical' criteria, the great role attributed to the ECB in the Maastricht Treaty must be mentioned. To this there was added the German insistence on protecting the ECB's independence from political influence. There is no doubt that the argument is valuable, even if it must be said that the Bundesbank's independence emerged historically from the difficulties relevant to the creation of the German Federal Republic in the aftermath of the Second World War and from the weakness of the government at the time, busy as it was with the reconstruction of its political credibility. Trust in a strong central bank was the only way to create an equilibrium among state institutions while at the same time strengthening the federal government's role.

Today, in a completely different historical context the same argument works partly to understand the EU and the Euro. As in post-Second World War Germany there exists a political 'vacuum' due to the fact that the European Council of Finance Ministers (ECOFIN) and the European Commission have neither the instruments nor the powers to claim to be governing the Euro. Relative to such a weakness in the institutional and political framework, there arose the logic of 'loading' the ECB with exclusive responsibility for handling monetary policy.

Which orientation will the ECB follow for the monetary policy of the Euro?

The experts expect a restrictive monetary policy, perhaps even stricter than the economic situation of the moment might require. Especially if EU economies, considering the Commission's recent data, will confirm the growth already seen in 1997. It must further be considered that the fiscal rigidity foreseen in the Pact for Stability and Growth cannot be disregarded by member states participating in the launch of the Euro.

Restrictive monetary policy, likely combining rising interest rates with strict budgetary discipline, may provoke a series of short-term economic consequences which, through increased competition with diminished production costs, will lead to further labor problems. Not even the predicted growth will bring great advantages since it occurs more slowly in the big economies and risks suffocating the small ones by creating differences among Euro-participating member states.

Who will manage these differences? How will further unemployment be faced while at the same time expecting that the restructuring of the European enterprises (those which will have survived the shock of monetary unification) will relaunch the international

competitiveness of the EU (which is generally expected to be the long-term consequence of the introduction of the Euro)?

One must ask, however, how to make a unified monetary policy without the harmonization of constituent national fiscal policies, without making social welfare regimes more transparent, and without more flexible labor policies. It is obvious that the answer is not to be found in the role of the ECB but rather in what Italian Finance Minister Carlo Azeglio Ciampi bluntly defines as a 'politico-economic institution with political authority.'

In the absence of this economic government one dares to say that the monetary policy of the ECB will not bring us that far, thus risking increasing fragmentation of markets and growing differences among national economic systems. On the other hand, it is considered to be in the interest of the ECB to avoid accepting all the responsibility for the success or the failure of the Euro. Once having 'locked in' all national monetary policies within the European one, the need for a 'credible' political interlocutor will spontaneously arise. Here we face the true problem: political legitimacy and efficacy.

As shown above, however, it is the neo-functional technique that will ultimately produce a 'spill-over' into the area of political institutions. The Euro represents exactly the step towards this final stage. This is not only explained through the economic and monetary affairs which brought about the Euro, but through the wider significance of the single currency in the designing of the political integration of Europe.

In fact, though the economic consequences have been thoroughly examined, the general policies which are intrinsically linked to the presence of the Euro have not.

The first consequence is that with the Euro one already has the outline for a Union of reinforced cooperation, which the Amsterdam Treaty has desperately tried to apply either within the first communitarian pillar (Article 5a) or within the third pillar, relating to justice and internal affairs (Article K12-17). The three-stage Maastricht Treaty with its plan for EMU, with the final stage reserved for the countries of the Euro 'club' (including independent organs and procedures), has already fixed the basic rules of reinforced cooperation.

This has at least two 'strong' political consequences:

Above all an Governing Council will have to be initiated not only with economic but also with political characteristics. It is hard to believe that those who take part in the launching of the Euro will not also take the 'leading role' in the construction of the Political Union. No one can deny the full legitimacy of the countries participating in the Euro in seeking to advance on their own in the area of political integration as well. This prospect will facilitate the embarking on the path to the political government of the economy of the like suggested by Carlo Ciampi, and will also lead to its responsibilities in other aspects of integration.

Further, the Euro 'club' will facilitate the design of a Union enlarged to twenty or more members. It will allow the massive inclusion of structurally much weaker countries than those participating in the Euro, without affecting the efforts of the leading group to more rapidly and more deeply integrate. Without this leading group enlargement would risk reducing the EU to a multilateral framework without real political and economic direction. Also, in this case, the strategy of EU enlargement would have to be lead and controlled by a political government able to avoid fractures and discrimination either with regard to the leading group or the new adherents.

The second consequence of the birth of the Euro regards the reinforcement of the Union's international role. It is obvious that the dollar-Euro relation will constitute the central focus for the foreseeable future, at minimum in the field of monetary policy. But it is also easy to predict that decision-making in the monetary field will also affect commercial, financial, and other related policies, in this way unifying the whole external economic policy of the EU.

From here it is but a short step to the more general political relations between the United States and Europe. These horizontal effects, from the monetary to economic, to the political and finally to the security sector, are the direct consequences of a progressive diffusion, in practice more than in theory, of the concept of global security and thus a soldering of the economic, diplomatic, and military policies in international relations.

It must further be added that economic questions have today assumed an absolute priority on the agenda of western governments and have been transformed into questions of national security (e.g. Tarnoff Doctrine, cf. the US President's decision to create a National Economic Council parallel to the traditional National Security Council). From its beginning, essentially regarded as a civilian power, the EU's launch of the Euro represents a decisive step on the way to reinforcement of the concept of internal and external policies. The Euro shows the major role of economic power as used as a means to promote internal and external stability. This projection of stability will have powerful impacts on the issue of common security as well.

In this view, the Euro definitely assumes the significance of a primary factor of security for the Union and of an instrument for the adoption of new responsibilities in the field of international relations. Obviously, this new factor must be governed and managed with responsibility and political efficiency: this aspect requires a strong political government for the Euro.

If these considerations have a base it is even more obvious which way the European governments have to go in order to regain the support of a public already disillusioned by the lack of mobilizing projects and by the too rhetorical and too technical symbolism surrounding the Euro. The lack of courage in explaining the true character of the Euro, due to the hesitations of the governments less inclined toward integration, has continued to deprive the Euro of its revolutionary significance. That significance is the ultimate passage towards the political government of Europe and thereby to the completion of the process of economic integration in view of the political one.

Without the power of this ideal end-state project, the Union risks limiting or even wasting the opportunities and potential of the Euro, one of the major European events of the post-Second World War period. ●

¹This article was translated from Italian by Brendan Fitzsimmons, Alessandra Nervi and Francesca Scasselati-Sforzolini.

The Politics of EMU

Pat Cox

The past decade has been marked by a period of enormous change in the European Community.¹ The Europessimism of the early 1980s was displaced by the enormous drive and focus on achieving the Single European Market. The project, which still remains to be completed in a number of sensitive sectors, was legislated for through the Single European Act. Once enacted, the foundations were laid for the successful completion of the single market and thoughts then turned, or given the Werner Plan of 1970s, returned to the question of economic and monetary union.

A single currency for a single market was the foundation of the grand design. Its author, Jacques Delors, as French Finance Minister some years earlier, had launched France on its "Franc fort" policy of disinflation. This policy, in spite of its obvious costs, has been pursued doggedly by each French administration since, and has transcended party and ideological divides. Meanwhile, the monetary union issue took on a new character in German politics.

Originally conceived as the monetary counterpart to the single market, the German government played a prominent part in its planning and definition. After the collapse of the Berlin wall and the thrust for German unification, economic and monetary union took on a more central role in Germany's political consciousness. It was to be the means to bind the unified Germany irrevocably to the European Union. Monetary union marks, for the current Kohl-led German administration, a right of passage for a *European* Germany rather than a *German* Europe, with the new unified state becoming increasingly bound to Europe and moving away from the re-emergence of a balance of power, with Germany being the king-pin of Mittel-Europa.

The Franco-German alliance has been the powerhouse of deepening European integration. In the monetary sphere that remains the case, and, in both instances, the politics points unmistakably toward completing the grand design.

The Politics of Convergence

The Maastricht Treaty set out the conditions required for entry to EMU and signalled a major regime change focused on low and stable prices, sustainable budget balances, stable exchange rates and convergence of long term interest rates. Annual reports of the European Commission and of the European Monetary Institute (EMI)

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indicate the substantial achievements to date. There has been remarkable progress on price stability across the European Community. While judged by other criteria, especially budget balances, progress has been impressive. It is clear that an enormous level of consistent political commitment underscores this change.

In many states the emphasis on increased fiscal restraint has been set against sluggish economic growth and high and rising unemployment. In the short term, given the stage many countries are at in the economic cycle, fiscal retrenchment may be adding to the problem, yet the policy focus on the utility of fiscal consolidation in the longer term has not shifted.

The consistent willingness of governments to press ahead in such circumstances is a measure of profound determination which should not be underestimated when assessing the momentum toward realizing EMU on time. Acceleration of economic growth would ease Europe's growing dole queues by between one then and one quarter according to different estimates. However, there is an increasing and widespread acceptance, not yet translated into significant policy change, that the bulk of Europe's unemployment problem is structural in its nature and also in its solution.

Short term fiscal fixes are progressively being ruled out in favor of recognizing that in the medium to long term, growth and employment prospects are enhanced by fiscal prudence. EMU's greatest political triumph to date has been to force politicians to recognize the fiscal corrections required to underpin the regime change contemplated.

The Politics of Sustainability²

Who will qualify for participation in the third stage of EMU is the source of endless and, as we get closer to the decision date, growing speculation. The Treaty on European Union (TEU) brings us a considerable way toward answering the question. In regard to fiscal positions it emphasizes three aspects not one. Firstly, it sets the two reference values of 3% deficit ceiling and a 60% debt ceiling which should not be exceeded. Secondly, it allows for deviations from these reference values under certain carefully described conditions which are not quantified. Finally, it insists that the fiscal positions have to be sustainable. The critical judgement call will hinge on the issue of sustainability.

Signaling a very early concern to place this issue at the core of the debate, the Germans proposed the stability pact aimed at ensuring a normal budget position of budget balance, or at least a budget deficit significantly below the 3% Maastricht ceiling. After a lengthy debate in all the European institutions, the Dublin II Summit agreed the general outlines of the pact for stability and growth as well as appropriate Council Regulations for dealing with excessive deficits, which were subsequently initialed at the Amsterdam Summit. This pact asks member states *inter alia* to commit themselves to respect the medium term budget objective of close to balance or in surplus set out in the stability programs to be submitted annually with the commencement of Stage III.

The prompts the conclusion that deviations from the reference values are likely to be granted only sparingly. Moreover compliance with these values should be interpreted as a necessary but not a sufficient condition for entry. Sustainability is the key requirement. Thus, another strategic political triumph of the EMU debate has been the generation of a Community-wide political consensus on the core role of sustainability, adding further fuel to the momentum behind the regime change.

The Decision-Making Calendar

Member states whose establishment arrives at the decision-making table in the 1998, exhausted from the rigors of creative accounting or self-deluding mini-budgets designed to improve deficits in one year by shifting expenditure backwards or bringing taxation forwards, will soon realize that just making the cut in 1997 does not suffice. That is why neither the Commission nor the EMI will publish their reports prior to the end of March 1998 in respect of the state of convergence of member states in 1997. The delay is occasioned by the insistence on having definitive economic data for 1997 and the full budget data for 1998. Thus, the figures for 1997 will be real, not estimates, and the budgetary data for 1998 will indicate whether these are genuinely sustainable.

Both the Commission and the EMI will adopt their reports and publish them as a package on the same day. The divergence of emphasis which attended such publications in the past will not repeat itself on this occasion. Both institutions, on my current understanding, will list which states fulfill the criteria. This package of reports will then be transmitted for the attention of national parliaments and the European Parliament whose opinions will feed into an EcoFin Council. This Council meeting will then make its recommendations to the European Council which will meet over the same weekend, perhaps even the same day, and announce the definitive list of participating states as of and from 1 January 1999.

This outline calendar is now unanimously agreed. No political concession is evident in this timetable. No delay scenario is being examined at this stage. None is likely to emerge. The political commitment is to deliver EMU on time. ●

¹ The following text is from a speech delivered to the 1997 Annual Conference of the Irish Association of Pension Funds, Dublin Castle - 16 April 1997. Reprinted with permission from the Office of Pat Cox, MEP.

² This section has been slightly modified in light of the signature of the Stability and Growth Pact at the Amsterdam European Council Summit, June 1997.

Britain and EMU: Emerging from Denial

Alan Butt Philip

The widespread and publicly expressed scepticism about economic and monetary union to be found in the United Kingdom conforms to a long established pattern. Doubt and ambiguity concerning the European integration process has dominated British attitudes toward the EC, and now the EU, since the 1950s. Government and people have usually been at one in this respect. Britain was wrong-footed by the development of the EEC, failed to appreciate the dynamizing impact of the Single European Act and pretended too long that economic and monetary union was not going to happen. Observers of the European integration process inevitably have a distinct sense of *deja vu* as the new Labour government starts to clear the political decks in preparation for possible late entry by the UK in the Euro-zone. Even now the discussion in Britain is dominated by fears of being left behind by the economic downside of being on the edge of the Euro-zone, and concerns about loss of political clout arising from maintaining a position of splendid isolation - all negative reasons which avoid making the positive case for renewed steps to achieve further economic and political integration in Europe.

The British approach to the development of the EU results from an over-economic perspective in the integration process generally. It has always been thus. So high politics justifications of building up an economic and monetary union in order to secure the post-1945 and post-1989 settlements of past European conflicts appear to have escaped the British. Such justifications are not part of the common currency of political debate and are rarely expressed, even by the EMU supporters in the UK.

In fact there is a growing problem, still largely hidden from view in the UK, which is that too many younger people just do not know anything about the political context which spawned and has driven the European integration process forward for fifty years. The good thing is that most people in the UK seem to accept that the EU is here to stay and should be treated as a fact of life that has to be dealt with and cannot be avoided. The bad thing is that so many still don't appreciate why Britain ever joined today's Union in the first place.

Even at the level of the political and economic elites in Britain there is precious little insight into the reality of European integration. Not only has the teaching of history in our

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schools and universities been marginalised and dumbed down so that few people under 35 have much sense of the twentieth century history of Europe as a whole. But our political class, still heavily recruited from the universities of Oxford and Cambridge, has not been educated about European integration. Oxbridge did not discover European integration as a legitimate subject of study until the 1990s, and even then the subject is taught mainly to postgraduates recruited from overseas!

Given the scepticism about the EU prevalent among the mass media and public opinion, and the continuing ignorance of our political and administrative elites on matters European, it is not surprising that Britain is unprepared for EMU. The wonder is that our government is now taking seriously the option of joining the single currency at all. The arguments in favour that do command attention in the UK are almost all economic - just as Britain's original decision to join the ECs was primarily governed by economic self-interest.

The British mindset became fixed upon the economic advantages of membership in the ECs back in the 1960s. The political case for European integration was seen as a secondary consideration and heavily qualified by claims that Britain could always protect her national interests by recourse to a national veto in the Council of Ministers. This has proved to be an unreliable crutch in the longer term, as the enlargement of the EC and the pressures to complete the common market have forced significant shifts in the decision-making procedures of the EC/EU towards voting by qualified majority in the Council, with powers increasingly being shared with the European Parliament. Events in the 1980s and 1990s have laid bare the British illusion that the EC could be run as an intergovernmental regime based upon co-operation rather than full integration. To stay in the political and economic game the UK has had to accept far more political integration than it had bargained for. Even in 1998 there are many in Britain, particularly on the right of the political spectrum, who do not understand that just to achieve the famous level playing field which governs the single market it is necessary to pay a political price, in terms of centralised rule-making by qualified majority through the European Community institutions.

Economic and Monetary Union thus represents for many in the UK yet another step (and a very major one) being taken down the slippery slope towards full economic and political integration in Europe. Conservative governments from 1979 to 1997 were hostile to this project, but once the EU embarked upon it they were keen to shape its development and to keep open Britain's options in relation to the single currency. Even that vital and modest concession to reality broke the unity of the Conservative party and, as much as anything, ensured the rout of the Major government at the polls in May 1997. The tone of the new Blair government in regard to the European Union represents an enormous reversal of policy. A positive face is now being put on matters European, and the framework of debate in Britain has now been transformed. But the substance of British actions so far in the European theatre of politics has not changed much, apart from the belated acceptance of the social chapter of the Maastricht Treaty. There is a delicious irony in entrusting to the British presidency the responsibility for setting the final arrangements for the launch of the single currency in January 1999. Indeed Britain's very detachment from the original EMU decision may prove to be a bonus in giving the Euro, and the decision on which countries are eligible to participate in the first wave, extra credibility. Yet, even if the Maastricht convergence criteria are met (however nominally) by the

eleven applicants for first wave Euro status, there is increasing recognition in the UK that the indicators of the real economic convergence necessary to underpin the credibility of the new currency are not being measured or even weighed in the balance when the decisions on participation are being made. Such indicators would have to include rates of unemployment, GDP per head, and rates of economic growth.

As far as the UK's own position in relation to the Euro, it is now dawning on the business and financial communities just how extensively they will be affected by the advent of the Euro, whether or not Britain formally joins it. When Marks and Spencer announce that they will be able at all 11,000 of their sales points to handle transactions in Euros this suggests that the Euro could quickly become a parallel currency in some sectors of industry and commerce in the UK. But lack of a government lead in the mid-1990s now means that there is no way that Britain could be made ready to join the Euro in time for 1 January 1999. The new Labour Chancellor, Gordon Brown, told the business world last year to get ready for the single currency and at last there are clear signs that the onset of the Euro is being taken seriously rather than dismissed as another European pipedream - just what British officials also said about the common market in the 1950s! Academic economists however are still critical of the timing of the project because so few of the hallmarks of an optimal currency area are in place.

But to get the British out of a mindset of denial about the Euro, the Labour government first of all had to promise that the UK will not sign up to the single currency without there first being a referendum held to assent to this step and secondly, Mr. Brown has pledged that the government will not propose such a move unless five further tests have been applied and satisfied. These are that there is 'sustainable convergence' between the UK and other economies participating in EMU; that EMU has the flexibility to cope with economic changes and its impact upon employment is positive. The impact of EMU upon investment in the UK and the financial service industry will also be assessed. Overall the Chancellor wishes to be satisfied that it will be in the UK's interests to join the Euro-zone and he may well come to this conclusion even if all five tests are not met in full. The question of the exchange rate parities which will be fixed for sterling upon joining the Euro is of great concern to British exporters of manufactured goods. They are currently being crucified by a strong pound, which is generally reckoned to be as much as 15 percent overvalued in relation to the German mark. No one is discussing how a major devaluation of sterling is to be achieved before the pound gets locked into the Euro, but everyone is all too aware of the potentially fatal impact of locking sterling into the 'wrong' rate, given the very raw memories of Black Wednesday 1992 when the pound was catapulted out of the exchange rate mechanism. Technically, the pound ought in any case to be rejoining the ERM up to two years ahead of any planned entry into the single currency, according to provisions in the Maastricht and Amsterdam treaties, but that is another subject that politicians in the UK would rather not talk about just now.

The British attitude to the Euro will above all be conditioned by how the Euro performs after its launch next year. If it performs well and is credible in the market place, then the UK is likely to put its own progress towards the Euro on a 'fast forward' track: the Labour government could even be forced to join forces with pro-EMU Liberal Democrats and Conservatives to carry Parliament and the ensuing referendum on this subject. If the Euro performs badly and does not enjoy market credibility, British caution will appear to have been justified, even though the role of Cassandra does not win friends

and the course of European integration would have been damaged, perhaps even irremediably. Either way Britain's approach to the single currency will have been an example of her walking backwards towards European integration. Business as usual! ●

EMU *sans* Sterling: Implications for Irish Policy and the Economy

Christopher L. Burdett

Ireland, once regarded as a third-tier economic power in the European Union, is now poised to join the European Economic and Monetary Union (EMU) - testimony to notable economic achievements as well as Dublin's strong fiscal and monetary policies. In Brussels, there seems to be little doubt that Ireland will be included in the first round. Irish Prime Minister Bertie Ahearn is determined as ever to bring his "Celtic Tiger" into EMU.

In early May, the exchange rate of the Irish pound (punt) will be irrevocably fixed relative to the currencies of all other qualifying nations, less the opt-outs and those Member States exceeding the Maastricht criteria. Irish monetary authorities will then be responsible for maintaining this rate on the market until the start of Stage Three (1 January 1999), after which the European Central Bank (ECB) will take over all monetary functions for the euro area. Subsequently, Ireland will no longer control the exchange rate of the punt nor its interaction with the currencies of the EMU *outs*.

Short of a radical policy change by London, the euro area is not likely to include the British pound sterling, prompting interesting and crucial questions for Irish businessmen and policymakers. The crux of their concerns rests upon Ireland's close market relationship with Britain. Previously, high levels of Anglo-Irish trade have been bolstered by a near *de facto* exchange rate parity between the punt and the sterling. EMU will permanently break this parity by fixing the punt, but it will not sever the close market ties. Both economies will remain subject to the effects of exchange rate movements/realignments. However, while Britain retains its monetary policy flexibility, Ireland will surrender its ability to adjust the punt and thereby divert negative spillovers brought about by exchange rate movements.

This article will attempt to assess the likely short-term dangers to the Irish economy once the punt enters EMU without the sterling. Special attention will be paid to potential changes of the Irish government's policy that may be necessary to offset negative effects of sterling fluctuations. However, I will first refer to a brief historical analysis of the modern Irish economy and its links with Great Britain in order to establish the context of this discussion.

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Evolution of the “Celtic Tiger”

Ireland's economy has experienced relatively high annual growth rates since the 1960s, when the Irish government structured its tax laws to encourage foreign direct investment. This industrial development strategy, built on tax incentives, made Ireland a cheap location for production, spurring general Irish GDP growth as well as the rapid expansion of the export sector.¹ Dublin's accession to the European Community (EC) in 1973, moreover, provided access to the Community's markets, increasing the country's attractiveness to investors and export firms. Ireland has since emerged as Europe's *tiger* economy.

During the 1970s, the Irish government promoted fiscal expansion to spur growth and following the oil shocks, was subsequently confronted by high inflation, high debt, and current account deficits. The government's first attempt at fiscal reform was structurally unsound, aiming at revenue enhancement rather than spending cuts. In turn, the annual government deficits remained high, between 7 and 7.9 percent of GNP from 1981 to 1986.² Though inflation fell, the overall debt soared to as high as 117.1 percent of GDP in 1987; growth slowed to as low as -0.4 percent in 1986; and unemployment increased dramatically from single digits during the 1970s to a level of 17.6 percent in 1987.

In 1987 a new government set its economic policy on three pillars: social consensus, fiscal correction, and exchange rate stability.³ The budgetary authorities began to initiate true spending cuts to lower the annual deficit. In conjunction with Irish social partners, Dublin introduced the Programme for National Recovery (PNR) which called for wage-stability and tax increases to eliminate the deficit. This would free the government from domestic wage pressures. Additionally, the European Community Support framework (1989) helped to compensate for the fall-off in public expenditure and thereby in part relieved the stress of fiscal cuts against the growth rate. Lastly, but equally important, the new approach committed the punt to the European Exchange Rate Mechanism's (ERM) central band relative to the Deutsche mark (DM).

The 1987 program was remarkably successful and supported high annual increases in growth. Restored confidence in Ireland contributed to lower interest rates, while tight monetary policy capped inflation.⁴ Ireland was better poised to exploit its export position, which had been growing throughout this period of instability - exports of goods and services had increased as a percentage of GDP from 30.6 percent in 1960 to 58 percent in 1985.⁵

Today, the basic pillars of Irish conservative fiscal policy and social consensus are still in place and have been key to the rapid expansion of the Irish economy throughout the 1990s.⁶ Moreover, the Irish export sector has continued to develop, fueling high growth rates and maintaining a positive trade balance over this same period.⁷ Foreign direct investment has encouraged the increase of Ireland's high-tech industrial base and increased the country's supply capabilities. For these reasons, even during the continental recession of the early 1990s, Ireland managed sound increases of 3.1 percent of GDP in 1993 followed by an upward trend peaking at 10.1 percent in 1995.⁸

The Punt/Sterling Relationship

Upon entering the ERM in 1979, the Irish government broke the official punt/sterling parity that had existed since the founding of the Irish Free State in 1921. Even as the punt was nominally stable relative to the DM during the 1980s, pressure from the sterling remained.⁹ In fact, after 1986, the movements of the punt in the exchange market shadowed those of the sterling though the Irish government had abandoned its official parity policy (See Graph 1). Noting the close Anglo-Irish relationship, market speculators, in essence, artificially pegged the punt to the sterling assuming Irish authorities would ultimately allow the currency to float and maintain nominal terms of trade.

Such speculation has undoubtedly complicated Irish monetary policy. Consider the 1992 ERM crisis. Britain's entry in 1990 at an overvalued rate relative to the DM (coupled with high domestic interest rates and a policy-credibility gap) immediately subjected the sterling to downward speculation.¹⁰ By 1992 German interest rate policy and this speculation made the sterling rate within the ERM untenable and Britain opted to float. The sterling's depreciation helped British cost-competitiveness, leading speculators to hedge against a punt devaluation.¹¹ Eventually, in the wake of market pressures, the Irish central bank decided to devalue the punt by 10 percent and stay within the ERM.

In the years since, the sterling has again appreciated in the world markets, pressuring the punt near the limits of the upper 15 percent band relative to the DM. The sterling appreciation has limited the ability of the Irish monetary authorities to fight inflationary pressures, giving rise to speculation that in May the Irish government may seek to revalue the punt (relative to the euro) in order to stave off importing inflation from the UK.¹² The Irish government, however, seems committed to holding out until the start of Stage Three.

The 'Embedded' Anglo-Irish Market and EMU

An embedded market structure between two countries, as defined in the context of this discussion, consists of strong, historical market ties supported by micro- and macro-economic similarities. In the case of Britain and Ireland, the embedded market rests on three key levels.

First, there is a pronounced Irish trading relationship with the Great Britain. In 1996, British trade accounted for 34.8 percent of the total Irish imports and 24.8 percent of all Irish exports - worth approximately 10.2 billion ecu and 8.9 billion ecu, respectively.¹³ These export/import levels with the UK have been consistently high, though declining (See Graph 2). Compared to all other Irish trading partners, Britain represents the single highest importer and exporter, exercising a relative dominance in virtually all sectors, and is notably the only country with whom Ireland runs a trade deficit.

Second, Ireland and Britain share a common employment market, at least in a *de facto* sense.¹⁴ The fluctuations of Irish employment levels are related to British changes due to a distinct pattern of emigration and the general ease of movement between the two countries. During periods of economic growth in Britain and an expansion of labor demand, Irish unemployment levels drop as the excess supply for labor has an alternate location to enter (See Graph 3).

Third, as discussed, the Irish punt and the British sterling have been linked by a shadow exchange rate parity.

Bearing in mind these general characteristics of the Anglo-Irish embedded market, one is able to determine possible consequences of EMU for the Irish economy and income/output levels. Theory explains that fluctuations in the exchange rate between two countries leads to changes in the relative prices of import/export goods. All else being equal, a country's income level will rise or fall according to the direction of the exchange rate movement: appreciation of the domestic currency will raise the price of export goods and constrict output; depreciation will lower export good prices and boost output.

Recalling that a high percentage of Irish trade is dependent on Britain, the exchange rate movements of the respective currencies are important to Irish output levels. In the past, the shadow punt/sterling parity helped alleviate pressures on output by maintaining a steady rate (nearly 1:1). Once Ireland enters the euro-zone, the exchange rate market might not service this shadow parity. If the sterling, either by government design or by market forces, remains on par with the euro-rates (the exchange rates set as of May), then there is no real cause for concern. If the sterling continues to float, however, Irish output could be duly effected.¹⁵

Policy Options

In light of the possible ramifications of EMU without the sterling, there are three key approaches to maintaining output stability and growth that the Irish government has at its disposal. Given the limitations on Dublin's policies once within the euro area and the historical predilections of Irish economic policy in general, the following discussion attempts to discern what, if anything, the Irish government might do if the sterling-euro rate entered a period of volatility.

I. COUNTERACTIVE MEASURES OF FISCAL EXPENDITURE¹⁶

As stated above, changes in output brought on by fluctuations in the exchange rate may be counteracted by government fiscal policy. For example, in the event that the pound sterling depreciates, Irish output will fall in step with declining aggregate demand for Irish exports. A rise in fiscal spending could increase output and domestic aggregate demand until the effects of the sterling depreciation are neutralized.

This policy option is handicapped, however, by the *Stability and Growth Pact*, which commits the Irish government to maintaining fiscal austerity. More specifically, deficits *on average* at or below 3 percent of annual GNP must be maintained, or suffer penalization for a continued or excessive infraction. Therefore, if the Irish government were running deficits near to or at 3 percent of annual GNP at the time of the depreciation, the freedom to raise fiscal spending or cut taxes would be inhibited. Dublin should thus do its best to maintain its fiscal policies and deficit levels at or around an even balance in the event that an adjustment in fiscal spending is needed.¹⁷ (Luckily the Irish government has shrunk its deficit steadily over the past decade, even obtaining a surplus in 1994.)

But is this in fact wise? Though the arguments for this policy are tempting, especially in the event of a decline in output, fiscal expansion would not likely yield any substantial short-term or long-term benefits. If Dublin increased expenditure, the money would first enter the domestic market. However, Ireland's economy is export-driven, and short-term growth is thereby not dependent on domestic demand. Therefore, unless the Irish government could raise expenditure in such a way as to simultaneously spur external

demand and purchases of Irish goods, output would still decrease and the government would instead face domestic inflationary pressures (stagflation).

Regarding unemployment shocks due to decreases in output, fiscal policy may likewise be ineffective. The Irish economy has proven itself incapable of creating jobs to match its population growth even during periods of economic expansion.¹⁸ The high-tech nature of its export industry creates a great deal of structural, long-term unemployment as more labor intensive, low-skilled sectors - namely agriculture and industry - shrink.¹⁹ Therefore, fiscal expansion would in the short-term bloat the public sector with unskilled, temporary workers who are still excluded from the growth engines of the economy: the service sector and high-tech industry.

Additionally, one must consider the relevance of a change in fiscal policy for the Irish economy's credibility as a whole. Throughout the 1980s, Ireland struggled with the fiscal disregard of the 1970s, which affected Ireland's debt-carrying capacity and levels of outside investment. The government's 1987 macroeconomic package was therefore primarily designed to restore faith in the Irish economy both domestically and internationally by reforming fiscal expenditure. A break from this pattern even after several years of consistent success and growth would contradict the principles upon which Ireland's *new* economy rests.

II. THE "DO NOTHING" APPROACH

Recalling that the main causal variable is the fluctuation of the sterling-euro exchange rate and that these fluctuations are considered to occur in the short term, one cannot be certain that the sterling exchange rate volatility will in fact affect trade volumes.²⁰ In an *embedded* market, where there is a strong and long-standing trading relationship between two countries, short-term changes in the exchange rate will not substantially influence trade flows as long as the changes remain short-term. Firms may adjust prices temporarily, but the level of purchases ought to be relatively constant as seeking new markets may incur greater costs than simply waiting out the fluctuation.²¹ As a result, aggregate demand would not shift and output would not rise or fall.

A model designed by Andre Sapir and Khalid Sekkat indicates that, theoretically, exchange rate fluctuations are translated into the market not via changes in trade volume but through changes in prices - which depend on the market structure and a firm's perceptions of exchange rate stability.²² Moreover, the depth of market integration has a tendency to neutralize the effects of exchange rate volatility.

Under this model, trade as related to exchange rate movements essentially becomes a function of risk, market perceptions, and market structure. In the short-term, firms are more likely to hedge against volatility and insure against adverse effects on trade.²³ Risk is lower as firms, expecting volatility, counter the effect beforehand. Additionally, if trade volumes are sticky in the short-run, these firms ought not encounter substantial drop-offs or expansions of demand as a result of the change in the exchange rate. The embedded market structure multiplies the stability of trade volume where volatility exists.

On the other hand, in the longer-term where misalignment is perceived, firms are prone to rethink their presence in the market, levels of production, etc. The risk of losses becomes greater and more pronounced. If the exchange rate fluctuates and is perceived by the firms to have long-term implications, firms may adjust their trade volumes or, more drastically, their trade flows.

Thus, in the short term, the Irish export/import trade stands to lose little, especially if the UK is seriously considering membership in the euro-zone by 2002. If perceptions continue to focus on the short term, intra-UK/Irish trade volumes will remain relatively stable in light of the integrated market. Firms should be inclined to wait out a period of sterling volatility (if one even arises) with the medium-term understanding that the UK will soon adopt the common currency and eliminate altogether the dangers of currency fluctuations.

Nonetheless, sterling-euro exchange rate volatility may encourage firms to adjust prices to account for revenue shortfalls rather than re-forge market connections. An appropriate means of clarifying this relationship is to look at the *Direct Approach* to the balance of trade as affected by changes in the exchange rate.²⁴ In the event that the trade volumes are stable in the short term, as the Sakkir (et. al.) model indicates, exchange rate fluctuations will only significantly influence prices, if at all.

The adjustment of prices is not always an automatic response to exchange rate fluctuations, though; instead, the impact on prices relies heavily on the degree of *pass-through*, or the translation of the cost of the exchange rate into market prices. For instance, if a firm occupies a precarious market position, where changes in price could lead to significant losses in market share (elastic demand), the firm may opt to keep prices constant and absorb any costs in trade profits (zero pass-through). Therefore, pass-through is primarily a distortionary effect and centers on firms' perceptions of risk and of how changes in price will effect demand.

The degree of pass-through is quite important in analyzing the market effect of sterling-euro fluctuations. As volumes are likely to be stable, fluctuations could result in price changes within the Anglo-Irish market. Nonetheless, there may arise certain circumstances where both British and Irish firms would be less willing to pass-through changes in the sterling-euro exchange rate. The latter possibility is deceptive, though, as this aggregate perspective glosses over negative effects on particular sectors.

Reviewing sectoral relationships could shed light on possible 'danger' areas where pass-through may not occur and thereby place downward pressure on a portion of the economy. For example, the agricultural sector - producing primary goods - tends to encounter higher demand elasticities to changes in prices without an extensive profit margin. In terms of Anglo-Irish trade, 55 percent of total Irish food and live animal imports (FLA) are from Great Britain, while 32 percent of Irish FLA exports are to Great Britain.²⁵ (It should be noted that FLA exports constitute 22 percent of total exports to Britain.) In light of such a market dependency, exchange rate fluctuations could create a crowding-out effect as the aforementioned high elasticities would dissuade price adjustment and firms would exit the market due to lower profits. The true extent of this crowding out, however, is uncertain.

The Sakkir (et. al.) model does not address this contingency. It presents a viable argument that Anglo-Irish trade volumes should remain stable as long as any sterling-euro fluctuations are short-term. The analysis, however, fails to take into account the ramifications of pass-through (or zero pass-through) on smaller, specific sectors.

Therefore in an aggregate sense, the Irish economy - bolstered by the embedded Anglo-Irish market - is in a strong position if the sterling-euro exchange rate enters a period of volatility. Thus in the short-term, Dublin may choose to do nothing in response to fluctuations, allowing the consistency of trade volumes to buffer the change in relative

prices. Nonetheless, this overall stability should not overshadow sectors that may be more sensitive to pass-through pressures brought on by the movement of the exchange rate.

III. GENERAL RESTRUCTURING OF THE IRISH MARKET

Concerns over the medium and long-term prompt alternative strategies for Dublin and firms operating in Ireland. If Britain does not accede to EMU, the possibility of misalignments becomes more realistic and more dangerous. The stability of trade volume I have described would be called into question. This would then influence, for better or worse, Irish output.

Irish firms should consider equalizing the trade market shares with other countries in the Community (or world), lessening the dependence on British goods and domestic markets. Recent trade statistics indicate that this market diversification is already underway. The shares of British trade for both imports and exports, though still substantial, have gradually decreased (See Graph 2). Meanwhile, both the US and German trade shares have increased. If present trends continue, Anglo-Irish trade levels will reach a more even distribution relative to other trading partners. This *normalized* distribution would help dissipate the dangers of EMU without Britain. A drop-off in export volume, for example, would have a greater effect on aggregate output if the particular market constitutes 30 percent of total exports. With a decreased share of Irish trade, a sterling-euro misalignment will be less severe.

Additionally, if Irish firms shifted trade toward euro-zone countries, the issue of exchange rate fluctuations would become moot. Cost/price distortions caused by misalignments would not arise as the single currency would ensure stability. Furthermore, this increased and diverse trade would help synchronize the Irish economy with the euro-zone, bringing Ireland's needs further in line with Frankfurt's policies.

The Irish government is best poised to confront negative spillovers from changes in output within the employment sector. (Community legislation prevents too strong a hand in trade affairs.) Fluctuations of the sterling-euro are more likely to affect the labor-intensive industries.²⁶ Retraining programs might actually provide some flexibility in the work force if employment shocks are incurred. Moreover, these programs - some of which are already underway - would address the larger, more consistent problem of structural unemployment.

Concluding Remarks

General prospects for the near future are bright. Irish growth is projected to decline, but remain above 5 percent per year through the turn of the century.²⁷ Unemployment, the bane of Irish economic success, is also expected to decline with job creation stemming from the service and high-tech industry sectors.²⁸ Likewise, Irish exports should grow due to increasing demand on the continent.²⁹ Dublin must note the expected loss of structural fund support after the year 2000, which is likely to increase strain on the budgetary authorities. (The Dublin Economic and Social Research Institute estimates that Structural Fund assistance accounted for 2.5 percent of GDP in 1993.)³⁰ However, the Irish budget figures indicate that the balance should reach a surplus possibly as early as 1999, and any loss of revenue could be absorbed by an increase in government spending without damaging Ireland's fiscal reputation.³¹

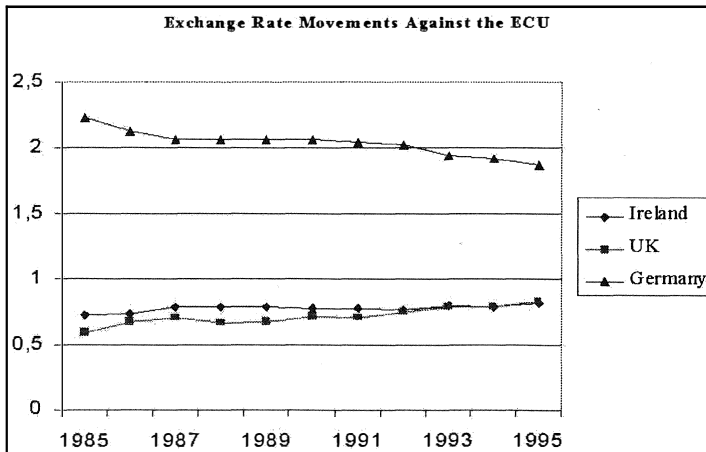
Ireland's continuing positive economic performance, though, does not remedy the problems of EMU without Great Britain. If anything, these problems arguably call into question the feasibility of the forecasts. But in light of the arguments this article has presented, a euro-zone without the sterling should be a concern and not a preoccupation. Granted, Dublin will have limited resources to combat changes in output in the short term - fiscal policy is likely to be ineffective; monetary policy will be set in Frankfurt; and direct interference in trade flows raises legal questions. Nevertheless, changes in output do not bear definite consequences as exchange rate volatility may not influence trade volume or prices. Certain sectors may be more vulnerable; but the Irish government is aware of this and is nonetheless confident.³²

Misalignments between the euro and the sterling pose a greater problem, as the cost and price pressures from exchange rates may impact upon more than just the sensitive sectors. Firms, as I have argued, will be more inclined to rethink their market position, and stable trade volumes may suffer. Whereas trade stability excuses Dublin's inability to extensively control output levels under the EMU regime, misalignments would highlight it. If the Irish market is able to diversify, the severity is lessened. If not, Irish output will be caught between two differing monetary policies.

Ultimately, the exact ramifications of Irish entry into EMU are not clear. Mostly, the degree of concern hinges on the time period of analysis: how long until Britain joins the euro-area? Though UK Prime Minister Tony Blair has expressed his open-mindedness to EMU, it is highly unlikely that the sterling will enter before the close of his first Parliament (or, prior to 2002).³³

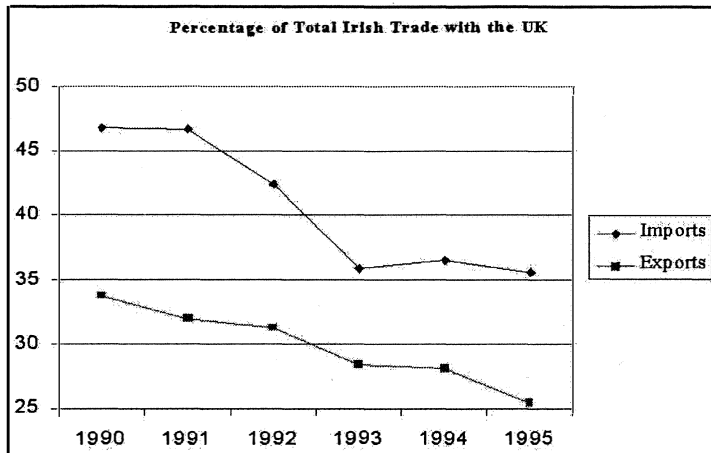
Regardless, in the face of possible dangers, the Irish government is intent on membership. Dublin has embraced the Union and through it created an Irish economic identity - some might say at the expense of British dominance. Thus, monetary union crowns the country's remarkable economic achievements and marks an important break from Britain, though trade may linger. EMU is in many ways a *fait accompli* of Irish politics, overriding the economic uncertainty. ●

GRAPH 1:



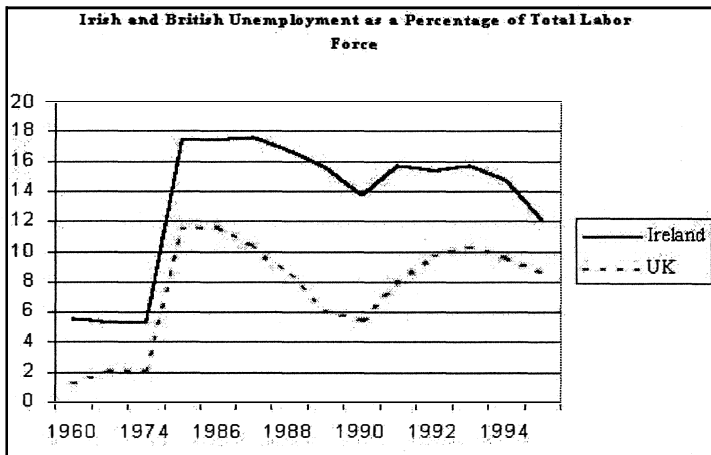
Source: *International Finance Statistics*. International Monetary Fund: Washington, D.C., October, 1997.

GRAPH 2:



Source: *Foreign Trade by Commodities: Volume 1*. OECD: Paris, 1997.

GRAPH 3:



Source: *Historical Statistics: 1960-1995*. OECD, Statistics Directorate: Paris, 1997.

¹ *European Economy*, (No. 1, 1996), 11.

² *Statistical Abstract*: 1996. (Central Statistics Office: Dublin, 1997), 282.

³ *European Economy*, (No. 1, 1996), 5.

⁴ *Country Studies: Ireland*. (Number 6). (Directorate-General for Economic and Financial Affairs: Sept. 1991), 4.

⁵ *Historical Statistics: 1960-1995*. (Organization for Economic Co-operation and Development, Statistics Directorate: Paris, 1997), 75.

⁶ In 1997, the Irish government introduced "Partnership 2000", maintaining policies of wage moderation "in exchange for tax cuts and public spending increases while allowing more flexibility in the determination of salaries at the local level". *OECD Economic Surveys 1996-1997: Ireland*. (OECD: Paris, 1997), 3.

⁷ Exports of goods and services, as of 1995, were valued at 74.6% in GDP terms. *Ibid.*, 75.

⁸ See Appendix A for additional data. *OECD Economic Surveys 1996-1997: Ireland*. (Organization for Economic Cooperation and Development: Paris, 1996), 12-13.

⁹ *European Economy: The Impact of Exchange-Rate Movements on Trade within the Single Market*. (No. 4, 1995). (European Commission, Directorate General for Economic and Financial Affairs: Luxembourg, 1996), 17.

¹⁰ Masson, Paul. "Modeling credibility: an application to the United Kingdom," *European Currency Crises and After*. Christian Bordes, Eric Girardin, and Jaques Melitz, eds. (St. Martin's: New York, 1995), 136-7. See also Minford, Patrick. "The lessons of European monetary and exchange rate experience," *Capital Controls, Exchange Rates, and Monetary Policy in the World Economy*. Sebastian Edwards, ed. (Cambridge University: Cambridge, 1995), 95-96.

¹¹ Boissieu, Christian and Thierry Coville. "EMU and the Outsiders: Analysis and Recommendations." (A report for the European Parliament, April 1996), 3.

¹² "Country Report: Ireland", (3rd Quarter 1997), (Economist Intelligence Unit: London, 1997), 26.

¹³ "Country Report: Ireland", (3rd Quarter 1997), 5. Also, *External and Intra-European Union Trade*. (Eurostat: Luxembourg, 8-9, 1997), 140.

¹⁴ *European Economy*. (No. 1, 1996), 18.

¹⁵ Due to a derogation received at Maastricht and reaffirmed at the 1996 Florence European Summit, the UK will be allowed to continue floating the sterling without any obligation to join a ERM-type system to be set up for the 'outs'.

¹⁶ The discussion of fiscal expansion will not consider the changes likely to occur in 2001 following the reform of the EU structural fund program. As I am primarily concerned with the short term, up to the introduction of Euro currency in 2002, I consider the structural fund issue beyond the immediate scope of this section.

¹⁷ This policy is also expressed in: *European Economy*. (No. 1, 1996), page 7, though not specifically in the context of sterling fluctuations. "In the case of Ireland the apparent under-utilization of labor and capital and the large balance of payments surplus might argue for some limited use of budget deficits, particularly, for example, if growth slows in order to sustain domestic demand. This implies that in periods of strong growth, deficits should be reduced or held in check so that room to maneuver is created to meet contingencies or adverse cyclical developments."

¹⁸ *European Economy*. (No. 1, 1996), 15.

¹⁹ *Ibid.*, 17.

²⁰ Exchange rate 'volatility' implies changes in the values of currencies over the short-term, whereas 'misalignment' applies to the medium and long-term.

²¹ The issues of firm size and memory are relevant in part to this discussion as they affect the willingness and ability of a firm to alter volume and prices. However, I will not address these points as, ultimately, the basis of my argument rests in the short term where volume is not likely to change, irrelevant to firm size/memory.

²² Sapir, Andre, Khalid Sekkat, and Axel A. Weber. "Working Paper: The Impact of Exchange Rate Fluctuations on European Community Trade," (European Parliament Directorate General for Research: Luxembourg, February 1994), 14.

²³ *Ibid.*, 9.

²⁴ $B = PaX - epM$, where B (balance of trade), X (exports), and M (imports) are fixed; and Pa represents prices of exports in destination country A, and p represents domestic prices of foreign imports. The change in the exchange rate may be expressed as, $-B/-e = -[PxX - epM]/-e$. Derived from Mundell, Robert A., "The International Adjustment Mechanism of the Balance of Payments," (prepared for the *Zagreb Journal of Economics*).

²⁵ *Foreign Trade by Commodities 1995*. Organization for Economic Cooperation and Development, Statistics Directorate: Paris, 1996.

²⁶ *Country Forecast*. (3rd Quarter, 1997) (Economist Intelligence Unit: London, 1997), 30.

²⁷ *Country Forecast*. (3rd Quarter, 1997), 24.

²⁸ *Country Report*. (3rd Quarter), 10.

²⁹ *Ibid.*, 11.

³⁰ *European Economy*. (No. 1, 1996), 14.

³¹ This should not be confused with the earlier discussion on the ineffectiveness of fiscal expenditure, which focused on spurring foreign demand. Structural funds are used solely on domestic projects, indicating that their vacancy will leave a void in domestic demand. See *Country Forecast*. (3rd Quarter), page 14, for projections.

³² "Ireland confirms its intention of taking part in the single currency from the outset even without the United Kingdom," *Agence Europe*: no. 6759, 28 June 1996.

³³ "Labour sees advantages in a single currency, but we would need to be convinced that economic conditions would allow it to succeed and be sustainable in the long term before joining. If there is a decision to join the consent of the people will be sought through a referendum." Taken from the current Labour government position on EMU, at www.labour.org.uk/licy/britain/europe.html, 5 December 1997.

Europa

1998

Introduction

European unification is not a new idea. It has been attempted many times through conquest and wars. From Caesar to Charlemagne, Charles V to Napoleon and Hitler thereafter, the efforts to create a unified Europe have been driven by imperial ambition, the lust for power, and the desire for preferential security. Today however, in the spirit of Immanuel Kant, Aristide Briand and Jean Monnet, we are witnessing a peaceful unification occurring through popular consensus, mutual security, and democratic institutions both national and supranational. In May 1950 Robert Schuman, the French foreign minister, proposed the formation of a Coal and Steel Community with Germany and invited other European states to participate. The desire for greater political stability on the continent and economic cooperation beyond a mere customs union helped create the ECSC. From this gradually developed the institutions that form the basis of the European Union today: the European Commission, the Council of Ministers, the Court of Justice, and European Parliament.

At the turn of the century European unity will not only be propelled forward by the adoption of a single currency. Just as the Euro's success depends greatly on the credibility of the European Central Bank, the European Union as a whole will be judged by our perceptions about this grand project and the extent to which Europe's identity evolves to meet the challenges of this mammoth undertaking. The changing domestic character of states, further economic globalization and the new security constellation emerging in the aftermath of the Cold War will collectively determine the fate of this new Europe. By shedding the myths, values and institutions of their past to construct new viable relationships, Europeans are confronting the responsibilities of a more complex, decentralized and interdependent global society. This process has both integrating as well as disintegrating qualities and will inevitably carry a degree of uncertainty. This section reflects on these transformations taking place at both the regional, national and supranational levels, as Europeans reexamine their past and look forward to the future to redefine themselves.

But, what does it mean to be European? The myth of Europa, a princess seduced by Zeus, taken from the shores of Phoenicia and brought to the Crete, had provided the Mediterranean civilization with a powerful and symbolic story through which the people of antiquity were able to define themselves in the world. Over centuries a variety of belief systems have existed through which Europeans have defined themselves in the same manner. These can be associated in broader terms with what may be called a European identity: Roman law, Christianity, monarchy, Human Reason from the age of Enlightenment, Nature from the Romantics, Imperialism and more recently modernism, social economics and pop culture such as sports. What complicates this definition is Europe's long, protracted history of strife and conflict that makes diversity and pluralism important features of this identity also.

While the ebb and flow of the above values over time have been woven into mainstream European consciousness, the most dominant social arrangement born of such values has been that of the nation-state. Currently, the European Commission acts as a

catalyst in the massive task of integration, laying the foundation for a centralized supranational government. However, the prevailing role of the member-states through the European Council serves as a reminder of the strong influence that the traditional state has in the process of integration. Any examination of the European Union cannot neglect the significant role of the state as a consensus builder and an influential force in shaping European identity.

As this notion of a European identity is vast, complex, and easily obscured, we have selected various articles that we believe reflect the more salient features of this identity and help define the formidable issues facing Europe. The enclosed perspectives though must be taken as merely fragments of a greater entity that no single volume can encapsulate. As they are here, these articles seem incongruous and disconnected. Yet, there are several themes that clearly run through them: the changing nature of individual states, continued economic integration both globally and within the EU, and the transformations occurring in the security structures of Europe. In them we see that Europe has many problems and also holds great promise.

The first article of this section explores how France is reexamining its relationship with the Vichy Regime and is unraveling certain illusions that are associated with the French state. This seems all the more appropriate in light of the most recent sentencing of Maurice Papon, a career French civil servant, for complicity with Nazi crimes. This event is seen by some as a watershed in French history, possibly a national "vindication" of the Vichy regime's participation in the Final Solution. After World War II president de Gaulle sought to reaffirm the French state's legitimate position on the continent and challenge American influence by not only establishing a nuclear arsenal (*force de frappe*) outside the NATO umbrella, but also by pursuing European integration. The latter consolidated a sound basis for Franco-German relations, a key element in securing peace in Europe and further cooperation through the EEC. Domestically, de Gaulle perpetuated the myth that he had been the embodiment of France during the occupation and thus negated the possibility of the state having to take responsibility for the actions of the Vichy regime. However, these issues have now reemerged and are changing how France views itself in terms of this traumatic and devastating European experience.

With the collapse of the former Soviet bloc, the landscape of Europe has changed dramatically as these new states strive to assert themselves. The veil of sameness and ideological rhetoric that pervaded the Communist regimes has been cast away, revealing very different cultural histories beneath the surface. These nations are not only having to transform their economies to integrate with EU and the international markets, but must address the unresolved questions of nationalism, tradition and identity. Since changes are occurring both at the transnational and national levels, we have included an article covering the eastern economies in transition and, for a more micro perspective, an article on Russian crime. The problem of Russian crime and its unique relationship with the Russian state provides us with an example of the structural and societal problems facing the nations of the East. Likewise, we see that the Central European Countries are undergoing economic reform and integrating with the global markets, and specifically the EU, along distinctive lines from that of the Former Soviet Constituent Republics. As these nations seek to redefine themselves in the international context, many are still struggling with vestiges of the past while others are advancing forward to embrace liberal reforms. This will affect the way in which the European Union will expand while it seeks to

incorporate new members and in turn, will determine the composition of the European identity.

With regard to Western Europe, the distinct role of the state as a maternalistic provider of welfare has come under increasing pressure with the collapse of the Bretton Woods system and rising global economic interdependence. As states have been forced to abandon their traditional welfare policies they have turned toward the European Community as means to achieving social and economic stability. The Swedish welfare state had served as a testament to the European ideal of social democracy, but eventually fell victim to the demands of the global markets. Accordingly, we have an article which explains the demise of the Swedish model. Can we say that what has been lost in terms of national identity in this case may reemerge at the supranational level? The European Union most likely will not shield the citizen completely from the detrimental effects of the global economy. However, Agenda 2000 proposes communal policies regarding unemployment, social exclusion, and the rights of the citizen that may redirect this European novelty towards a more flexible, responsive and equally responsible set of values.

In the defense and foreign policy realm, there is also the potential for a new collective identity and we have chosen several articles that offer engaging perspectives on this issue. The implementation of a more integrative Common Foreign and Security Policy (CFSP) could, conceivably, supplement and reinforce the efforts towards greater European integration and what defines the boundaries of Europe's political, economic, and military strength. The EU has already acted with a common policy towards countries of the former Soviet bloc, played a diplomatic and observatory role in the Balkan conflict, and has provided humanitarian aid to Somalia and other regions. Undoubtedly, the international community acknowledges and is affected by these actions - they seemingly bear the qualities of a foreign policy employed by that of a single nation-state. In addition, the ever-expanding role of European military cooperation is exemplified in the concept of Combined Joint Task Forces (CJTF).

Yet, these efforts have been complicated by the persistence of national aspirations among member-states which has limited the possibility of a consistent and coherent voice. We also find that this dimension of European identity is ultimately intertwined with the transatlantic relationship. The United States is still of invaluable importance to European security arrangements. NATO enlargement and Partnership for Peace are two tangible ways in which American leadership has been vital in altering the European military framework. Concepts such as the CJTF, on the other hand, have yet to truly become fully functional institutions. Will European defense and security always have to operate in the shadow of this transatlantic relationship? Could not non-military activities of the EU where national divisions are not so pronounced, such as promoting democracy in the former Yugoslavia, compensate by producing positive externalities that spillover into the security sphere? There is no question that, in the post-Cold War era, EU enlargement based on the criteria of the rule of law, democracy and human rights has security implications. The question remains though whether such efforts may advance toward the creation of an integrated European military force, either within or beyond the NATO structure.

The following articles serve as a corollary to our European Monetary Union feature in that they open up a wider range of issues related to European identity. The unification

of Europe in the past could only emerge from the belligerent aspirations of its political leaders and proceed by means of violent upheaval. Today it is occurring peacefully through negotiation and bargaining within a complex, multilayered set of institutions at the regional, national and supranational levels. The various elements of what is being described here as a European identity, in itself, actually covers a huge gamut, from the most concrete issues such as security to those which are merely hues of the larger substance. Thanks to the following authors' contributions, Europa 1998 is able to explore the ways in which Europeans are redefining themselves and help to illuminate the essential aspects of this changing identity.

Jonathan M. White

Vive la France?

Patrick Carpenter

Fact alone is a poor storyteller. What a nation chooses to remember in its books, songs and around the table is a calculated attempt to construct a national psyche both fitting for its present and instructive for its future. This psyche drives the political, intellectual and cultural spheres of the nation and creates a persona congruent to the definition of what it means to be, for example, French, American, or Japanese. Therefore, the implication is that the persona of a nation is a malleable myth. It also may be self-perpetuating: by forming the political vision, politicians may then mold revisions in order to make them appear as a logical progression. But who decides what to remember? Who receives these views? How do they react?

By their very nature some members of society - most obviously the politicians, media, intelligentsia and artists - formulate views of the past, interpret history and invest it with meaning. The public has a diffuse memory; it comprises many different histories and sensibilities. Of these, it is the eye-witness that first controls the floor: "I was there" usually equates with gospel. As such, the messages received by the public *en masse* are modified by the individual. Some choose to publicize their own interpretations, some choose to forget. What a nation chooses to forget may be all the more revealing, especially if one holds the opinion that closet skeletons betray the truer persona. The history of memory, then, is the science of applied fiction or perhaps better called interpretive truth, and guarantees that scaffolding periodically be set up to redress outdated interpretations.

Penultimate to the history of memory is time, in the sense of distance from the event. It overrides all aspects, subtly or drastically altering a nation's character through waves of revisionism, seeking definitions that suit the present narrative and conform to future visions. It may also act as a panacea, making examination of the past bearable. Herein lies the twist: the persona is therefore the interpretation of the past in the light of the present and not necessarily the reciprocal. History becomes the pupil rather than the lesson and the event updated to gel with the present mindset.

Lately it appears that in the run-up to the millennium, nations have begun to reevaluate their behaviors over the past century. The current generation of politicians has seized upon this with alacrity and used the opportunity to issue statements of apology on behalf of the past, present and future citizens of their country for wrong-doings alleged and committed. The cynic would read this as an astute way for a nation to improve

international social posturing and/or broaden personal appeal. Apologies, even when heartfelt, are intangible currency. They may have a beneficial psychological effect, both for the wrongdoer and the victim. But, they scarcely cost anything except perhaps a pride that should have been checked years ago. In any case, the weight of the grievances are rarely on the breasts of the empowered generation. Moreover, they are seldom refused. For who wants to be seen in an unforgiving light?

France is arguably the nation harboring the most visible *crise de conscience*. Two years ago President Jacques Chirac chose to acknowledge what a generation of political leaders had not. He became the first to accept the French state's responsibility for the arrest and deportation of 76,000 Jews to German extermination camps during World War II by the Vichy. He went one step further this past December by handing over a file of all information assembled on Jewish citizens during the Vichy period to representatives of France's 600,000 strong Jewish community (the largest in Europe).¹ In between these two gestures, French headlines brought out more of the less glorious aspects of the nation's history: the brutal repression of the Algerian rebellion in the late 1950s (spearheaded by Maurice Papon); the announcement by the French Catholic hierarchy of its own belated *mea culpa* in "acquiescing by its silence" in the persecution of the Jews; and the creation of a commission to track down confiscated art and property taken from the Jews during WWII.

France has always preferred, in the words of Pompidou, to "cast a veil and forget," but Vichy in the terms of France's historians is "the past that will not pass." Vichy has split French politics, spawned the Gaullist ideology, and haunted politicians and government officials. It has long divided those who otherwise would share the common belief that they were loyal sons of France. One thing is clear: the obsession with Vichy and the Occupation, since its reemergence as an integral national issue in the late 1960s, has shown few signs of waning.

At present is the trial of Maurice Papon, a former Vichy official who went on to become Paris' police chief under de Gaulle and a budget minister under President Giscard d'Estaing. Papon has been accused of complicity in crimes against humanity, ordering the arrest and deportation of 1,560 Jews when he was secretary-general of the Vichy government's administration in the Gironde, at the height of the war. The trial, begun last October and expected to conclude March 25th, has provided what is widely regarded as the final tangible opportunity for France to delve into its collective memory, and define the transgressions nagging at the national persona.

It is the intention of this paper to investigate certain crucial events in France's post-war history in conjunction with the Vichy problem and its sociological repercussions. It will focus primarily on the watershed trials of Klaus Barbie, Paul Touvier, and Maurice Papon, which provide a legal link to France's introspection and will also take into consideration the impact of cultural and scholarly interpretations that caused a resurfacing of the issues as well as reevaluation. Political implications will be duly noted. In order to better address the repercussions, it will be necessary to offer a brief definition of what the Vichy regime was, based on documented facts and established interpretations. In Rousso's *The Vichy Syndrome*, the conclusive argument is:

that internal quarrels left deeper scars than either the defeat or the German occupation. The crux of the matter, from the amnesty debates to the scandals

of the seventies and eighties has been the existence of Vichy and the consequent emergence of a political resistance, which was organized to fight not only the Nazis but also the collaborators and the regime born of defeat. The same structural factors that make this crisis an archetype of Franco-French conflict have also shaped the way it has been remembered since the end of the war.²

To adequately assess his argument, it is necessary to investigate the depth of the roots of the Vichy syndrome in French society and how they have been treated in the post-war period.

The Armistice and Marshall Pétain

Marshall Pétain's deluded attempt to preserve the soul of the country by remaining "on the spot" actually tarnished it - perhaps permanently. It was a strange form of wisdom that did not ask whether, in fact, there could be any worse catastrophe for cultural and economic life than to let oneself be conquered "by a robber society."³ But for Pétain, the armistice was the "necessary condition for the survival of our eternal France."⁴ Pétain based his decision on two key miscalculations: a quick German victory; and at the same time the belief that through collaboration, France would become a political partner on beneficial terms with the Reich. Thus the armistice opened a prolonged chapter of Franco-German relations and set off the Franco-French war. It was destined to divide the French people in all the more lasting fashion given that, in the view of many Vichy men, it was the enemy within rather than the occupying power that had to be eliminated.⁵ Alongside the divisions of prewar political ideologies now existed the divisions of interpretation of France's capitulation: an armistice to save France; an armistice that was the least of all evils; an armistice of betrayal.

Also crucial was the power that the Armistice gave Pétain over the politicians. The political regime swept aside the ruling elite of the Third Republic and the Popular Front and it was placed into the hands of a minority groups thirsting for revenge. The regime was, in essence, a reaction against the revolution that the Popular Front had represented in the eyes of the majority of the French bourgeoisie. During its four year existence, the adherents of Vichy included both the old monarchist opposition to the Third Republic and the newer fascist and quasi-fascist opposition - indeed virtually all the critics of the liberal republican tradition save the Communists.⁶ "Better Hitler than Blum" had been their early slogan. The only point these opposing views had in common was their emphasis on the "enemy within." These views had been exacerbated by the world economic slump which resulted in aggrandizing anti-parliamentary feeling.

For most Vichy men, Pétain's vision of the national revolution meant what they labeled as restoring France to the French. This meant exclusion and worse: the hunt for Communists (both Moscovites and local French), Jews and later the laborers to be shipped to Germany under German war productivity agreements. These acts were accomplished while posing as paragons of public virtue.

The German Aspect

Collaboration with Germany can be reduced to two culminating issues: the wartime economy; and the participation in the Final Solution. In the former, records prove that

France was considered the jewel in the captured crown of Europe and was subsequently exploited economically to the hilt. Under state collaboration agreements, it has been calculated that 42 percent of Germany's "special revenue" from abroad had been provided solely by France. France not only supplied agricultural produce but also strategic raw materials, war equipment, use of its transportation lines and networks. Most importantly, Germany was able to use French manpower in Germany in its war economy.⁷

The Reich expected the French state to collaborate on four counts, each where considered top priorities: help suppress 'terrorists' (i.e. Resistants, dissidents), hand over the Jews, transfer man-power to Germany and mobilize economic resources to an unprecedented degree. The French state complied with the demands of the occupying power, alleging that it did so in order to avoid the worst.⁸ But Hitler realized that by continuing to maintain the French state, the Reich would obtain far more efficiently than it would by force and would be in a position to use the State apparatus to its own profit. There would be no need for the *Wehrmacht* to take charge in the administrative domain and the safety of the troops would be guaranteed. It also prevented the French government from fleeing to London or North Africa.

The Jewish Aspect

Robert Paxton's book, *Vichy State*, demonstrated the willingness of Vichy to collaborate and the purely domestic origin of much of Vichy's most hideous legislation, stressing the continuity between Vichy and prewar French conservatism, reaction, and pro-fascist sympathies. Vichy's anti-semitism, which had concrete, official ramifications in law and justice, came from French anti-semitic traditions which long predated Nazism.

The French state did not go so far as to favor racial extermination but it did unremittingly enforce what Xavier Vallat, the general commissariat for Jewish questions, with the blessing of Pétain, called state anti-Judaism. This xenophobic measure meant that the Vichy regime and the collaborationists were directly responsible for the deportation of a minimum of 75,721 French and foreign Jews (over 10,000 of which were under the age of eighteen). France had been a refuge for Jews before the war, so the wartime open anti-Semitic policies resulted in around one-fifth of the Jewish population vanishing into concentration camps. With a relatively small number of German officials "on the ground," the glaring conclusion is that French participation in these matters was not an example of the "stall for time, question everything" policies pro-Vichy arguments usually take. The French state was evidently incapable of protecting individuals of French nationality whom it claimed to be under its protection - to say nothing of foreigners.⁹ These figures help destroy the feeble attempts to construct the myth that there was both a good and bad Vichy and therefore directly discredit loyal Pétainist revisionist accounts.

Rebels and Resistance

Despite de Gaulle's implicit underplaying of its existence, the Resistance, defined as a specific movement and not just a general manifestation, truly did have an original impulse within France itself. While it is impossible to assess the true number of French men and women who were involved, deeply or remotely, records illustrate that at the time of Liberation 220,000 cards were issued to voluntary Resistance fighters.¹⁰ This figure would seem to prove that the Resistance movement was confined to a small minority of

citizens, even in the latter stages of the war, when the inherent dangers had greatly subsided. Little wonder then, that de Gaulle's post-war visions and exclusions were so widely embraced (see de Gaulle).

The development of the Resistance is fairly clear. The summer of 1940 was a time when rebellion was a more or less symbolic matter, made by those who opposed the Armistice and did not subscribe to the "Victor of Verdun" myth. By 1941 the Resistance had moved beyond this phase by taking root, with networking and founding movements already operational. The movement came to maturity in 1943 with the establishment of the foundations for an underground state. The convergence of the internal Resistance with the dissidents and Free French abroad led to a general cohesion and coordination of action. However, the nature of the internal Resistance was split along geographical lines: most of the rebels in the northern zone, perhaps because they found themselves in direct confrontation with the occupying power, wanted first and foremost to fight; in the southern zone, in contrast, the rebels were for the most part inclined to much more political forms of action.

The Role of the Communists in the Resistance

Apart from the Communists, not many leaders of the resistance were in a position to rapidly set up a truly popular organization. Their embrace of the Resistance appears to be forged along the lines that "the enemy of my enemy is my friend." Historical opinion is divided on the expediency of the Communists to join the Resistance. The more extreme suggests that communists did not start to resist until after the Nazi invasion of the Soviet Union. Others maintain that some communists did join the resistance, but not the French Communist Party (PCF) as such. The main catalyst was, however, the invasion of Russia which pulled together many of their enemies. Less than one month after the Nazis entered the Soviet Union, Vichy and various pro-Vichy movements appeared to be competing with vehemence for military cooperation to support the Reich in the decisive fight against Bolshevism. Pierre Laval and others equated Realpolitik with Anti-communism (not to mention anti-semitism).

The eventual incorporation of the PCF was particularly important for two reasons: they advocated and exercised a strategy of direct action; and by the nature of their ideology, changed the forces' internal and external relationships. Their strategy at first led to higher numbers of executions on both sides, heightened awareness, and indirectly caused suspicion as to their motives - owing to their political targets.

The importance of the Resistance in the history of memory actually outdistances the events that caused its formation: the war, the defeat, the Occupation. Such precursors had external origins or influences, whereas the Resistance was French and members proclaimed themselves as the true sons of France, fighting to save the nation from the *Wehrmacht*. Of course, Laval and other collaborators used the same argument, albeit from a significantly different angle. But the Resistance directed a worse reproach against the collaborationists than against the Germans themselves, harboring all the passion of a vengeance that is engendered in the course of a civil war.¹¹

Members of the Resistance then, felt entitled to moral and political superiority over their fellow citizens - those with dirtied hands as well as those who tacitly acquiesced. The blood on the hands of the Resistance, and there was a great deal of it,¹² was not seen by

them as loyal French blood; it had been tainted with that of the *boche*. Clearly, such attitudes would be problematic during and after the Liberation, when attempts to were made to harmoniously integrate.

De Gaulle and the New French Myth

Charles de Gaulle, leader and founder of the Free French Army, saw the Armistice as an unpardonable error, with the result that a legitimate French government no longer existed. He appointed himself as France's true savior, first by working to ensure that France officially continued to take part in the war, later by liberating Paris and ultimately by forging a script of the war years in a manner appropriate to the nation's former perceptions of *grandeur*.

His liberation rested on two main ideological cornerstones: the obliteration of Vichy and the redefinition of the Resistance as an abstraction - an achievement not of the Resistants but of the "nation as a whole." Thus his version marginalized the Allies and the Resistance, and preferred instead to glorify a people *in resistance* without intermediaries such as political parties, movements, or clandestine leaders. France's elites agreed, either out of a desire to bury an ugly past or out of self-interest to avoid embarrassing scrutiny, and the general public, which deep down knew that the myth was a cavalier interpretation of reality, pretended that it was the truth. Thus Vichy became the creation of a small group of misguided men and the crimes committed were crimes of the Germans and of very small bands of collaborationists. Most of the population did, in fact, resist the Occupation in some degree. De Gaulle, his legitimacy unchallenged, was able to restore honor and patriotism.

Why the simultaneous exclusion along with a general accreditation of heroism for the nation? Because the Liberation - as was widely acknowledged - would transform French politics. This could lead, if not carefully monitored, to more civil unrest and a new chapter in the Franco-French war. To prevent such escalation, France would require a purge.¹³ The misguided needed to be brought out (pardoned in many cases, or at least receive symbolic sentencing) so that the nation could associate the myth with proof and believe judgment had left most vindicated. At its outset, the purge was aimed at the entire right wing, the collaborationists (Pétain received a death sentence, commuted to life imprisonment; Pétainists were effectively barred from retaining office). But later this came to encompass the Communists, who had attempted to restore their political virginity by playing hard on their role as Resistants. However, they were perceived by de Gaulle (who did not like to share the spotlight with distinguished and legitimate heroes) as a political threat. Thus, by discrediting them and hatching his own competing myth, de Gaulle intentionally rendered it impossible that the Resistance could unite the country.

The Trials

Trials are the permanent and definitive methods of molding a nation's persona. A verdict is the final word on more than the individual tried; it also finalizes judgment on the correlative aspects of the case. History is made on the block. The judge is forced to write history and pronounce historical judgment based on the facts in his possession - where memory may rather remain selective and historians cautious in their interpretations. The timing of the trial is also crucial, as courts must interpret both the law and collective

memory. Memory and witness testimony may be sharpest immediately after the event, but the national mood may not be prepared to begin processing victims. Conversely, testimony after significant time lapse is unreliable and inadmissible.

In the few noteworthy post-war trials, it was evident that amnesty and leniency were in the national mood. A reprieve from the war, the Liberation, and the purges was desired - despite the fact that the ties that bound some collaborators with their German counterparts were undissolved. The first tangible signs of change in the national mood came in 1964, the year that Jean Moulin's ashes were moved to the Pantheon. Moulin was a Resistance member betrayed and then murdered by the German, Klaus Barbie. He was an important, symbolic martyr and brought France back to embracing the Resistance. Twenty years had passed since the Liberation, time enough for a new generation with new interpretations to arrive on the scene. They had reread the Occupation and had moved to credit the Resistance fighters. Thus the commemoration of Moulin the martyr was superseded by the commemoration of Moulin the Resistant. The issue now at hand was the inability of the Gaullist myth to eradicate repressed bitterness towards the collaborators as well as its unaccountability for why so few misguided were able to wreak so much havoc on the soul of the nation.¹⁴

Nineteen sixty-four was a watershed year in France legally as well. In June 1964, a bill suspending the statute of limitations as defined by the Nuremberg Trials and the United Nations Charter passed unanimously. Ironically, the law was passed with the intention of bringing Nazi war criminals to justice, however its effect was ultimately to reopen French wounds and to involve the courts in complex affairs reminiscent of the purge trials at war's end.¹⁵ Only two years earlier, the sentencing of Josef Eichmann to death in Jerusalem had opened the possibilities to condemn the anti-semitism that was the essence of Nazism. This put Vichy in an entirely different light. No collaborator or member of Vichy had been indicted at the time of the Liberation for acts pertaining to the deportation of Jews and crimes committed in connection with the Final solution had been left out of the debate altogether. So Eichmann was tell-tale: the nation's collective memory was about to be legally reexamined.

Paul Touvier

On 23 November, 1971, President Pompidou attempted to quietly pardon the former official of the Milice. Touvier had received two death sentences in absentia immediately after the war, but had not been "captured" by the time the statute of limitations took effect. The pardon was an ignorant display of poor timing and reading of the mindset of France on Pompidou's part. The same year, the cultural milieu had picked up on the growing interest in the World War II period, not just in France but in Western culture generally. More films were targeting this era, and thereby calling for closer and more detailed inspection of its history. By all accounts, the most important film on the Occupation was the French *The Sorrow and the Pity*,¹⁶ a direct rebuke of the Gaullist myth. Through individual testimony, interspersed with French newsreels and German propaganda film, the director Marcel Ophüls broadened the chasm between history and memory. All the while he was pointing to the lesson that the German presence was not the sole or constant determinant of the actions of Vichy France. It also revealed a continual thread of

anti-semitism. This was important also because the early 1970s was a period of a reawakening of the Jewish conscience, which would play vital roles in the later examinations.

With a public swept into confrontation by *The Sorrow and Pity*, Touvier's pardon was widely seen as excessive provocation by Pompidou. It was also in direct opposition to the hard-line policy the government had taken on Klaus Barbie, who was arrested in Bolivia on request by France. Touvier and Barbie had exercised similar responsibilities. Touvier typified the extremist wing of the collaboration as a member of a parliamentary unit created by Vichy for the express purpose of combating the Resistance. Public outcry, predominantly from Jewish organizations and Resistance groups, pushed him into hiding. Only in 1981 did an examining magistrate indict Touvier, and not until 1989 did police unearth him in a priory near Nice.¹⁷ Touvier's trial proceeded in 1994, after a 1991 acquittal was overturned. In 1994 he was found guilty of executing seven Jewish members of the Resistance who had been taken hostage in revenge for the killing of a German officer, and was sentenced to life imprisonment.

In contradiction to the earlier collaboration trials, the defense could not argue the familiar character issues, as Touvier was an ardent anti-semitic and Nazi waging war for Christian civilization. He never expressed remorse at the crime of rounding up the seven Jewish men. Like the Barbie case, Touvier's anti-Jewish activities were first seen to be secondary to his battle against the Resistance, but owing to the strict designation given by the Minister of Justice, emphasis was necessarily shifted to racially motivated crimes. According to the Minister of Justice:

Not included under the head of crimes against humanity are acts alleged to have been committed against the person of members of the Resistance. These acts were war crimes for which the statute of limitations is now in effect, and they do not appear to constitute crimes against humanity (that is, inflicted on civilians during the occupation). Because resistance fighters fought against the Vichy regime and the army of occupation, they are considered to have been volunteer combatants, as they themselves have always forcefully insisted and as the law has recognized legally, therefore, they cannot be confused with the civilian population....¹⁸

Ironically therefore, in order to prove that Touvier was guilty of crimes against humanity, the prosecution had to argue that he obeyed German orders in sending the Jews to their deaths, when in fact the evidence pointed largely to him acting on his own. Thus the prosecution had to run the risk of exonerating Vichy and enforcing the hoax that the Germans were to blame for everything bad to receive a guilty verdict.

Klaus Barbie

The Barbie affair and trial had obvious parallels to the details of the Touvier case. Although Barbie had, like Touvier, been convicted of war crimes in 1952 and 1954 and twice sentenced to death in *absentia*, he managed to elude the feeble efforts to arrest him, surpassing the statute of limitations. Therefore, the 1983 indictment against Barbie concentrated on three specific crimes categorized as crimes against humanity and thus were not subject to the statute of limitations. These involved charges that he had

personally planned and supervised, with the full knowledge that many of those affected would be killed: the arrest and deportation in February 1943 of 86 Jews; the deportation of 44 Jewish children and five adults in 1944; and the deportation on 11 August 1944 of some 650 Jews and members of the French Resistance (of whom over 300 died in concentration camps). The courts had learned from the Eichmann and Touvier examples.

The infamy of Klaus Barbie was not his anti-semitism, but the fact that he was the torturer and murderer of Jean Moulin. At the trial the government aimed therefore to shape the nation's collective memory, pushing it away from the darker Franco-French calamities. To the extent that Jean Moulin was a symbol of France's defiance of the enemy, Klaus Barbie was a symbol of Nazi barbarism. His unrelenting hunting of guerrilla fighters in the Lyon region (the capital of the Resistance) and subsequent admittance of this information made the trial hugely symbolic for France.

But the trial was to be remembered for other, unanticipated reasons. Maitre Jacques Verges, Barbie's defense attorney, based his trial not so heavily on the "one-small-cog-in-a-complex-machine" argument that had been anticipated, but rather on the question of a state's moral legitimacy to try Barbie for crimes against humanity when similar crimes were being committed by the state in its overseas territories and blanketed in amnesty.¹⁹ Verges showed that Eichmann's trial had a lesson for the defense as well. He demonstrated the hypocrisy involved in judging a man as the representative of a defeated system when other totalitarian systems and forms of genocide still existed in the world.

The role of the Resistance was also discovered by Verges as the essence of the trial that led directly to the nation's psyche. The prosecution, and indeed the public in general, desired to take the political approach and emphasize the unity of the Resistance. It was therefore going to turn the trial into something larger than the Touvier affair: instead of focusing on one aspect of Nazism, the approach was to have stressed the struggle of the people against oppressive regimes. This would be an entirely different message to the world than an indictment on account of participation in crimes against humanity.

Verges anticipated this and was able to derail the strategy by publicly planting a series of overt threats to the Resistance that would have linked the Barbie's betrayal of Moulin to weaknesses and sub-plots in the Resistance movements. When former members began to speak out publicly against Verges they exposed the stratifications and multiplicity of aims inherent in the Resistance. Thus the prosecution was forced to shift emphasis away from its "loyal sons of liberty" argument and back toward the tried and proven argument of anti-semitism. The Resistance was reduced to silence, from which it has never fully recovered; while the Holocaust took center stage, a position from which it has not moved.

Ultimately Verges was unsuccessful in defeating the charges against Barbie because the authenticity and reliability of much of the eye-witness evidence directly linking Barbie to the crimes (there was only one case of documented evidence) was made highly suspect with the argument of the accuracy of memory over time. His allegations that the crimes committed had been the responsibility of other agencies such as the German Army or the collaborationist Vichy government were consistent with the other unsuccessful defenses against the charge of crimes against humanity. Such familiar arguments appear to anticipate defeat, and the court found Barbie guilty on all charges. He was sentenced to life imprisonment and ordered to pay symbolic damages.

Jean Leguay

Leguay's case, though it attracted far less publicity and attention from both the government and the general public, was the true watershed event and the essential step in the prosecution of Touvier and Barbie and other related cases. The 12 March 1979 indictment against Leguay for crimes against humanity marked the first time that this statute of limitations was applied to a French citizen. It set the legal and historical precedent, though it failed to arouse emotions or passions comparable to the future landmark Touvier and Barbie affairs.

From May 1942 to the end of 1943, Leguay had been the representative of the Vichy's Chief of Police, Rene Bousquet, in the occupied zone (Bousquet was to be charged later, in 1989 but murdered in 1993 while preparing for trial). Leguay was responsible for the deportation of large numbers of Jews from both the occupied and unoccupied zones. Both he and Bousquet were rehabilitated and permitted to pursue their careers. His case took ten years to come before the courts in 1989 - proving again that legal issues can move exceptionally slow when the government is not expressly in favor. By 1989 Leguay was dying, the Barbie trial had been over for two years and the nation had turned its Vichy obsession toward the arrest of Touvier. However, the investigation was complete, and the case about to be sent to a Paris court when Leguay died on 2 July 1989. In a break with custom, the statement declaring the case closed by virtue of death alluded to Leguay's guilt: "The investigation established that Leguay, Jean, did participate in crimes against humanity committed in July, August, and September 1942."²⁰

Maurice Papon

Described by Mitterand in 1994 as a "man of outstanding stature," Maurice Papon has become the second Frenchman since the Liberation to stand trial for his alleged crimes during Vichy. Indicted in January 1983, it has taken fourteen years for his case to come to court. The reasons are purely political. Mitterand, who was the last French president to deny the involvement of both the French nation and the French Republic in the Vichy state, consistently interfered with the criminal proceedings on behalf of his loyal subject and on behalf of the "postwar consensus on which modern France was built."²¹ It took a conservative president to break the taboo. Since the right-wing parties took power in 1993 the courts have moved faster.

The particulars on Papon's case are consistent with the preceding landmark trials: judged to have committed crimes against humanity and not war crimes, the statute of limitations offers no sanctuary for the 85 year-old pensionist. But unlike Touvier, who was relatively low ranking Papon is to be the first member of the Vichy ruling class to be judged. He is also the first member of the post-war elite to represent Vichy guilt. He even had a place in de Gaulle's Fifth Republic presidency, as a prefect of Paris, where he was in charge of the police during the repression - some say massacre - of Algerians in 1961. Unlike Barbie's case, Mr. Papon left behind a paper trail of signatures that directly link his authority in the round-ups and deportations of the Jewish community. To these, Papon has assumed the familiar lines that he, as a local official under foreign military occupation, had no freedom to disobey orders and was unaware the fate that awaited the deportees. According to the lower court magistrates, there is a mountain of evidence that suggests otherwise. One particular case in point was a Nazi request in 1942 to round up Americans

at the same time that requests were made to round up Jewish families. Papon did not obey the order concerning the Americans, receiving no subsequent punishment or retribution from either the SS or his prefect, while he did obey the orders concerning the Jews. Thus, the prosecution alleges, Papon was able to exercise free will in administering the responsibilities of his office.²²

The trial has followed the historical pattern, hinging on whether, as Papon claims, he was only a cipher, or whether he was a willing and efficient tool of genocide - not necessarily out of anti-semitism or pro-Hitler beliefs, but from self-interest. Papon, it appears clear, was no ideological supporter of the Nazis, nor was he ardently anti-semitic. His fault may very well be his obsession with career advancement. As the number two civil servant in the Gironde, he soon acquired a reputation for being "quick and reliable" to German military officials. Though he never abandoned his post, when it later proved politically expedient to be seen on the side of the Resistance, Papon established contacts with the Resistance and personally rescued a number of what he called "interesting Jews" that eventually helped him escape the postwar purge - and have now been used in his defense.

As important to the verdict will be how responsibility in a crime against humanity is read. Hannah Arendt, in *Eichmann in Jerusalem: A Report on the Banality of Evil*, grasped the crux of a crime against humanity. Eichmann and his defense had steadfastly insisted that he himself had never committed an overt act, but rather was guilty only of following the orders of hegemony. The jury saw this as the crime in-and-of-itself. Arendt explains:

What the judgment had to say on this point was more than correct, it was the truth: in such an enormous and complicated crime as the one we are now considering, wherein many people participated, on various levels and in various modes of activity ... there is not much point in using the ordinary concepts of counseling and soliciting to commit a crime. For these crimes were committed en masse, not only in regard to the number of victims, but also in regard to the numbers of those who perpetrated the crime, and the extent to which any one of the many criminals was close to or remote from the actual killer of the victim means nothing, as far as the measure of his responsibility is concerned. On the contrary, *in general the degree of responsibility increases as we draw further away from the man who uses the fatal instrument with his own hands....*²³

One would expect that France would also soon come to the same conclusion.

It may be dangerous to propose that the trial of Maurice Papon is too limited in its accusations to satisfactorily encompass the stain of 1940-1944. But there is a vital element to Vichy that lies outside the confines of the trial's allegations. Crimes against humanity, a term which has come to be read as crimes against victims of the Final Solution, neglects what many believe to be the most crucial aspect of Vichy: the Franco-French Civil War. Most of the apologetic posturing done of late has been directed towards the injustices suffered by the Jews. Vichy was an exclusionary regime, but its worldview, unlike Nazism, did not place hatred of the Jews at its center.²⁴ There were collaborationists responsible for eliminating the Resistance, a movement with both Jew and non-Jewish

membership. The Touvier and Barbie affairs are therefore better illustrations of the dilemma to convict on the basis of crimes of anti-semitism, war crimes, or crimes against the Resistance - or combinations thereof. Critics of the Papon trial in particular, and subsequently of the political posturing of France and other European nations, are suggesting that such events are illustrative of countries (other than Germany) succumbing to worldwide pressure from Jewish lobbies to accept a share of responsibility in the Final Solution.

Papon's case has brought new questions which lie outside of the legal jurisdiction as well. These have shaken France in a way that Leguay or Touvier or Barbie could not. How could one so easily escape the purges and prosecutions surrounding the Liberation? How could one pass so fluidly into the government of de Gaulle, a man who Papon had previously labeled a traitor? How could one with such a past continue to thrive throughout his career, never once apparently being held back?

What ultimately may be at risk in the aftermath of this trial is the somewhat sanctified image General de Gaulle still appears to command. De Gaulle's calculations for rebuilding the Republic will be re-exposed, in a harsher light, with negative implications for the Gaullist myth. His image may become one where the left hand is shown condemning Vichy, collaboration and the naïve Pétain, and the right hand preferentially escorting the thousands of middle-ranking Vichy officials back into post-war government. What did it mean then, to be misguided? Is this term reserved purely for those Vichyists who had directly fought the Resistance or had been responsible for the deportation of French forced laborers? More importantly, what did it mean to resist? Furthermore, the heroic stance of de Gaulle is coming under criticism. The far right has made comments that it is easier for one to resist in London than to resist in Paris, essentially pushing for de Gaulle and Gaullism to join Papon on the block.

De Gaulle's choices were, in a sense, vindicated. National unity was restored; France was accepted as one of the victors of the war and the foundations for thirty years of economic and social progress were laid. His shrewdness appeared to have paid dividends. It is now accepted that de Gaulle and his entourage used Papon and other collaborationists in a calculating utilitarian manner, banking that their damaged resumes would ensure blind loyalty. But the decision to blind the nation, albeit with its consent, to the wounds of Vichy has come back to haunt.

The far right, and parts of the center right have dismissed the trial as a pointless, damaging display. But this should be expected from the platform of Jean-Marie Le Pen, who has discounted the Holocaust as a mere "detail in history" and expressed outrage at the recent apologies by the church, finding it incredible, "that people who were not even born at the time of the events should come ... to ask for pardon." Brash words, but one can hear in them the strains of Pompidou and more recently Mitterand, who felt the whole period best forgotten - "one cannot go on living on bitter memories and resentment for ever."²⁵

But the younger generations increasingly want to know and much of the older generation appears willing to reopen their memories for introspection. Almost two-thirds of French people regard Vichy as a relevant issue today. Those under 25 are especially insistent that Vichy is something that still has important connotations for their lives. A recent poll in *L'Express* found that 72 percent of the population approves of the

prosecution of Papon, while just under half of those surveyed hoped that the trial would also focus on the wider role of the Vichy administration.²⁶

Conclusion

Vichy appears to have become a two-way street. The memory of the regime, and thus the conflicting representations that serve to inaccurately define it, has been denominated the root of the nation's central issues. All values, all antagonisms have been sourced from this four year period. At the same time, the Vichy era has been taken by some to serve as a screen on which the nation can project its current conflicts and controversies. The conclusion therefore, is that one first needs to have a grasp of Vichy before one can ever hope to identify the true persona of the nation, the true flavor of France. Much like the emphasis given the American Civil War, Vichy has become the crossroads of France's being in this century.

Touvier, Leguay, Bousquet and Papon - four former Vichy officials who were called on to atone for their pasts. The Final Solution is the chain that binds, but there it ends. In manner and achievement their differences are noteworthy: Touvier the fascist and violent man, the others unexceptional in ideology or manner and best distinguished from one another by their career advancement. Of the four, only the trials of Touvier and Papon have incited widespread interest - along with Barbie. From these it appears that Papon's trial offers the nation the broadest possibility for introspection. Touvier and Barbie were famous for who they were, or more accurately, whose lives they took. Such characteristics inhibit diagnosis on a national level. Papon, the man, is relatively uninteresting: a calculating careerist to the degree that any search for a strong personality goes unrewarded. It is the issues behind Papon which spread out into the functioning of the Vichy and postwar government systems that have captivated the public. The consequences threaten France's postwar mythology.

The Resistant Marcel Bloch, a Jew, in his memoirs written shortly before he was caught and executed, eloquently predicted the arduous task facing his country in the years to come:

A day will come, of that I am convinced, after no matter how long a delay, when this old and sacred soil of France, from which, in the past, so many harvests have been lifted - harvests of free thought and of judgment unrestrained - will once more burgeon into ripeness. In that happier future many secret records will be made public. Gradually the mists of ignorance and malice, which now begin to gather about the most terrible collapse in all the long story of our national life, will thin ... and those on whom the duty falls will see through them to the truth beyond....²⁷

It may have shocked him to know that after fifty-six years, his country was still awaiting the day of reckoning.²⁸ ●

¹President Chirac was only twelve when the war ended. Thus he has been able to look history in the face with considerably more ease than his predecessors, Mitterand had his own controversial and ambiguous past; d'Estaing falsely insinuated he was in the Resistance; while Pompidou, who was not, tried to repress the idea of the Resistance. Incidentally, it was the discovery of Papon's files in the run-up to the 1981 elections that helped, it is claimed, to bury d'Estaing's election chances.

²*Ibid.*, p.300

³Marcel Bloch, *A Strange Defeat*, p.11

⁴from Jean Pierre Azéma, *From Munich to the Liberation, 1938-1944*, p.23

⁵Rousso, p.48

⁶Paul Farmer, *Vichy: Political Dilemma*, p.6

⁷Azéma, p.182

⁸Farmer, p.127

⁹*Ibid.*, p.112, From 3 October 1940, Jews of French nationality were made subjects to a statute severely modified on 2 June 1941: they were henceforth excluded from all elective and public functions, from the magistracy and from the army (except if they were veteran combatants); they could exercise no responsibilities in the cultural domain or the media. A strict quota limited their access to universities (3 percent) and to many of the liberal professions (2 percent). Finally, all enterprises belonging to Jews could be Aryanized by enforced liquidation or the appointment of trustees. As for the 'foreign Jews,' a decree passed on 4 October 1940 gave prefects powers to put them under house arrest and intern them in special camps: by the Spring of 1941 40,000 had already been rounded up and crowded into camps. The efficient coordination of all these measures was the responsibility of the general commissariat for Jewish questions, created in March 1941 and initially intrusted to the extremely reactionary and ultra-xenophobic Xavier Vallat. It is worth pointing out that the Jewish statute was the brainchild of Vichy and Vichy alone.

¹⁰Rousso, p.113

¹¹Farmer, p.143

¹²The Free French killed approximately 10,000 people without trial or legal authorization by the Provisional Government. Such estimates are highly controversial. See Robert Paxton, p.382

¹³*Ibid.*. There was a purge in professions, 10,000 death sentences (estimations on 1,500 actually carried out), national degradations, prison terms, loss of civil rights, and so on.

¹⁴according to Barry James article, "The Final Trial for Vichy?" in the *International Herald Tribune* (January 6, 1996), p.2, there were only 3,000 German police officials in France, who left the execution of their policies to the 47,000 French police officials.

¹⁵Rousso, p.96

¹⁶see John Lichfield's article "Papon's sins put post-war France in dock", in *The Independent* (December 2, 1997)

¹⁷*Ibid.*

¹⁸Rousso, p.203

¹⁹see Keesing's Record of World Events, Vol.40, p.39, 987

²⁰*Ibid.*, p.160

²¹Barry Lewis, p.2

²²see John Vinocur's article, "In Vichy Trial, Papon Stands Not Silent, but Mute," in the *International Herald Tribune* (January 16, 1997), p.1

²³taken from an excerpt entitled, "The Trial of Adolf Eichmann" in Lawrence Freedman's War, p.174

²⁴Rousso, *The Vichy Syndrome*, p.104

²⁵see "Our Trespasses" in *The Economist* (October 4, 1997), p.30

²⁶Lichfield

²⁷Bloch, p.4

²⁸The 3rd of April 1998 Maurice Papon was ordered by a criminal court to pay 4.6 million francs in legal fees and damages. The sum is equal to \$750,000. The court also sentenced him to ten years imprisonment. He has appealed this conviction and may remain free until his case is tried again in 1999 (Editors' remark).

Full bibliography was not available upon publication.

Russian Organized Crime: An Impetus or Impediment to Political and Economic Progress?

Robert Heilman

One of the most salient features of Russia's progress toward a market-based economy and democratic political system is the extent to which crime and lawlessness has become part of the transitional process. Along with hopes and expectations, the break up of the Soviet Union gave rise to a dramatic increase in crime and the formation of large, well-organized criminal groups. The Western press quickly picked up on this theme; the "Russian mafia" soon became a catch phrase for most criminal activity in post-Soviet Russia. But the popularity of Russian organized crime has not been limited to the media. Both academics and professionals have given the matter much attention during the past few years. Economists, criminologists, historians and sociologists have all taken up the issue. A central debate circulating throughout these different appraisals questions the overall impact of organized crime on Russia's political and economic development.

Although this paper focuses on Russia's internal situation, Russian organized crime is in fact a transnational issue. One of the greatest potential risks from organized crime is its implication in smuggling nuclear materials out of Russia for sale to pariah states or terrorist organizations. The extent of organized crime involvement in this trade is highly contested, but the seriousness of the threat demands that the West take note. The operations of Russian organized crime extend beyond national boundaries into the countries of the former Soviet Union, Europe and North America. In fact, wherever Soviet hegemony existed, the influence of Russian organized crime is present. The pervasiveness is due in part to organized crime's connection with the Soviet ruling elite, a major theme of this study. As the institutions of the West, such as the European Union and NATO, expand eastwards, Russian organized crime will become an even more apparent menace.

Some experts describe Russia's present situation in catastrophic terms, calling today's woes the worst crime wave since the "Time of Troubles"¹ when Tsar Ivan the Terrible's untimely death at the end of the sixteenth century led to a succession crisis marked by chaos and bloodshed. Their argument follows that organized crime is the

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primary menace, undermining reform, sparking violence and posing a serious threat to democracy in Russia. These experts regard Russian organized crime as a savage and potent foe which is destroying Russia's fragile economy. Stephen Handelman calls the Russian "mafia" a "hydra-headed phenomenon that feeds on the emerging market economy."² Claire Sterling is another ardent supporter of this view. She likens Russian organized crime to a "predatory shark" in the following words: "insatiable and seemingly invulnerable, it swallows factories, co-ops, private enterprises, real estate, raw materials, currency and gold...."³ Not only does this "mafia" jeopardize the private sector, but its powerful influence has penetrated the government at all levels. One expert even claims that Russian organized crime has replaced the Soviet state as a new type of authoritarianism.⁴

On the other hand, there are those who believe that the West tends to overstate the extent of crime in Russia, especially in comparison to the Soviet era.⁵ Likewise, these scholars feel that organized criminal groups provide a net impact which is beneficial. While there are certain negative costs associated with mafia-type groups, they do provide certain duties, such as contract enforcement, which are necessary for a market economy to function. Ordinarily these tasks would be performed by the state. But when the state is weak, as in the case of Russia, other groups fulfill the role.⁶ In addition, advocates of this view claim that the phenomenon of organized crime is simply a phase in Russia which will run its course as reform continues and the state grows stronger. Under these assumptions, those who made their riches through illegal means will eventually turn legitimate, investing their wealth in legal enterprises and soliciting a strengthened state for protection against the next generation of ruthless criminals. Thus, leaders in Russia's criminal underworld are likened to the robber barons (Carnegies, Vanderbilts, Morgans) of late nineteenth century America, who amassed huge amounts of capital through dubious means yet reinvested the money such that society ultimately profited.

While both the best and worst case assessments of Russian organized crime have unique strengths and weaknesses, the former argument has been losing ground in recent years. Despite continuous attempts at reform, organized crime persists in Russia and challenges the authority of the state. However, before discussing both cases in detail there are several other questions which must be answered. First of all, the term *organized crime* needs to be elaborated. There are some key assumptions from an economic approach which are very helpful in determining what defines a criminal group as organized crime. Much of the best case scenario argument is based on these assumptions. Once the basic guidelines for an organized criminal group are established, the next pressing question is in what form does organized crime presently exist in Russia. Despite the extensive coverage of organized crime in both scholarly and general publications, there seems to be a range of subjects to which the term applies. For example, it is very difficult to assess organized crime in Russia without simultaneously addressing the issue of state corruption. The lines become blurred when attempting to distinguish between criminal overlords and the corrupt political elite. Reasons for this overlapping are found in the history of the criminal underworld and its relationship with the state since the end of the Tsarist era. The crux of the worst case analysis stems from this historical connection. By examining organized crime using economic theory and historical analysis, we can then evaluate the best case and worse case assessments for Russia and determine why the optimistic appraisal has proved false.

What is organized crime?

Economists generally describe organized crime using two models: a profit-seeking firm and a government. An organized criminal group acts as a *firm* by providing goods and services to other *unorganized*, small scale criminals. What sets the organized criminal group apart from the other criminals is the attainment of market power.⁷ An organized crime firm dominates the market of a particular criminal activity by acting as a monopoly, selling products above the competitive price, or as a monopsony, buying illegal factors below the market price. As a monopolist an organized crime group might sell a good, such as illicit drugs to a drug dealer, at a monopoly price. The dealer in turn sells the drugs to the public. Thus, the organized crime firm obtains monopoly rent, while also shifting most of the risk of being caught onto the unorganized criminal. An organized crime firm is a monopsonist in a market where it can impose an artificially low price as the only buyer, such as for stolen goods. Again, the profit goes to the organized crime group buying illicit goods at low prices, as the risk is largely assumed by the small-scale hoodlums committing the robberies.

The monopolist and monopsonist economic models help explain why organized criminal groups behave the way they do.⁸ For example, if a mafia-type group operates in a market which is relatively competitive, such as prostitution rackets, they might invest in weapons and hit-men to discourage new entrants to the market. In the same way, a legitimate firm might invest in research and development or advertising to protect its market share. Physical violence, or the threat of it, is the principle market tool used by organized criminal groups to optimize a market share. For example, if there is instability in the market, as when a rival gang attempts to enter, violence is the result.⁹

The second paradigm characterizes organized crime as a *government*. Under this model, a crime syndicate works on a large scale, enjoying exclusive jurisdiction over legal and illegal businesses of a given geographical or operational area. An organized crime group acts as a government by setting the rules for certain activities to take place, with ultimate recourse to coercion if necessary. Like a government, this type of organized crime has a monopoly over the use of force. The organized crime government charges legitimate or illegitimate businesses a tax or tariff in the form of extortion payments, or bribes, for permission to undertake particular projects. Thus, the organized crime government is a sort of redistributive agency, raising funds from some citizens and dispersing them to others.

What is organized crime in Russia?

These models of the firm and government are not mutually exclusive. Organized crime often exhibits both features. For example, a gang may, as a firm, specialize in the drug trade, while just like a government, demand a percentage of profits from the drug dealers who work in their territory. In Russia organized crime may function both as a firm and a government. Statistics show a continued growth in the number of organized criminal groups, from an estimated 3,000 in 1992 to around 8,000 in late 1995/early 1996.¹⁰ Organized crime in Russia is active in a wide range of illegal undertakings, such as gambling, prostitution, drug trafficking and arms dealing, where they act as profit-seeking firms. Moreover, criminal groups have infiltrated many raw materials industries. Speaking in November 1996, then Russian Interior Minister, Anatoly Kulikov lamented the “almost

complete criminalization” of the gold and diamond mining industries and admitted that criminal gangs “were waging open war” for control of the energy industry.¹¹ Again, criminal groups fit the firm model by dominating markets and vying for monopoly rights.

In May 1996 the Moscow paper *Finansovye Izvestiya* stated that organized criminal groups have controlling influence in more than 40,000 Russian businesses in disparate sectors of the economy.¹² In exerting its power, organized crime assumes the role of government. For instance, the same source reported that nearly 70 percent of commercial firms pay some type of bribe to organized criminal groups. In this way crime groups impose a kind of tax. Organized crime also wields very heavy influence in the banking sector, which provides criminal groups with a source of preferential loans and a convenient method for money laundering. In other words, organized crime *regulates* the banking sector just as a government does, ensuring that banks operate under certain guidelines. Contract killings - used to settle debts, establish territorial rights, and eliminate whistle-blowers - have become a so-called growth industry in Russia.¹³ The number of contract murders is small in proportion to overall murders. However, the victims are usually prominent public figures, such as bankers and journalists and these cases are rarely solved. These murders are a grim example of organized crime functioning as a government which may resort to violence to enforce its rule.

Who comprises organized crime in Russia?

It is clear that the activities listed above constitute organized crime as they fit into the firm and government archetypes. Yet the Russian perception of who is part of organized crime is not so clear cut. During the Soviet era, the *mafia* referred to anyone with money or connections.¹⁴ Today, it is often the case that the public does not distinguish between *organized* and *unorganized crime*. The breakdown of the Soviet system created many opportunities for crime in general to increase. However, much of what should be recognized as unorganized crime, such as theft, burglary, holdups, drug dealing, is equated with organized crime.¹⁵ Therefore many small scale criminals are mislabeled as members of organized crime. Another element which muddles the notion of what is organized crime is a holdover of Soviet thinking. Presently, various economic middleman activities, which are perfectly legitimate according to Western market values, are still considered to be criminal in the eyes of many older Russian citizens. One of the most ideologically loaded economic crimes under Soviet law was called "speculation," the buying up of goods and reselling them at a profit. This law remained on the books until 1991.¹⁶ But the rationale behind it has remained, adding to the misconceptions surrounding organized crime.

There have been some attempts to delineate whom Russians refer to when speaking of organized crime. One such profile describes four categories.¹⁷ The first, and of least importance, is the *small businessman*, who is most likely a victim of gangs rather than a member. Nonetheless, regular contact makes him guilty by association. Next up in importance are the *neanderthals*, or thugs, who collect extortion payments, control the prostitutes, and peddle drugs and arms. Above them are the *businessmen* whose members could be described as a cross between Al Capone and early American robber barons. This group made their money by bribing the largest and most insidious group, the *state mafia*.

This last category is seen as the worst component of organized crime - the corrupt governing apparatus.

James Millar's explanation of Russian organized crime corresponds with this last category of a state mafia. Applying the economic model, Millar includes in his definition of Russian organized crime the "ability of strategically-placed individuals in government or state enterprise positions to claim, transfer, and otherwise appropriate state assets for private gain."¹⁸ Others also conclusively link the government with organized crime.¹⁹ This connection is not coincidental. The foundations of the present day state mafia date back to the age of the Russian Empire. In fact, simply using the economic models which the best case scenario rely upon is inadequate in determining who comprises organized crime in Russia today. Instead, we must take an historical approach to the subject as well. This method, which is the primary analytical tool of the worst case assessment, will explain why so many now refer to a corrupt government when identifying the components of organized crime.

History of Russian organized crime and its relationship with the State

A criminal underworld has existed in Russia for centuries. Under the Tsars, bands of outlaws and rebellious peasants lived in defiance of the law. Outlaws did more than simply reject authority. These criminal societies also demanded that their members withdrawal from conventional society and renounce any allegiance to the state or excessive materialism. In the twentieth century, when the newly formed Communist Party replaced the Tsarist autocracy, the ideology of the regime changed, but the oppression did not. Traditional outlaws were just as reluctant to acquiesce to Soviet authority as they were to Tsarist rule.

In the first years of Soviet rule, criminal societies crystallized into what became known as the *vorovskoi mir*, or thieves world. Led by a criminal elite called *vory-v-zakone*, literally thieves-in-the-law,²⁰ members of the *vorovskoi mir* continued to abstain from all aspects of conventional, in this case Soviet life. The worst violation of the *vorovskoi mir* was to cooperate with the authorities. In fact, collusion with the government in fighting the Germans during World War II is what led to a schism within the *vorovskoi mir*, which subsequently transformed its relationship with the state.

During this schism a fratricidal battle ensued in the late 1940s and 1950s, through which the power structure of *vorovskoi mir* was dramatically altered. From the aftermath a different breed of criminals appeared, ostracized from the traditional group and indifferent to the old-school *vory* values and restraints. There was greater cooperation among the prison authorities and prisoners as some of the latter turned into informants. Other rules changed as well. Amassing wealth was no longer taboo for the new ilk of criminals. Soviet authorities eventually took advantage of these changes in the rules of the game.

The inherent inefficiencies in the planned economy system became more apparent in the decades following World War II. As the state determined supply failed to keep up with consumer demand, the Soviet leadership looked to other means in order to ameliorate the growing scarcity. A budding relationship with a new criminal class which exhibited some entrepreneurial spirit suited the needs of the state. From the 1960s until the demise

of the Soviet Union, a second economy prospered which filled the gaps left by the state planning mechanism. Black market trade and underground factories collaborated with state enterprises in order to fill quotas for production. Very influential positions emerged: *tsekhoviki*, the underground factory owners and *tolkachi*, the unofficial though well-connected supply officers of state firms. The new type of criminals which grew out of the split in the *vorovskoi mir* became these black marketeers. In this manner, they attained wealth and political influence which was unheard of by their predecessors.

The shadow economy developed rapidly in the 1970s under Brezhnev, as the need for its services increased. As William Clark expressed in his study of Soviet officialdom during the years 1965 to 1990: "Informal practices that tended to produce better outcomes than those of the formal system overcame formal Soviet procedures and acquired something close to the status of an informal regime supported, if only implicitly, by the Soviet leadership."²¹ These informal practices grew so much that by the 1980s it was estimated that 83 percent of the Soviet population employed the shadow economy to obtain necessary goods and services. State corruption had become institutionalized in the wake of bribes and mutual favors, which were the driving force behind the system. However, official corruption did not only reflect the abuse of power by the political elite for personal gain. There were social benefits as well. Bending the rules was a method of "system maintenance."²² Soviet leaders, at least until Gorbachev, favored supporting the system through functional corruption rather than reform. As a result, government officials came into ever increasing contact with post-vory criminal elements.

When the Soviet leadership did attempt to preserve the system through active reform (*perestroika*) instead of passive acceptance of corruption, the nature of the Soviet elite changed correspondingly. By the 1980s the ruling political elite, or *nomenklatura*, had well established itself as a privileged class. However, they were not rich in the conventional sense. The *nomenklatura* enjoyed a higher standard of living, which was supported by an entire system of indirect payments and benefits: exclusive housing rights; distribution of high-quality foodstuffs; special polyclinics, stores, etc. As the transition under Gorbachev made political positions less certain, the emphasis for privileges shifted from power to private property.²³ Members of the *nomenklatura* were the first, and arguably biggest, beneficiaries of economic reform.

One of the most effective ways they secured their advantages was through the so-called "Komsomol"²⁴ economy of the late 1980s. A series of initiatives beginning in 1986 gave Komsomol officials exclusive rights in setting up the first commercial structures in the Soviet Union. What started as a network of scientific and technical centers founded to provide services to other enterprises, by 1990 gave birth to a Komsomol commercial bank, an import-export center, a chain of fashion shops, and over 17,000 cooperatives with a staff of about one million. The privileges awarded the *nomenklatura* during the late Gorbachev period were of an increasingly economic nature, including: establishment of joint ventures with foreign enterprises; conversion of assets into cash; advantageous credits from the state; property dealings; privileged import-export operations; and "privatization of the state by the state."²⁵ Thus, the outlook of the elite assumed a more monetary character, and so did the corruption associated with it. Reform triggered what has been called the "monetisation" of corruption.²⁶

By the end of the Soviet era, the foundations of today's organized crime were in place. The criminal underworld which existed for centuries had transformed from outlaw

groups in opposition to the state to more profit motivated organizations colluding with the authorities. Likewise, the nature of the political elite evolved during the Soviet period. Soviet leaders used corruption as a means to maintain the state system and their hold on power. As the need for corruption increased, government officials developed closer ties with the new breed of the criminal world. When the economic reform of the late Soviet era allowed the political elite to acquire more monetary privileges, connections with organized criminal elements became stronger. What occurred was not only an increase in interaction between the two, but a shift in the balance of power from the state to organized crime.

Patricia Rawlinson, in her doctoral work at the London School of Economics, offers an insightful assessment of the relationship between organized crime and the state in Russia. "The history of organized crime in Russia," she writes, "...has been a history of responses by legitimate structures to the presence of the former."²⁷ By *legitimate structures* she refers to the political, economic and criminal justice system - in short, the state. Her interpretation makes the legitimate structures the initially dominant partner, since it is their responses to organized crime which determine, up to a certain point, organized crime's development. Rawlinson explains her analysis within the framework of an intriguing model called the Chameleon Syndrome, which traces the ability of organized crime, through interactions with the legitimate structures, to merge with and eventually play a proactive role in the Russian state.²⁸ Organized crime was able to assert itself because the legitimate structures increasingly relied on the former's services for survival. Looking at the history of Russian organized crime and its relationship with the state through the Chameleon Syndrome allows us to appreciate why the Russian perception of organized crime is synonymous with the state mafia.

Best and worst case scenario: a critical evaluation

Having gained a deeper understanding of organized crime, both through economic theory and historical analysis, we may now evaluate the two main schools of thought regarding the impact of Russian organized crime. First let us take the best case scenario. Supporters of this view claim that many in the West exaggerate the negative effects of organized crime as it exists in Russia. Instead, these critics see many favorable aspects of organized crime. They usually adopt an economic standpoint in analyzing organized crime, using both the *firm* and *government* models. This approach is more objective, which is one merit of the best case argument. By conducting a rational analysis of organized crime, and avoiding the myth surrounding it, we can recognize its strengths and weaknesses and be better equipped to confront its challenges. For instance, their argument maintains that organized crime, acting as a government, fills the power vacuum left by a weakened state, providing services such as property right protection and contract enforcement, which are the rudimentary elements allowing the market economy to function. While there are certainly drawbacks from receiving these services from organized crime, such as violence and monopoly prices, primitive enforcement of property rights is better than none at all. As long as there exists a public demand for these basic services, which the state cannot perform, organized criminal groups will remain.

Facilitating business, albeit crudely, is not the only way in which organized crime in Russia establishes its dominance. As mentioned earlier, organized crime is in a sense

a redistributor of wealth, extracting funds from one segment of society and allocating them to another. Usually the money raised remains in the hands of organized crime, but sometimes wealth is transferred to other sections of society in the form of charities or other public services. For example, it is not uncommon for Russian criminal groups to sponsor sports and recreation centers for the local youth. In this way, crime bosses improve their popularity, appearing as Robin Hood-type figures. Since Russia is a country with a nascent civil society and whose government is often unable to pay for basic social services, such generosity is that much more significant. At the same time, these sports centers usually offer martial arts training, which provide organized criminal groups with their labor supply for bodyguards and henchmen.

Recognizing organized crime in terms of monopoly and monopsony enterprises, which market illegal goods and services, explains another reason for its persistence. As with any monopoly, organized crime results in a lower output of its product at a higher cost to the consumer. For example, when organized crime monopolizes the prostitution trade in an area, it may limit the overall amount of prostitutes available while selling their services at a higher price. As a result, consumption by the public decreases. Therefore, there is a temptation for police to work in tacit agreement with organized criminal groups, since the crime statistics tend to decline. For Russia in particular, a police force which is understaffed and underpaid makes cooperation that much more enticing for police officials.

The methodology underlying the best case argument is its main strength. However, most of the conclusions reached by its supporters have been losing their credibility with time. The optimistic critics believe that with continued economic reform, organized crime's sphere of influence would "dwindle to 'normal' Western levels."²⁹ The legions of gangsters, having acquired their illegal fortunes, would invest the money back into Russia and become legitimate businessmen. They would therefore render another valuable service to society, capital accumulation, which is so critical in the early stages of economic development.

Unfortunately, this does not appear to be the case. Examples of criminals turning into honest businessmen seeking protection for their property rights from the government are uncommon. It is more often the case that a thief will advance from "primitive" crimes (e.g., stolen cars) to more sophisticated ones in the "legit" areas of the economy (e.g. bank fraud), which usually involve the compliance of a corrupt government official.³⁰ While organized crime no doubt accumulates capital, it does not reinvest it on a large scale in Russia. Capital flight remains a major problem, for lawbreakers will always need a stash abroad in case of a quick getaway. In addition, as long as Russia is a risky environment for investments, organized criminal groups will continue to invest out-of-country. As Millar notes, "getting organized crime to invest in Russia is essentially the same as getting Western firms to invest in Russia."³¹

What the best case scenario fails to address is that the symbiotic relationship between organized crime and the state will not just fade away on its own accord. This is also the strongest point of the worst case assessment. As the previous section demonstrates, organized crime has to a certain degree usurped the authority of the state. Proactive organized crime is the biggest threat to democratic progress. With time society will take the impotence of the state for granted. Economist Petr Filippov, commissioned by President Yeltsin in 1993 to report on organized crime, warned that this is already

occurring: "An entire generation is growing up for whom this situation is normal and who in such circumstances will not turn to official authorities, but to unofficial ones. These people are more likely to hire a murderer to punish a guilty or even an unpleasant partner than to go to court or arbitration."³² Those who insist on the best case outcome fail to give this warning the attention it deserves.

The problem with the worst case scenario lies more within the way it is presented than in the prognoses. The tendency towards sensationalism in analyzing organized crime can lead to over-simplification which limits the search for viable solutions. While the worst case scenario loses some credibility by demonizing the subject matter, ultimately its verdict rings more true. As the discussion above reveals, the degree of organized crime's influence in most levels of government, in the national media, and in the private sector shows that it is more a permanent feature of Russian society than a transitory one.

There are no easy answers to this problem. The best case scenario, although its conclusions fall short, is correct in stating that organized crime exists because it fills the vacuum left by a weak state. But the worst case scenario demonstrates that this power vacuum did not materialize all of a sudden with the fall of the Soviet Union, or that this is a temporary phenomenon. The challenge is how to battle organized crime which is in many aspects interwoven with and indistinguishable from the state structure. Legal experts have proposed concrete measures, such as more effective Russian legislation against official corruption and increasingly more sophisticated economic crimes. Western law enforcement agencies have already begun to coordinate efforts with their Russian counterparts against transnational crimes. But the strongest points of both assessments show that organized crime is highly ingrained in society, possibly beyond the scope of such measures. Therefore any feasible solutions would have to involve much broader action. Changes must occur within society, so that the next generation does not grow up according to Fillipov's prediction. ●

¹ Ariel Cohen "Reexamining Russia. Crime Without Punishment" *Journal of Democracy*, Vol. 6, No. 2 April 1995, p 41; and Handelman, Stephen *Comrade Criminal. Russia's New Mafiya*, (New Haven: Yale University Press) 1995, p 5.

² Here the term "mafiya" is a transliteration from Russian. In order to avoid confusion with the Mafia of Italy, I generally use the term "organized crime" instead of "mafiya." In Stephen Handelman's "The Russian 'Mafiya'" *Foreign Affairs*, Vol. 73, March/April 1994, p 83.

³ Claire Sterling, "Redfellas" *New Republic*, Vol. 210, 11 April 1994, p 19. See also Claire Sterling, *Thieves World* (New York: Simon and Schuster) 1994.

⁴ Louise Shelley "Post-Soviet Organized Crime: A New Form of Authoritarianism" in *Russian Organized Crime. The New Threat?*, ed. Phil Williams (London: Frank Cass & Co. Ltd.) 1997. This book is a reprint of a series of articles which first appeared as a Special Issue on "Russian Organized Crime" in *Transnational Organized Crime*, Vol. 2, No. 2/3, Summer-Autumn 1996, published by Frank Cass & Co. Ltd.

⁵ Jim Leitzel, Clifford Gaddy, and Michael Alexeev "Mafiosi and Matrioshki" *The Brookings Review*, Winter 1995, p 26-9.

⁶ This argument is not unique to Russian organized crime. Diego Gambetta attributes the origins of the Mafia in Sicily to the social and economic conditions of the nineteenth century. In his analysis, the collapse of feudal society created more owners of private property, which in turn increased the demand for protection of property rights. Because these demands could not be met by a strong central authority, mafia families emerged to provide this protection. See Diego Gambetta, *The Sicilian Mafia. The Business of Private Protection* (Cambridge, MA: Harvard University Press) 1993.

⁷ James Millar "What's Wrong with the Mafiya Anyway? An Analysis of the Economics of Organized Crime in Russia" *Economic Transition in Russia and the New States of Eurasia*, ed. Bartłomiej Kaminski (New York: M. E. Sharpe) 1996, p 207-8.

⁸ "Theories of the firm" *The Economist*, 10 February 1996, p 76.

⁹ In summer 1997, St. Petersburg had not seen economically motivated violence in over a year; the worst bloodshed took place over three years ago during the fall 1993/summer 1994 with over 30 "gangster" murders. But when "investors" from Moscow attempted to enter the Petersburg market, disrupting the "balance of power," violence erupted once again. See Daniel Tsygankov "St. Petersburg Assassinations Result from Invasion of Moscow Capital" *IEWS Russian Regional Report*, Vol. 2., No. 44, 18 December 1997.

¹⁰ Phil Williams "Introduction: How Serious a Threat is Russian Organized Crime?" in *Russian Organized Crime*, p 11.

¹¹ "Money Kills" *The Economist*, 16 November 1996, p 51.

¹² Statistics from the American Bar Association's Central and East European Law Initiative (CEELI) as printed in *Russian Organized Crime*, p 270.

¹³ Reported in *Moscow News* according to CEELI in *Russian Organized Crime*, p 232.

¹⁴ "Russia's Mafia. More Crime than Punishment" *The Economist*, 9 July 1994, p 20.

¹⁵ Millar, p 207.

¹⁶ Sergio De Sanctis "Legal and Criminal Law Reform: Another Failure of Perestroika?" *Journal of Communist Studies*, Vol. 9, No. 1, March 1993, p 154.

¹⁷ "Russia's Mafia. More Crime than Punishment" *The Economist*, 9 July 1994, p 20

¹⁸ Millar, p 209.

¹⁹ Stephen Handelman defines the "comrade criminal" as the "unique post-Soviet gangster-bureaucrat." *Comrade Criminal: Russia's New Mafiya*, p 70.

²⁰ A "thief-in-the-law" refers to the traditional law, or code, under which all thieves lived. The term *vory-v-zakone* came into use by the early 1930s according to Soviet criminologist Aleksandr Gurov, one of the first, in the late 1980s, to address the issue of organized crime during the Soviet era. See Patricia Rawlinson "Russian Organized Crime: A Brief History" in *Russian Organized Crime* p 37; Handelman *Comrade Criminal* p 54-8.

²¹ William Clark "Crime and Punishment in Soviet Officialdom, 1965-90" *Europe-Asia Studies*, Vol. 45, No. 2, 1993, p 260.

²² Ibid. p 261-2.

²³ Olga Kryshnanovskaya and Stephen White "From Soviet Nomenklatura to Russian Elite" *Europe-Asia Studies*, Vol. 48, No. 5, 1996, p 715-6.

²⁴ The "Komsomol" is an abbreviation of what translates to the "Young Communist League," the state-sponsored organization for all Soviet youth, which existed from 1918-1991.

²⁵ Kryshnanovskaya and White, p 717-20.

²⁶ "Russia. Rotten to the Core?" *The Economist*, 7 August 1993, p 47.

²⁷ Patricia Rawlinson "Russian Organized Crime: A Brief History" in *Russian Organized Crime* p 50.

²⁸ Ibid. p 29.

²⁹ Leitzel, Gaddy, and Alexeev, p 29.

³⁰ Bill Powell "A Culture of Criminals" *Newsweek*, 19 January 1998, p 20-2.

³¹ Millar, p 215.

³² "The high price of freeing markets" *The Economist*, 19 February 1994, p 58.

Combined Joint Task Forces as an Instrument of European Security

Armand A. Perry

With the demise of the Soviet Union and political upheaval in Eastern Europe and the Balkans came the need to reevaluate existing European security arrangements. Although by 1998 many of the resulting adaptations and new forms have begun to assume recognizable shape, debate continues regarding the appropriate roles of key institutions: NATO, the European Union, and the Western European Union (WEU). These institutions seek, in addition to continuing the traditional armed defense of European territory, to assert their continued relevance in a changed security environment, to reach out to the new democracies of Central and Eastern Europe, and to preserve the security link with North America while enabling Europe to take greater responsibility for its own defense. NATO has introduced, and the European Union and WEU have endorsed, a concept known as Combined Joint Task Forces, or CJTFs, as a means to these ends.

This paper will examine the possibilities and limitations of CJTFs as a means of achieving the last of those objectives, that of enabling Europe to assume a larger security role. This essay first provides background on European Union (EU) and WEU aspirations for and steps toward such a role and second it covers NATO decisions, starting with the Brussels Declaration of January 1994, intended to facilitate this approach. Third it examines CJTFs in practical detail, emphasizing the obstacles to their actual implementation and possible solutions thereto. The conclusion evaluates the likely outcome of the debate given current trends and offers a broader perspective on the difficulties of making CJTFs a shortcut to a European defense capability.

The European Union and the WEU

THE EUROPEAN UNION AND EUROPEAN SECURITY

European integration had by the early 1990s reached the point where EU member states sought to advance the European Union as an actor not just in economic matters but in the security and defense spheres as well. The 1993 Treaty on European Union (Maastricht Treaty) provided that the "Union and its Members shall define and implement a common foreign and security policy" (CFSP) covering "all questions related to the

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security of the Union, including the eventual framing of a common defence body, which might in time lead to a common defence.”¹ The CFSP grew out of two decades of European Political Co-operation, and a desire to strengthen the European voice in security and foreign affairs in particular.

EU member states have designated the once-dormant WEU as the potential defense arm of the European Union. The Maastricht Treaty charged the WEU with elaborating and implementing the “decisions and actions of the Union which have defence implications.”² The ten WEU member states further agreed in the Declaration on the WEU attached to the Maastricht Treaty to “build up WEU in stages as the defence component of the European Union” and “to develop WEU as a means to strengthen the European pillar of the Atlantic Alliance.”³

The enhanced role of the WEU raised the question of whether the WEU should be formally incorporated within the European Union governance structure, as suggested by the first phrase quoted from the WEU Declaration above, or retain its nominal independence, as the second phrase might suggest. The more integrationist states, among them France, Belgium, and Germany, favor the former option. The Atlanticists (Great Britain, Denmark, the Netherlands) and the four neutrals (Ireland, Austria, Sweden, Finland) have expressed varying degrees of opposition, generally believing that the WEU should not become a separate defense body rivaling NATO. The integrationists would thus prefer that the EU Council, not the WEU Council, exercise supreme political authority over defense questions. The EU would issue directives to the WEU, which would execute them in coordination with NATO.⁴ The opposing vision is of the WEU as the European pillar of NATO, independent of the European Union.⁵

RECENT DEVELOPMENT OF THE WEU

The WEU (originally the Western Union Defence Organization) originated following World War II from the 1948 Brussels Treaty of Self-Defence between the United Kingdom, France, and the Benelux countries. It was intended to demonstrate West European resolve in security matters and, via its 1954 expansion, to integrate West Germany into a European defense network. For various reasons, including rivalry with NATO and lack of clear purpose, the institution fell into long disuse.⁶ It was reactivated in 1984 to help develop a European defense identity. Following this revival, the WEU Foreign and Defence Ministers issued the 1992 Petersberg Declaration, listing the WEU’s possible military missions as humanitarian and rescue operations, peacekeeping, peacemaking, peace enforcement, and crisis management (the Petersberg Tasks).⁷

The WEU’s current membership consists of ten EU states that are also members of NATO. Denmark and the four neutral EU states are observers. The three NATO states outside the EU (Iceland, Norway, Turkey) are associate members. The WEU is governed by a WEU Council similar to NATO’s North Atlantic Council. The Brussels Treaty, like Article 5 of the North Atlantic Treaty, obligates members to undertake collective territorial defense but there is no *a priori* geographical limit on WEU operations.⁸

Accomplishments of the WEU include establishing a Brussels headquarters with a situation center and intelligence section and setting up a satellite data interpretation center in Torrejón, Spain.⁹ The WEU has also compiled a list of national military units answerable to it and has engaged in a number of missions of increasing importance, beginning with the 1988 dispatch of minesweepers to the Persian Gulf during the Iran-Iraq

War. The WEU subsequently participated in the naval blockade of Iraq during the Gulf War; the enforcing of sanctions against Yugoslavia; and the policing of the town of Mostar, Bosnia.¹⁰

Phillip Gordon discerns four potential functions for the WEU. First, it could help define a European Security and Defence Identity (ESDI). It could reach out to the East via the participation of Central and East European "associate partners" in WEU missions. It could defend Europe, and it could perform external military missions (Petersberg Tasks) such as placing peacekeepers or observers in Central Europe, in former Soviet republics, in North Africa, or wherever the US opposes action - forcing the US to consider carefully its opposition to such missions.¹¹

Potential aside, the WEU is still struggling to define its role.¹² Gordon notes that the US - and thus NATO - would surely become involved in any major crisis, pre-empting WEU leadership, while minor crises, such as a need for small-scale humanitarian aid, are more likely to be handled by interested countries acting individually.¹³ Even the theoretical scope for WEU action would therefore be limited to missions of intermediate size. Concerning the WEU's actual capabilities, for the it truly to become Europe's defense arm would require more military hardware than is now available to it and greater political will on the part of member states and the United States.¹⁴ As explained further below, European political will is needed to agree on a role for the WEU. While American political will is needed to provide the material support. The WEU cannot mount a large-scale mission without drawing on military infrastructure from elsewhere, including communications, intelligence, command, and transport capabilities. In 1995 the WEU Secretary General warned that without access to such equipment from NATO, the WEU would be "'reduced for a very long time to very modest activities.'" ¹⁵ NATO's decisions and actions in support of the ESDI and WEU are accordingly considered below.

NATO Decisions of 1994-96

THE PROBLEM

The Russian withdrawal from Eastern Europe appeared to nearly obviate NATO's *raison d'être*. NATO's primary objective, the provision of collective territorial defense against armed attack as set forth in Article 5 of the North Atlantic Treaty (an "Article 5 mission"), became less compelling absent a serious foreseeable threat. This development could conceivably undermine the American commitment to European security and the relevance or even existence of NATO.

In response to this concern and the crisis in Bosnia, NATO member states have undertaken to redefine NATO's strategic concept in an ambitious adaptation of NATO to the new security environment. Their goals were threefold: 1) enable NATO to take on new types of missions, and thereby maintain its post-Cold War relevance, while retaining a collective defense capability; 2) afford the Europeans a greater political and economic responsibility within the Alliance while preserving the transatlantic security link; and 3) reach out to the new democracies to the East. The missions newly emphasized, by definition non-Article 5, included conflict prevention, peacekeeping, peace enforcement, and provision of humanitarian aid.¹⁶ NATO thus intended to join the WEU in addressing the growing number of Petersberg situations.

A SOLUTION: CJTFs

The solution ultimately selected to serve all three NATO reform objectives was the notion of Combined Joint Task Forces, now considered central to NATO's adaptation.¹⁷ Before detailing NATO's official endorsements of this concept, however, it may help first to define it. In military parlance, a task force is a temporary force, usually operational, for carrying out a specific mission. A joint task force consists of forces from two or more armed services, and a combined task force involves forces from two or more countries. The North Atlantic Council accordingly describes a CJTF as a "multinational and multiservice formation established for specific contingency operations."¹⁸

The US first proposed the CJTF concept at a 1993 meeting of NATO's defense planning committee in Travemünde, Germany. It was accepted and later included in the January 1994 Brussels Declaration of the North Atlantic Council:

We ... have agreed ... to ... endorse the concept of Combined Joint Task Forces ... as a means to facilitate contingency operations, including operations with participating nations outside the Alliance. We have directed the North Atlantic Council ... to develop this concept and establish the necessary capabilities.¹⁹

According to Robert Grant, this Declaration "established the CJTF concept as the key instrument for updating the Alliance's military structures in order to deal more effectively with non-Article 5 missions and support ESDI's development." In effect NATO lent its support to the development of the ESDI, the US agreeing in principle to make NATO hardware available for purely European missions.²⁰

The June 1996 Berlin Declaration of the North Atlantic Council carried forward the development of CJTFs. The Defense Ministers of the NATO member states expressed their desire to build an ESDI within NATO as part of the ongoing NATO adaptation and welcomed:

the progress achieved in the internal adaptation of [the] Alliance, ... in particular: the completion of CJTF concept. By permitting a more flexible ... deployment of forces ... for new missions, this concept will facilitate the mounting of NATO contingency operations, the use of separable but not separate military capabilities in operations led by the WEU, and the participation of nations outside the Alliance.²¹

They then requested NATO's Military Committee make recommendations regarding implementation of CJTFs.

The Declaration thus indicated how the CJTF, of necessity an omnibus concept, could in theory fulfil all three of NATO's fundamental reform objectives.²² CJTFs would help NATO accomplish its traditional defense mission and new missions in two ways. First, the flexibility and mobility of CJTFs allow for the out-of-area force projection required for the Petersberg tasks. Second, with the shift from a forward defense posture to reduced forward presence, including the decision not to station NATO troops on new members' territory, defending new members would involve out-of-area force projection just as would tasks undertaken outside NATO territory. In a December 1996 communiqué the Ministers accordingly noted that while intended primarily for non-Article 5 operations,

use of CJTFs for Article 5 operations was not excluded.²³ Regarding the desire to reach out to the newly democratic East, NATO CJTFs may include units from non-NATO states, particularly the Partnership for Peace states²⁴ east of NATO. CJTF participation would also allow them to demonstrate membership potential. Finally, CJTFs help preserve the transatlantic link by obviating the creation of a costly and redundant European-only rival to NATO; now Europe can act on its own *through*, or in coordination with, NATO. CJTFs could simultaneously facilitate the development of a European security identity by allowing the WEU to lead all-European coalitions of the willing possible EU guidance. "CJTF is the practical means by which the ESDI within NATO will be given military expression."²⁵

Implementing the CJTF concept as a means to developing an ESDI within NATO would, according to the Berlin Declaration, entail 1) identifying the Alliance troops, headquarters, and equipment needed for WEU-led operations, 2) elaborating European command arrangements within NATO to conduct those operations, and 3) double-hatting personnel in the NATO command structure rather than creating an entirely new command.²⁶ The Declaration also put several conditions on the use of NATO assets in European CJTFs: 1) asset use subject to North Atlantic Council decision, monitoring, and review; 2) separable but not separate forces and command structure; and 3) involvement of (double-hatted) NATO command personnel.²⁷

Theory notwithstanding, obstacles have blocked the smooth implementation of CJTFs as a tool of European security and defense. The remainder of this paper considers CJTFs in practice, focusing on obstacles to implementing WEU-led CJTFs and some proposed solutions.

CJTFs in Practice

TOWARD IMPLEMENTATION

The implementation of CJTFs has progressed since the Berlin Declaration. NATO Secretary-General Javier Solana, in a statement prior to the July 1997 meeting of the North Atlantic Council in Madrid, boasted that "the practical arrangements to enable NATO assets to be identified and transferred ... in an operation led by the WEU have largely been completed."²⁸ The ensuing Madrid Declaration noted substantial progress in settling the European command structure for WEU-led operations. A Capabilities Coordination Cell (Brussels) and Combined Joint Planning Staff (Mons) have been established. In addition, three NATO headquarters have been selected as parent headquarters for CJTF nuclei. *NATO Review* has claimed further that many (unspecified) aspects of the CJTF concept had been put into practice.²⁹

Despite coherent theory and progress on paper, numerous obstacles remain. The four-year debate on CJTF implementation is indicative of the magnitude of the problem.³⁰ The problems have been variously characterized as presenting serious difficulties, "considerable frustration," and even an "impasse," and have arisen from inter-institutional and inter-state disagreement over the details of implementation. Of the three types of CJTF anticipated - NATO-only, NATO plus other states, and WEU-led - it is the latter, the focus of this paper, that presents the most intractable difficulties.³¹

OBSTACLES AND POSSIBLE SOLUTIONS

The first problem for European-led defense or security operations is the need for an identifiable voice, for effective decision-making mechanisms and institutional leadership. The European Union has taken a step in that direction by designating the WEU as its potential security and defense organ. Until the WEU becomes a credible actor in security matters, however, progress in CJTF implementation will be stymied; at this point the WEU has little in the way of military structure as compared for instance with NATO.³²

Another obstacle, and inherent danger, is the possible institutionalization of zones of differential or ambiguous security. That is to say, due to the neutrality of some members, the European Union cannot offer the security guarantee that NATO can. If an EU member of NATO (e.g. Germany, or Poland in the future) were attacked, some EU members (e.g. Denmark) would be obligated to defend it while others (e.g. Austria) would not be. Furthermore, EU members of NATO are committed to defending some European states outside the Union (e.g. Turkey) but not some European states within the Union (e.g. Finland).³³ Enlargement of the European Union and of NATO will extend this existing difficulty to additional states, especially given that the enlargements appear not to run in parallel. That it may be some time before these additional and historically insecure states can be fully integrated militarily with NATO only exacerbates the problem.

Two more difficulties are, first, the possibility that European states may renege on prior military commitments to CJTFs and second, the definition of the role of NATO commands in WEU-led (i.e., non-Article 5) CJTFs. Defining NATO's role is important as an attack on a WEU-led CJTF could threaten NATO territory, necessitating an Article 5 operation. The CJTF's lines of command would have to lead back seamlessly to NATO to avoid the military anathema of conflicting chains of command, here between Article-5 and non-Article 5 operations.³⁴

The greatest obstacle to implementing WEU-led CJTFs, however, remains the lack of military hardware commensurate with the WEU's potential role. The air transport, intelligence, communications, and command capabilities necessary even for the Petersberg tasks are nonexistent. The two simplest solutions to this quandary are unlikely and unattractive. The first would be for European nations to simply build the necessary equipment themselves and lend it to WEU missions. Not only is this option unrealistic in an era of defense cuts, but it might also result in costly and competitive redundancy with NATO. The other obvious alternative is for Europe and the WEU to make do with forces they do have, foregoing aspirations to Petersberg-type missions for the foreseeable future. This modest approach, however, would severely constrain any significant European defense responsibility or burden-sharing.

Inasmuch as European and American interests now converge, for different reasons, in support of the ESDI, a third, more complex approach has prevailed. NATO member states have agreed to provide the WEU with the assets necessary for it to lead CJTFs. However, while NATO could offer air support, satellite intelligence, and as many as 70,000 combat troops - including U.S. technical experts - NATO does not itself own most of these assets. NATO's only assets are an air-defense system, command and communications systems (of little use in external intervention since immobile), immobile bunkers and oil pipelines shelters, and a few dozen AWACS.³⁵ The US, as the main guarantor of European security, currently earmarks for NATO the necessary

communications, intelligence, and transport capabilities. In reality, then, the WEU would borrow these capabilities not from NATO but from the US.³⁶

How might this provision of assets work? The North Atlantic Council, proceeding on the basis of unanimous (including U.S.) case-by-case approval, would first have to agree to provide a CJTF headquarters and supporting materiel. NATO would then direct one of its commands to prepare a CJTF for deployment. Finally it would transfer control of the CJTF headquarters to the WEU. The Eurocorps or a WEU member state's national headquarters could alternatively serve instead of the NATO headquarters. NATO logistics and infrastructure would follow and provide the same support as for a NATO CJTF.³⁷

This putative solution, the lending of U.S./NATO assets to European CJTFs, unfortunately creates several new difficulties. Among those now partially resolved are the identification of 1) the specific troops and hardware upon which a WEU-led CJTF would draw, including the possible categorization of U.S. assets into those routinely available for European CJTFs and those available subject to special decision; 2) the NATO headquarters, if any, from which the CJTF would operate; and 3) the European command and decision-making arrangements to be employed within NATO.³⁸ Nevertheless, "the question of command continues to be the major stumbling block for reconciling under what conditions the American SACEUR (Supreme Allied Commander Europe) will transfer command of one part of NATO forces" to a European officer.³⁹ A further complication is that U.S. personnel, especially technical experts, will probably need to accompany weaponry loaned. Different levels of troop commitment, and hence of vulnerability to hostile forces, will generally yield differing threat perceptions and thus differing action preferences, as happened in Bosnia between the US on one hand and Britain and France on the other.⁴⁰

Even more controversial are the terms and procedures according to which NATO would monitor and review European use of its forces. The Berlin Declaration admitted the need to "clarify North Atlantic Council 'monitoring' and 'review'" of WEU use of NATO assets. Although the 1997 Madrid Declaration claimed progress in developing "the necessary practical arrangements for release, monitoring, and return of NATO assets and exchange of information between NATO and WEU," the controversy continues.⁴¹ According to NATO Secretary-General Solana, NATO would naturally prefer to retain at least a right to inspect, if not continuously monitor, the use of its weapons and personnel. Do NATO's legitimate interests extend also a right of veto - of indirect control - over WEU operations?⁴²

This question goes to the heart of the dilemma embedded in the loaning of U.S. troops and weaponry to the WEU: political control over the CJTF.⁴³ According to the Berlin Declaration, European CJTFs come under the "political control and strategic direction of the WEU." This could in time imply the EU Council of Ministers, rather than the WEU Council, if the EU absorbed the WEU. The WEU Council could remain as an additional ministerial filter or the chain of command could bypass it altogether.⁴⁴

In practice, however, the US may not always be inclined to relinquish *its* control of the necessary supplies. The US would almost certainly not commit them automatically, but rather retain the right to decide each case on individual merit. Even if the US supported an operation politically, it might still be reluctant to transfer political control from the North Atlantic Council to the WEU Council. U.S. support for an ESDI is not after all unqualified. It would in fact be highly improbable for the US to surrender control with U.S.

weaponry and personnel at stake, especially if it perceived a likelihood of the WEU-led CJTF needing additional assistance to extricate itself. The Pentagon reportedly desires near-continuous control of U.S. assets and their use. Within NATO itself the Secretary-General argued that it is only natural for an alliance to retain an interest in the use of its capabilities. One begins to comprehend that the issue of political control and the potential US/NATO veto will indeed be nettlesome, elaboration of the practical procedures needed to make CJTF a reality requiring some years.⁴⁵

It seems, then, that an enduring U.S. veto power over European security missions will be the unintended by-product of this "solution" to the WEU's lack of equipment. Analysts' opinions vary concerning the extent to which the veto would hinder development of a truly European security identity. Perhaps the most positive interpretation is that, since the interests of the US regarding European security and European responsibility therefor will generally coincide with European interests, the veto poses no real limitation on European autonomy.⁴⁶ Grant and Paul Cornish take less sanguine views by saying the veto is "illogical" and should create "unease" among integrationists. Cornish comments even more darkly that CJTFs seem "as much about restraining a European defence identity as enabling one." At the extreme, the American veto is considered incompatible with a European defense identity - "it is difficult to imagine a U.S. veto being part of a permanent solution" for the ESDI - and the CJTF concept consequently useless for developing the same when its price is a U.S. veto.⁴⁷

Given the severity of the above-enumerated difficulties with this solution, especially the issue of political control, one may well inquire whether there are any solutions to the problems *it* creates. How best to balance the European interest in autonomy with the American interest in how its assets are used? For one, the WEU could force the issue by threatening to supply its hardware needs from elsewhere. It has already attempted to do so, requesting transport aircraft from Russia and the Ukraine.⁴⁸ If successful, this would certainly eliminate the NATO veto - as long as the WEU's threat were credible. Another possibility is a division of labor *within* non-Article 5 operations (as opposed to between Article 5 and non-Article 5 operations), the WEU taking humanitarian and rescue missions, NATO combat missions.⁴⁹ However, being excluded from a specific pre-determined category of operation (here combat missions) is just as limiting as being excluded from operating when the US disapproves.

A more realistic alternative might be to work out, in advance, agreements on the situations and uses for which various types of materiel would be made available. Assuming the agreements were binding and sufficiently unambiguous, the WEU could undertake those operations without fear of a situational veto. While this option may sound more attractive than the last, the two are essentially the same: the only differences are how far in advance of actual missions the US exercises its veto power and whether it exercises it with general or specific applicability.

A more probable (because more viable) option takes the Americans partially out of the NATO loop. At the troop level, the training of Europeans on American weapons systems could begin now, so that when a crisis occurs there would in theory be no need for American soldiers to operate them, eliminating any American veto with respect to personnel. At the command level, the duties of a Deputy SACEUR (or Deputy SACLANT) would be refined to make one of those European officers also the European commander of WEU-led CJTFs. In the event of a WEU-led CJTF, the Deputy SACEUR would control

the operation and by virtue of his office also control access to the NATO supplies that the CJTF needed. This would to an extent leave the NATO veto in European rather than American hands and would also preserve unity of command in case an Article 5 situation arose, as described earlier. SACEUR rather than a Deputy SACEUR would command regular NATO (i.e., non-WEU) CJTFs, and the WEU would command internally those missions to which NATO lent no assets.⁵⁰ This option would go partway toward resolving the crucial issue of political control over WEU-led CJTFs that draw on NATO materiel.

Having explored in depth the possibilities and limitations of CJTFs as originally conceived, it is now possible to step back and evaluate the potential of the CJTFs as a means of devolving upon Europe greater autonomy and responsibility in its defense and security without undermining the transatlantic link.

Assessment and Conclusion

Rapid resolution of the foregoing difficulties of CJTF implementation appears unlikely. In the absence of an immediate Soviet threat or functional equivalent, European cooperation has lost much of its air of urgency. Lack of a pressing reason to compromise makes compromise less likely. Past and future expansions of the European Union further complicate the matter, as the Union must accommodate states with significantly differing opinions on the proper extent of European integration in security and defense matters. Without substantial willingness to compromise or immediate threat, the four-year delay in implementing WEU-led CJTFs may foreshadow the future pace of progress. The WEU could act using NATO arms in consensus situations where the US approves or acquiesces in European operations and remain inactive when there is no agreement. But assuming continued European resistance to major increases in defense outlays - as seems likely unless by inaction Europe should find itself impotent in some vital crisis in the near future - it would be surprising if the combination of insufficient resources and a NATO-U.S. veto on WEU operations did not guarantee a relatively modest role for the WEU.

CJTFs are therefore no palliative for the European security dilemma. But recall that CJTFs were only a shortcut anyway, a seemingly painless way to confer on Europe a defense capacity it lacked. It is perhaps unrealistic to expect from what is in essence a loan the resolution of long-term and fundamental imbalances. As Gordon has pointed out:

since automatic access to U.S. national means is out of the question - no country will make its national assets automatically available to an alliance without a veto over their use - Europe must accept [this] dilemma: it must either put the resources behind developing independent capabilities or accept dependence on the United States. This is a reality that CJTFs cannot be expected to resolve.⁵¹

The dilemma can be stated even more generally. The basic difficulty is a symmetrical unwillingness on both sides of the Atlantic to face up to one unpleasant verity: everything worthwhile requires sacrifice. In international affairs, the privilege of control exacts a burden of responsibility. Within the context of European security, Europeans⁵² seek control without burden: they would act by borrowing U.S. assets rather than providing their own. The US similarly seeks control without burden. It would renounce - to a degree - the burden of European security, by distributing more evenly either the necessary

armament or its cost, but without in the end relinquishing the control that must accompany such a burden.⁵³

The dilemma reduces, then, to the question of whether Europeans and Americans are collectively willing to pay the inevitable price of some form of autonomous European defense capability. Assuming they are, who will pay: the Americans by relinquishing control, or the Europeans by shouldering burden? The former option (Europe deploying American assets) would yield greater transatlantic ties, the latter security independence (Europe self-sufficient). The choice ultimately depends on each side's relative discomfort with, thus readiness to change, its current position. Which will be renounced first: American burden or European dependence? The answer will largely shape the future of European security and its transatlantic link. ●

¹ Rafael Estrella, *Structure and Functions: European Security and Defence Identity (ESDI) and Combined Joint Task Forces (CJTF)*, at ¶9 (Draft General Report to NATO International Secretariat, May 1995) (citing Maastricht Treaty on European Union at Title V Art. J) [hereinafter Estrella 1995].

² Estrella 1995, *supra* note 1, at ¶13 (citing Maastricht Treaty on European Union at Title V Art. J).

³ John Gerard Ruggie, *Consolidating the European Pillar*, 20 *Washington Quarterly* 109, 113, 115 (1997); Paul Cornish, *European Security*, 72 *International Affairs* 751, 754 (1996).

⁴ *NATO Review* 20 (Mar. 1996).

⁵ Phillip H. Gordon, *Does the WEU Have a Role?*, 20 *Washington Quarterly* 125, 134 (1997).

⁶ See Office of Info. and Press, *NATO, NATO Handbook* 196-97, 295 (1995) [hereinafter *NATO Handbook*]; Duke, *Second Death of the WEU*, 34 *J. Common Market Stud.* 167, 167-69 (June 1996).

⁷ Charles Barry, *NATO's Combined Joint Task Forces in Theory and Practice*, 38 *Survival* 81, 89 & n.13 (1996).

⁸ Ruggie, *supra* note 3, at 115.

⁹ *Id.* at 767; Gordon, *supra* note 5, at 125.

¹⁰ Cornish, *supra* note 3, at 754; Gordon, *supra* note 5, at 125.

¹¹ *Id.* at 127-30.

¹² Barry, *supra* note 8, at 92.

¹³ Gordon, *supra* note 5, at 126.

¹⁴ *Id.*

¹⁵ Robert P. Grant, *France's New Relationship with NATO*, 38 *Survival* 58, 69 (1996).

¹⁶ Barry, *supra* note 8, at 89; Cornish, *supra* note 3, at 761, 763.

¹⁷ Cornish, *supra* note 3, at 753.

¹⁸ Barry, *supra* note 8, at 83; *NATO Review* 23 (Sept.-Oct. 1997).

¹⁹ Barry, *supra* note 8, at 83; Declaration of the Ministerial Meeting of the North Atlantic Council, at ¶1 (held in Brussels, Jan. 10-11, 1994) [hereinafter *Brussels Declaration*]; Rafael Estrella, *After the NATO Summit: New Structures and Modalities for Military Co-operation*, at III (Draft General Report to NATO International Secretariat, Nov. 1994) (citing *Brussels Declaration*) [hereinafter Estrella 1994].

²⁰ Ruggie, *supra* note 3, at 115; Barry, *supra* note 8, at 81; Grant, *supra* note 16, at 66; Cornish, *supra* note 3, at 754; Gordon, *supra* note 5, at 126-27; Paul Taylor, *U.S. Sees Shift to Greater European Role in NATO*, *Reuters World Service* (Feb. 29, 1996).

²¹ Final Communiqué, Ministerial Meeting of the North Atlantic Council, at ¶5, ¶6 (Press Communiqué M-NAC-1(96)63) (held in Berlin, June 3, 1996) [hereinafter *Berlin Declaration*].

²² Cornish, *supra* note 3, at 761.

²³ Barry, *supra* note 8, at 82; Cornish, *supra* note 3, at 764; *NATO Review* 14 (July-Aug. 1997) (citing Final Communiqué, Ministerial Meeting of the North Atlantic Council, at ¶5) (held in Brussels, 12-13 June 1997) [hereinafter 1997 *Brussels Declaration*].

²⁴ These are the 44 states participating in the Partnership for Peace, that is, the U.S. and Canada, Russia and the former Soviet Republics, and nearly all other European states except Bosnia and Croatia. The Partnership for Peace is a NATO initiative designed to reinforce security, mutual confidence, and democratic principles through cooperation and consultation in defense and security matters. See *NATO Handbook*, *supra* note 6, at 50-51.

²⁵ Cornish, *supra* note 3, at 761, 764; Ruggie, *supra* note 3, at 114; Barry, *supra* note 8, at 83; Adam Daniel Rotfeld, *Europe: In Search of Cooperative Security*, *SIPRI Yearbook* 1997 127, 132 n. 18.

²⁶ *Berlin Declaration*, *supra* note 26, at ¶7; Barry, *supra* note 8, at 81; Rotfeld, *supra* note 32, at 131.

²⁷ Cornish, *supra* note 3, at 761-62.

- ²⁸ M2 Presswire, Opening Statement by the Secretary General (May 29, 1997) (avail. in LEXIS cumnews library).
- ²⁹ M2 Presswire, Madrid Declaration on Euro-Atlantic Security and Cooperation, at ¶15 (July 9, 1997) (avail. in LEXIS cumnews library) (citing Declaration of the North Atlantic Council (held in Madrid, July 8, 1997)) [hereinafter Madrid Declaration]; NATO Review 34 (July-Aug. 1997); Final Communiqué, Ministerial Meeting of the North Atlantic Council, at ¶16 (Press Communiqué M-NAC (DM)-3(96)172) (held in Brussels, Dec. 17-18, 1996)].
- ³⁰ Brooks Tigner, Will Alliance Embrace or Evade CJTF Issue?, Defense News (June 3, 1996).
- ³¹ Estrella 1995, supra note 1, at ¶2; Grant, supra note 16, at 67; Estrella 1994, supra note 23, at ¶70; Barry, supra note 8, at 90.
- ³² Id. at 93; Financial Times (Mar. 1, 1996).
- ³³ Ruggie, supra note 3, at 115.
- ³⁴ Ruggie, supra note 3, at 114; Barry, supra note 8, at 85; but see Estrella 1995, supra note 1, at ¶62 (U.S. position on this point “softening”).
- ³⁵ The Washington Times, at 4 (May 14, 1996); Gordon, supra note 5, at 133.
- ³⁶ Tigner, supra note 40.
- ³⁷ Ruggie, supra note 3, at 114; Barry, supra note 8, at 90, 92; Sandra Mezzadri, Il Principio delle CJTF, at § 3.2.1 (1997) (2d chapter of unpublished work) (available through the author).
- ³⁸ Ruggie, supra note 3, at 114; Barry, supra note 8, at 85; Grant, supra note 16, at 68; Estrella 1994, supra note 23, at ¶79.
- ³⁹ Estrella 1995, supra note 1, at ¶59.
- ⁴⁰ Ruggie, supra note 3, at 114.
- ⁴¹ Id.; Cornish, supra note 3, at 762; Madrid Declaration, supra note 37, at ¶18.
- ⁴² Estrella 1995, supra note 1, at ¶65, ¶66; Tigner, supra note 40.
- ⁴³ Political control, while related to the issues of monitoring and review, differs in that monitoring would occur continuously throughout a mission, whereas political control is either given or not, and if given may be withdrawn should circumstances change. One observer comments that “as a diplomatic nicety . . . the old conundrum of political control has now been replaced by a new one officials . . . call ‘monitoring.’” Tigner, supra note 40. Regardless of the label applied, however, the underlying issue remains the same: who controls and to what extent?
- ⁴⁴ Berlin Declaration, supra note 26, at ¶7; Cornish, supra note 3, at 766.
- ⁴⁵ Taylor, supra note 25; Gordon, supra note 5, at 133; Reuters World Service (May 12, 1997); Grant, supra note 16, at 69-70; Tigner, supra note 40.
- ⁴⁶ Mezzadri, supra note 50, at § 3.2.1 (“C’è domandarsi però per quale motivo gli Stati Uniti rifiuterebbero di fornire determinate capacità militari della NATO alle CJTF dell’ UEO? . . . [P]er quale motivo impedire l’assunzione di maggiori responsabilità militari da parte dell’ UEO quando essa serve anche un ben preciso interesse americano, ossia quello di limitare . . . i propri impegni internazionali?”).
- ⁴⁷ Cornish, supra note 3, at 765-66; Grant, supra note 16, at 69; Ruggie, supra note 3, at 115; Financial Times, supra note 43.
- ⁴⁸ Grant, supra note 16, at 70; Jane’s Defence Weekly (May 21, 1997).
- ⁴⁹ Cornish, supra note 3, at 763.
- ⁵⁰ Grant, supra note 16, at 71; Mezzadri, supra note 50, at § 3.2.2; Financial Times, supra note 43.
- ⁵¹ Phillip H. Gordon, Recasting the Atlantic Alliance, 38 Survival 32, 51 (1996).
- ⁵² “Europeans” is used here in an *abstract* sense to denote the common stance that European members of NATO and the EU have collectively adopted through those institutions, without denying the variety of individual opinions espoused by individual European states and citizens. The same applies to the term “American.”
- ⁵³ Tigner, supra note 40.

Globalization and the Crisis of the Swedish Welfare State

Martin Wikfalk

In the 1950s and 1960s Sweden was often referred to as a 'model' country capable of combining an egalitarian society with high economic prosperity and growth. People from all over the world envied the 'Swedish model' which was able to maintain its goal of redistribution, a relatively low inflation rate, high economic growth and full employment while also adjusting to international competition. The Swedish model is based on an active role of the state in allocating and distributing resources. Some important features are: a politically strong labor movement, represented by the Social Democratic Party and the trade union federation, LO; a large and increasing public sector; government intervention in the economy through various policy packages characterized by stabilization, growth, labor market, and far-reaching welfare policies.

However, beginning in the early 1970s this model has come under increasing strain. Between 1970 and 1992 the growth rate of Swedish GDP has only been around 60 percent of that of the OECD average. In 1970 Sweden's GDP per capita measured in purchasing-power parity was the third highest in the OECD. In 1990 it fell to fourteenth place and by 1993 it had fallen to seventeenth place, 13 percent below the OECD average. The low rate of unemployment (1-3 percent), which has characterized the Swedish model since 1950 rose to 8-13 percent in the early 1990s.¹ This deterioration of Sweden's economic performance combined with high long-term interest rates, unemployment and large public debts has resulted in a reduction in public spending and social insurance entitlement-levels and services. "Domestic demand has been depressed, public expenditure cut and a process of welfare state dismantling has been proposed, accompanied by the spread of an anti-welfare, market-oriented ideology in previously consensual, corporatist politics."²

Accounts of the fall of the Swedish model have proliferated during the last years and although the explanations provided range widely, some of the most oft-repeated factors are: wage-cost explosion, the catching-up effect, insufficient saving and physical capital formation, the lack of competition, the effects of stabilization and labor market policies, public sector expansion, and allocative inefficiencies (sclerosis). While these

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factors have certainly been important to bring about this change, it is the argument of this paper that any explanation of the crisis of the Swedish welfare state is insufficient as long as it fails to include what has occurred in the international sphere. The reason might seem rather obvious; Sweden is a small country with a large export sector, making it strongly dependent on foreign trade. It is estimated that exports account for more than 30 percent of its GDP.³ Therefore, it seems that it is not a pure coincidence that the period of the decline of the Swedish welfare state has also witnessed an increase in the globalization of the world economy. Henrekson, *et al*, argue that when examining economic growth and the Swedish model one must consider that “in addition to domestic reasons ... crucial changes in the conditions regarding production and the international division of labour have occurred, and that these changes disfavoured the Swedish model.”⁴

The purpose of this paper is to investigate whether there is indeed a link between the increasingly globalized international economy and the crisis of the Swedish welfare state.⁵ First, the concept of globalization will be unpacked and assigned analytical meaning. Second, the mechanisms by which globalization is assumed to undermine the welfare state are presented. It is argued that these processes will operate through the labor market. Two distinct but interlinked areas of globalization will be investigated, i.e., production and finance. Third, the Swedish Model and some of its most important features are presented following an analysis of how it functioned, first in a world-economy *à la* Bretton Woods and then in a more globalized economy. It is the argument of this essay that the demise of the Swedish welfare state is to a large extent caused by global factors. Three factors that are all closely linked to the globalization process seem especially important. First, the shift from a Fordist to a Post-Fordist mode of production which can be seen as a continuation of the globalization of production process. Second, the deregulation of capital markets and hence the increasing power of capital. This can be seen both as a cause and a result of the globalization of finance. Third, the shift of economic order from an expansionary Bretton Woods system to a world economic order with a *deflationary bias*.

Globalization, a Contested Concept

It is now widely held that we live in an era in which our lives are becoming increasingly determined by global processes. However, there is greater controversy over what such globalization entails and what its implications are. The fact that globalization in the 1990s has become a buzzword, often used without any analytical meaning has not made things any clearer. Therefore any attempt to define such a contested concept is a difficult endeavor. Nevertheless, the term globalization is often invoked to “describe the process of increasing interdependence and global enmeshment which occurs as money, people, images, values, and ideas flow ever more swiftly and smoothly across national borders.”⁶ According to Anthony Giddens globalization should be understood in two discrete dimensions. One is a spatial dimension which considers the degree to which international interactions have been stretched across the globe, while the other examines how there has been a deepening or increased density of these interactions.⁷ Most writers argue that technology is the major driving force behind this globalization, which influences power, wealth and relations between societies, governments and states. Economic globalization, which will be the focus in this paper, designates a change in the

operation of capitalism. In this paper the term will be used to denote the process of deepening internationalization of production, trade, investment, and finances. The advantage of using economic globalization is twofold. First, it makes it possible to grasp and understand these interrelated processes in one single analysis. Second, the concept facilitates an investigation on how global processes can have an impact on the internal structures of nation states. In order to demonstrate that globalization is indeed occurring there will be a brief presentation of some figures of the increasing internationalization of three different sectors (trade, foreign direct investment, and finances) and an account of a shift from the Bretton Woods system to a new economic order.

Trade is one economic process by which globalization can be illustrated. Since WWII, the increase in the volume of trade has exceeded the increase in volume of production in almost every year. Between 1960 and 1989, exports of the OECD countries have grown almost twice as fast as GDP, 6.3 percent annually compared with 3.7 percent. However, it has to be noted that the ratio of trade relative to GNP did not reach its pre-WWI level of 11 percent until 1970. Sweden's exports as a share of GDP increased from a low of 5 percent at the end of WWII to above 30 percent in the 1980s.⁸

Foreign direct investment (FDI), another commonly used indicator, is growing even faster than trade. World outflows of FDI grew 3 times faster than output and 2.5 times faster than both exports and domestic investment between 1986 and 1990. Between 1980 and 1991 there was almost a fourfold increase in the world stock of FDI. Specifically, Swedish direct investment in the European Community rose almost sevenfold between 1985 and 1988.⁹

Notwithstanding, the sector in which globalization is argued to be most advanced is that of finances where, coupled with instant world communications, vast dealings can be executed around the clock. Their magnitude is manifested by the fact that in 1990 daily transactions in foreign exchange markets were almost 40 times the daily value of international trade. Moreover, it is estimated that 'five days' worth of foreign exchange transactions are equivalent to a full year's exports worldwide of goods and services, "while 24 days worth of those transactions are equivalent to a full year's output of world goods and services."¹⁰

Globalization can also be seen in terms of a change in the world economic order. The Bretton Woods system, sustained by the dollar-based fixed exchange rate regime, and public multinational norms governing capital controls and flows has been replaced by a market mediated, global credit system. The purpose of the Bretton Woods system was to enable individual states, in capitalist countries, to manage their internal economies so as to maintain a high level of employment and social services while sustaining international economic relations from which all could benefit. Funds were available to help avoid a conflict between national welfare and international cooperation by giving countries time to make necessary and internationally agreed adjustments in national economic policies. In sum, this so-called 'embedded liberalism' was an attempt to construct a stable international economic order that also harmoniously achieved the national goals of the managerial welfare state.

The break down of the Bretton Woods era in the mid 1970s caused a substantial shift in state-market relations so as to maximize the exposure of states to international capital markets.¹¹ Two features in the post-Bretton Woods system are central to this. First, the importance of circulating forms of financial capital has increased at the expense of

productive forms of capital. Second, since states compete for scarce investment resources, financial capital that is both highly mobile and transnational has gained unprecedented structural power. It is now 'business confidence' that determines "the direction of capital flows, the availability of finance, and future investments, upon which future production, employment, and tax revenue depends."¹² To conclude this section, we have seen by looking at economic processes, trade, FDI and finances, and the shift in economic order that the trend towards globalization is clear. Now let us see how this relates to the erosion of the welfare state.

Globalization and The Welfare State

Having established that the world economy is becoming increasingly globalized our task is now to show in what ways this phenomenon is linked to the demise of the welfare state. In other words, what are the mechanisms through which these economic processes can have an impact on the internal institutional structures of nation states? Andrew Martin argues that globalization will work through the labor market, in the sense that it is making it more difficult for states to maintain full employment. This, in turn, will strain the resources of welfare states in two ways. First, its revenues will fall simply because less people work, in other words, the tax-base diminishes. Second, public expenditures will increase since claims for social assistance and/or unemployment benefits will increase. The result of these factors is a deterioration of public finances, thus increasing the likelihood of a fiscal crisis.¹³ This is a rather straightforward argument, in fact William Beveridge claimed already in the aftermath of WWII when he designed the British welfare state that full employment was an essential condition for the economic and, in turn, political viability of welfare states. The influence of his findings among policy makers in Sweden is evident. Full employment was clearly named as the number one target and this had been delivered until 1990 when the unemployment rate rose to between 8-13 percent. What remains to be explained, however, is how globalization makes full employment unattainable in the first place. The following analysis will try to demonstrate this by focusing on two dimensions of globalization: the globalization of production and the globalization of finance.

The Globalization of Production Argument

According to the globalization of production argument there has been a global shift in the production of manufactures using unskilled labor. In terms of world trade, the South exports raw materials to the North,¹⁴ and in turn the North exports manufactured goods to the South. Now there has been a shift in this structure leading to a situation in which both the South and the North are exporting manufactured goods. This can be seen in the dramatic change in the composition of the South's exports. In 1955 manufactures made up 5 percent of the South's total exports; by 1990 they made up more than half.¹⁵ This increase in production of manufactures is largely made up of goods produced with unskilled labor. In the North, on the other hand, exports have been concentrated in skill-intensive goods. One of the main reasons why production by unskilled labor in the South is able to be more competitive than production in the North is that workers there are paid much lower wages. As a result of this the demand for unskilled workers in the North has fallen while the demand for skilled workers has increased. Because of downward wage

'rigidity' in labor markets, this has led to increased unemployment of unskilled workers in the North. In addition, in a country like Sweden with a *solidaristic wage policy*,¹⁶ wage differentials have been resisted. Thus, wages of those unskilled workers that remain employed, the *insiders*, have increased almost as much as those of skilled workers. The effect of this is an acceleration of inflation since wages rise for both skilled and unskilled workers. The resulting problem is that it is now more difficult to reconcile low unemployment with low inflation. If the monetary goal is that of price stability "it must deflate the economy to eliminate the shortages of skilled labour."¹⁷ Such deflation will result in an increase in unemployment among unskilled workers. In one way, this reveals how globalization of production undermines Sweden's capacity to implement an employment and wage policy.

This argument seems plausible but it is weakened by the fact that trade with the South does not make up a large enough portion of the North's total trade to be such a decisive factor in raising the unemployment level. For example developing countries account for less than one tenth of Swedish trade. Furthermore, it is now asserted that the basis for global competition in manufacturing has shifted from a Fordist system based on mass production to a Post-Fordist stage in which the wage costs are becoming less important and flexible specialization, automation, innovation and geographical proximity of the production to final markets are becoming more important, thus disfavoring the South's competitive advantage in unskilled low-cost labor. This has increased the importance of production in countries that are close to the final markets. However, as we will discuss later, Post-Fordism has disfavored the Swedish model by shifting production to the continent.

The Globalization of Finance Argument

The globalization of finance argument maintains that full employment will become unattainable because the globalization of finance is rendering governments increasingly constrained and restricted in their macroeconomic policy choices. After the fall of the Bretton Woods system there has been an enormous increase in the size of the private international exchange markets.¹⁸ This has led to an increased discrepancy between the amount of *hot money*, that is, short-term capital that can be shifted almost instantaneously from one country to another depending only on where the rate of return is the highest, and the official reserves that central banks can deploy to defend their currency. A *Business Week* article claims that "in a market that trades \$1 trillion worth of currency daily, the few billions that central bankers can buy and sell are peanuts."¹⁹ The core of the globalization of finance argument is that the world financial markets will respond negatively to expansionary policies adopted in order to keep unemployment down while they will respond positively to policies that aim to maintain or reduce the level of inflation. In other words, the globalization of finance has created a 'deflationary bias'²⁰ in the world economy making it very difficult and costly for governments to keep full employment.

To see how this mechanism works imagine a country whose government pursues relatively more expansionary policies than other countries, for example, in order to increase social services or to create employment. In this case money will flow out from the country in the expectation of a higher relative rate of inflation unless offset by interest rate increases, which would defeat the purpose of the expansionary policies. The result of

this outflow of money is depreciation, if the exchange rate is floating, or depletion of reserves if the currency is fixed or pegged. In the first case depreciation will put upward pressure on inflation thus speeding up the flight of capital which will lead to further depreciation and so on. In the case of fixed exchange rates the credibility of the government's commitment to keep the currency pegged will decline at the same rate that the currency reserve is being depleted. The closer it comes to the point where the government has to choose between abandoning the peg or reversing its expansionary policies, the more likely it is that this will be speeded up by a speculative run on the currency. In order to prevent a devaluation the state will have to adopt restrictive policies, increase interest rates as well as tightening fiscal policies, to dampen the demand and stem the outflow of money, which means that it will have to deliberately increase unemployment. It is in this way global finance is assumed to discipline governments to reduce their welfare policies.

The Swedish Model in the World Economy

Two distinct features of the Swedish economy have made it heavily dependent on changes in the international environment. First, Swedish mass production was relatively undiversified; it was composed of a few large firms with a narrow product composition, e.g. IKEA, Volvo, Asea, and Electrolux. Their viability rested not so much on domestic demand but export performance, which therefore made them dependent on demand in the world economy. Mass consumption, on the other hand, was diversified. Therefore it was dependent on imports, which were financed by foreign exchange earned from high value added commodities in the export sector.

Second, the institutional configuration for economic planning was formulated in the doctrine of the "Rehn-Meidner Model." It was based on solidaristic wage policy that forced Swedish industry to transform itself through technical innovation so it could afford to pay the centrally negotiated wages. A restrictive wage policy forced stagnant firms that could not pay the going rates out of business and hence productivity increase could proceed without high inflation. This system ensured that Sweden's export sector remained competitive. However, technological innovation was not assured through an expansion of domestic aggregate demand. "Rather it was ensured through the 'transformation pressure' the Rehn-Meidner Model exerted on the Swedish economy ... and by the demand-pull of the international economy."²¹ Thus, both Sweden's economic structure and its economic policy paradigm made the Swedish economy heavily dependent on the international economy.

The Rehn-Meidner Model's emphasis on profit-squeeze and transformation structure meant expansion of external demand was a prerequisite for macroeconomic policy to be able to ensure full employment. This was provided firstly by the expanding international economy and the reconstruction of Europe through the Marshall Plan, and subsequently by expansion of trade and increasing liberalization. Furthermore, the Bretton Woods system made it possible for macroeconomic policy makers to fine-tune the economy which was needed in order to make full employment and the profit squeeze compatible.

...And in a Globalized Economy

This section will analyze the Swedish performance in the globalized economy from the 1970s onwards by focusing on the three elements mentioned in the introduction, that is, the shift from Fordism to Post-Fordism (globalization of production), the fall of the Bretton Woods System, and the deregulation of financial markets (globalization of finance).

POST-FORDISM

Following the international recession after OPEC I in the 1970s, the Swedish government adopted a policy of *bridging over*, which entailed an expansionary policy in order to compensate for the fall in foreign demand. Magnus Ryner argues that while Sweden had benefited from the 1974/75 raw-materials boom it was badly hurt by a stagflation crisis in 1976. This crisis was enforced by the fact that "Sweden's 'narrow' export sector was disproportionately composed of firms producing in a late phase of the product cycle and in special steels, that became 'price takers' rather than 'price makers.'"²² In sum, there was a loss of competitiveness internationally, which meant that the Swedish crown had to be devalued twice, which was mainly due to Sweden's particular form of Fordism.

The incompatibility of the Swedish model and Post-Fordism can also be showed by the results of the Swedish government's shift in policy direction in the 1980s when they adopted 'the third way' (between Thatcherism and Keynesianism). The idea was to create an export-led recovery through a one off devaluation, combined with a tight domestic fiscal and monetary policy and an active labor market policy. This recovery was then believed to increase total tax revenues and stabilize the economy while ensuring full employment and the existing levels of social benefits and services. Helped along by the Reagan boom, this strategy of export-led recovery was remarkably successful in the beginning in meeting its aims of competitiveness, profitability, investments, macroeconomic stability and full employment. Sweden's balance of payments was showing surpluses, and the budget deficit was rapidly being eliminated.

However, the policy ultimately faltered because the long term GDP and productivity growth was not realized. Apart from the success of pharmaceuticals, there was little growth in new dynamic sectors and enterprises. Instead the strategy benefited existing firms, which enjoyed a *golden decade* despite the pale performance of Sweden's economy. These firms disproportionately located high value-added activities in continental Europe. Most importantly, this form of post-Fordist restructuring has resulted in a relative peripheralization of the Swedish production structure, as its multinationals reorganize themselves on a continental scale. Swedish companies pursued this strategy partly in order to be closer to final markets but also as a response to the relatively high wage cost in Sweden. It is estimated that the 25 biggest Swedish companies have 75 percent of their employment, production and sales abroad. Therefore, globalization of production in the form of a movement from Fordism to Post-Fordism, explains a great deal why unemployment has increased in Sweden and thus why the Swedish welfare system has been put under pressure.

POST-BRETTON WOODS

The fall of the Bretton Woods system was significant since Sweden relied on the demand-pull of the world economy in order to generate sufficient aggregate demand. This demand-pull lessened as other western states abandoned their full employment commitment, and started focusing on fighting inflation instead. The end of fixed exchange rates made the situation even worse. "Sweden initially joined the European monetary snake to retain a stable framework for economic policy, but withdrew in 1977 when the full employment commitment could not be rendered consistent with Bundesbank-led monetary policy."²³ After that failure Sweden has tried to compensate for the comparatively high price increases, resulting from trying to keep unemployment lower than trade competitors through devaluing the Swedish currency at frequent intervals. This policy of national reflation has not been very successful, since it has led to wage and price increases and thus further inflation. "In other words, the Swedish Model required anchoring in an international expansionary regime *qua* Bretton Woods, but could not work in a restrictive one, *qua* EMS."²⁴

DEREGULATION

The Swedish government deregulated capital and money markets at a period of a booming economy in 1985 (a formal deregulation of foreign exchange markets followed in 1989), which contributed to the 'overheating' of the Swedish economy at the end of the 1980s and consequently increased the rate of inflation sparking capital flight. In an attempt to 'cool' the market, previously inconceivable policies were adopted by the Social Democrats such as the decision to apply for EC membership and to abandon the full employment commitment in favor of keeping the rate of inflation down.²⁵ The political support of the Social Democrats declined sharply and they suffered a humiliating electoral defeat in 1991. Furthermore, the recession of 1991-1994 was especially severe in Sweden, resulting in an increase in unemployment from 2 to 8 percent and thus a shortfall of tax revenues and an increase in public expenditure in the form of unemployment insurance, thus showing the adverse effect of globalization on the welfare state.

The public deficit did not improve after the Conservative government's decision to cut taxes. Speculations about overvaluation triggered off a run on the Swedish crown in the end of 1992. The interest rate rose dramatically in an attempt to defend the currency. The short-term marginal rate was forced up to 500 percent before the government had to give up and float the crown, which subsequently fell sharply in value. Of course both the increase in interest rate and the depreciation of the Swedish crown further exacerbated the fiscal crisis. The debt as a percentage of GDP increased from comparatively low 45 percent in 1989 to approaching 100 percent in 1994. This led the government to present a number of so-called 'crisis-packages,' which focused on cutting back on welfare universalism.

Therefore, one cannot fail to conclude that capital deregulation and the strategy to increase Sweden's interest sensitivity seriously backfired. When quantitative controls were abandoned internationally determined interest rates, enforcing a discipline through the balance of payments constraint, was seen by the Central Bank as the only effective means to control inflation.

Conclusion

This paper has linked the crisis of the Swedish welfare state with the process of economic globalization. By doing so it reveals implicitly how purely domestic explanations cannot fully explain this change. By taking the transnational approach, the main findings have been the following. First, the Swedish Model was geared towards an international economic system such as the Bretton Woods, which not only provided sufficient aggregate demand but also gave the macroeconomic managers enough leeway in adjusting the national economy. When the Bretton Woods system was replaced by a world economy with a deflationary bias, aggregate demand in Sweden fell short of full employment. Furthermore, the Swedish economy became less insulated from shocks in the world economy as a result of deregulation in capital and money markets and increased capital mobility. Second, the structure of the Swedish export sector has led it to relocate core economic activities on the European continent as a response to the crisis of Fordism. There is therefore no doubt that "the Swedish Model fundamentally presupposed the post World War II 'embedded liberal' world order and the process of neo-liberal globalization is central to its crisis."²⁶

Let us now see what the policy options are for the future. It is possible to discern two main alternatives: Sweden can either choose to adopt a neo-liberal market oriented model with a higher level of unemployment, higher inequality and lower social security than before or it can try to rebuild the Swedish welfare model. There are problems with both alternatives. The problem with the neo-liberal model is that due to an increased polarization of the society it will intensify social conflict and might therefore be unstable over time. Furthermore, in the light of today's unemployment levels in Europe, the argument that by reducing social entitlements in the labor market, more employment will be created, is not particularly convincing. On the other hand, it is naive to think that there can be a return to a 'golden age' of the social democratic welfare state with full employment and continuous high growth. As shown in this paper the international circumstances are not the same as two or three decades ago. In particular, an attempt to unilaterally recreate such a model on a national level is not viable in an increasingly globalized world economy.

The best solution would be to 'disembed' the world economy by creating a new international monetary regime. In practice, capital markets do not work best when they are completely unregulated as the last months' events in South East Asia have demonstrated. The EU in general and the Economic and Monetary Union in particular can be seen as stepping-stones for such a project. In this light, it is unfortunate that Sweden has chosen to remain outside the EMU cooperation, at least from its inception. For a small country like Sweden, a multilateral strategy is the only viable solution and although a European welfare model will necessarily be less extensive than the Swedish model such an alternative is in contrast to the other two both stable and achievable. ●

¹ The lower numbers are the open unemployment rate while the higher numbers include also those on training and make-work schemes.

² Rhodes, M. p. 6 *Globalization, Employment and European Welfare States*. Nota Di Lavoro 65.96, Robert Schuman Centre, European University Institute, Florence, 1996.

³ Sweden trades primarily with other industrialized countries. In 1995, almost 75 percent of exports were destined for other European nations. Almost 90 percent of trade were with members of the Organization for Economic Cooperation and Development (OECD), which supplied the same proportion of imports. The Swedish Institute, Fact Sheets on Sweden, *Swedish Trade Policy*.

⁴ Henrekson, M., Jonung, L. and Stymne, J. p. 282 'Economic growth and the Swedish model' in *Economic Growth in Europe Since 1945*, Crafts, N. and Toniolo, G. (eds.) 1995.

⁵ The 'crisis' or 'fall' of the Swedish Welfare State implies its deterioration not its collapse or total disappearance.

⁶ Hurrell, A., Woods 'Globalisation and Inequality' in *Millennium*, 24, 3, 1995.

⁷ Giddens, A. pp. 63-65 *The Consequences of Modernity*, Stanford University Press, Stanford 1990

⁸ Henrekson, M., Jonung, L. and Stymne, J. (1995) p. 247.

⁹ The Economist p. 15 'A Survey of the Nordic Countries', November 5, 1994.

¹⁰ Martin, A. pp. 5-6 *What Does Globalization Have to Do With the Erosion of Welfare States? Sorting Out the Issues* ZeS-Arbeitspapier Nr. 1/1997, Center for European Studies, Harvard University, 1997.

¹¹ Cox, R. 'Democracy in hard times: economic globalization and the limits to liberal democracy' in *The Transformation of Democracy*, McGrew, A. (editor). Polity Press, Cambridge, 1997

¹² Ryner, M. p. 3 *Neoliberal Globalization and the Crisis of Swedish Social Democracy*. Research Center of International Political Economy (RECIPE), University of Amsterdam, 1996.

¹³ Public sector deficit can be offset by cutting down public expenditures or by borrowing money.

¹⁴ Here the 'South' is taken to include the newly industrializing or less developed countries of Asia and Latin America while the 'North' is referring to already industrialized or developed countries of Europe, North America and Japan.

¹⁵ Martin, A. (1997) p. 33.

¹⁶ A system of centralized bargaining of wages according to the principle of equal pay for equal work regardless of profitability and productivity in the various branches and firms. A central component of the Rehn-Meidner model upon which Swedish labor market policy originally was based.

¹⁷ Quoted in Martin, A. (1997) p.34.

¹⁸ The growth of private international exchange markets is explained by 1) technological development making instantaneous shifts of unlimited amounts possible, 2) increased opportunities for gains from speculation on anticipated exchange rates changes as exchange rates have become floating and 3) Increased capital mobility as the insulation of national capital markets was broken down by deregulation and liberalization. Although some argue that states have been instrumental in liberating and deregulating financial markets this does not mean that states can exercise control over these markets once they have been set free.

¹⁹ Quoted in Martin, A. (1997) p. 19.

²⁰ This argument is put forward in depth in Martin, A. (1997) p. 19-21.

²¹ Ryner, M. (1996) p. 10.

²² Ibid., pp. 15-16.

²³ Ibid., p. 16.

²⁴ Ryner, M. p. 23 *Maastricht Convergence and Post-Fordist Transition in Sweden and Germany*. Hrsg. vom Institut für Politikwissenschaft, FernUniversität, Hagen, 1997.

²⁵ Henrekson, M., Jonung, L. and Stymne, J. (1995) p. 256.

²⁶ Ryner, M. (1996) p. 1.

The International Dimension of Transition Trade and Foreign Investment in Central and Eastern Europe

Tim Gould and Paolo Miurin

In Europe, after World War II, foreign economic relations were determined more by politics than by economics. As Europe divided itself into two competing blocs, countries that had historically enjoyed strong reciprocal trading relations found themselves on different sides of the ideological divide and were forced to sever previous economic links. Trade was diverted by the communist central planners and later, albeit less dramatically, also by the architects of the European Economic Community. Since 1989 and the collapse of political barriers, there have been widespread expectations that 'natural' economic links would re-assert themselves. These expectations were strengthened by the conviction that the system of the Council of Mutual Economic Assistance (CMEA) - a system for inter-locking foreign economic relations of the Soviet Union and its satellites - would have to change. The direction of this change remained, however, unclear: on the one hand, CMEA members were keen to maintain at least some of the existing economic relationships, particularly if these could include energy supplies at prices below world market levels; on the other hand, they were worried by the political implications of maintaining 'socialist' economic ties. Poland, the CSFR and Hungary in particular looked with distaste at membership in any system that would imply formal Soviet or Russian influence over their affairs.

Hence the roots of the choice between 'big' integration into the world economy, including immediate moves towards currency convertibility and free trade, and 'small'

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integration through a re-elaboration - at least for a temporary period - of CMEA trade and payments arrangements. The ultimate aim of Central and Eastern European countries (CEEC) - if not necessarily of Russia which still had some hegemonic aspirations - was full participation in the global economy. The question remained whether a swift move in this direction was a sound decision in the short term, when these countries had to face the rude shock of the transition from plan to market. A sudden exposure to foreign competition might have exacerbated, instead of attenuated, the problems related to the structural adjustment of their economic systems.

This article aims to demonstrate that the choice made by some CEEC in favour of rapid trade and payments liberalisation was fundamentally sound, and that the problems in terms of external equilibrium that these countries are now facing as a result of this choice are only partially due to their incapacity to build up in time and manage efficiently an apparatus for internal macro-economic control. A certain timidity of the western partners in dismantling the protectionist components of their own systems, and a substantial insufficiency - in quantitative and qualitative terms - of western financial flows towards CEEC contributed significantly to these problems. Drawing lessons from the past, we will single out some policy measures that might in the future enhance the intensity and the utility of East-West trade and investment relations. In order to reach these conclusions, we will start by analysing possible post-CMEA trade arrangements and the reasons that led Central European countries (CEC) and the former constituent Republics of the Soviet Union (CIS) to make different choices in the organisation of their foreign economic relations (Section 2). We will then examine the economic consequences of these choices and the relative responsibilities of East and West for the present difficulties (Section 3). A minimal agenda for future initiatives to be taken by entrepreneurs and politicians in the East and in the West will be proposed in Section 4.

2. What after CMEA?

2.1 THE END OF CMEA

Prior to the end of the 1980s, CEEC pursued policies of national self-reliance and trade aversion. This inwardly oriented strategy sought to spur industrialisation through policies that replaced imports, as far as possible, with domestically produced goods. Imports played the residual role of filling excess demand gaps for machinery, equipment and, to a lesser extent, consumer goods. Exports sufficient to pay for these imports were then identified without any reference to comparative advantages or price elasticities. Trade relations were controlled by sectoral Foreign Trade Organisations, which would arrange negotiations, terms, pricing and the handling of foreign currencies. Exporting firms had little or no control over the amount of goods to be sold abroad nor over their foreign currency earnings. In these circumstances, producers had few incentives to expand production of goods for which there was strong international demand and to sell in the international market.¹

Arrangements under CMEA² crystallised this model of inefficient trade and divided the foreign economic relations of CEEC into two blocks: 1) relations within the CMEA area, where trade took place in manufactured goods of poor quality, energy and raw materials - the latter two types of goods being provided essentially by the Soviet Union; 2) relations with the Western world where, on the import side, machinery and

equipment, and, on the export side, raw materials, energy and semi-finished products were traded.

CMEA arrangements were facing a deep crisis well before their formal demise in 1991: Table 1 shows the intensity of the fall in trade flows among members in the years 1970-89. These arrangements, however, survived as long as the following three conditions prevailed; first, the Soviet Union extended a strong ideological and political influence on the area; second, the Soviet Union remained willing - as a counterpart - to supply other CEEC with unlimited quantities of energy and other inputs at prices well below world levels³; and third, it was possible for CEC to settle these imports and other reciprocal trade in non-convertible currency (transferable rubles). The first condition faded in Autumn 1989: the lack of reaction to the fall of the Berlin Wall indicated that the Soviet Union was not any longer willing or capable of imposing its hegemony on its close partners. The other two conditions disappeared in January 1991, when the decision was taken to move prices of traded goods gradually towards world market levels and to shift payments from transferable rubles to convertible currencies. This decision, imposed by Moscow, demonstrated that the Soviet Union, faced with internal difficulties and a growing mass of foreign debts, could not any longer bear the costs connected with the imposition of ideological leadership on its satellites. It also revealed the economic foundations of Soviet passivity vis-à-vis the Berlin events.

For CEC, trade of poor quality manufactured goods to be settled in convertible currencies became an economic nonsense. At the same time, there was little reason to concentrate purchases of energy and raw materials in the Soviet Union when, at world market and dollar prices, these goods could have been obtained from any other external source. These considerations led to the formal dismantling of CMEA during the last meeting of this organisation in Budapest, in June 1991.

2.2 NEW TRADE AND PAYMENTS PATTERNS FOR CEEC

The immediate consequences of the end of CMEA were a collapse of trade among CEEC and a serious contraction of the volume of industrial production. These developments led some (Eastern and Western) analysts and policy-makers to believe that a continued exposure of CEEC to world competition and dollar settlements could have devastating effects on their economic structures, well in excess of those deemed opportune in the framework of a normal - and long overdue - process of industrial restructuring. Even enterprises viable in the long term, after the completion of a more gradual adjustment process, would have been left in the short term without markets and in danger of premature and unjustified closure.

On the basis of these considerations, a discussion began on the opportunity of organising new CEEC trade and payments arrangements capable of softening the landing in the realm of free trade and currency convertibility. The debates concentrated on the creation of a privileged trade and payments area for CIS, to which the CEC could also be aggregated. The case for specific trade arrangements within the CIS was particularly strong: the geographical distribution of industrial activity created for the Soviet Union by the original planners under the direct influence of Stalin was economically insane and dictated only by political considerations. The purpose was that of preventing any constituent Republic from disposing of a relatively autonomous input-output structure; this was intended to discourage separatist temptations and forcibly keep the Union

together. This structure was never corrected and, still at the end of the 1980s, for Republics other than Russia inter-republican trade accounted on average for more than 50% of GDP; for Russia this proportion was 18% (Bofinger and Gros 1992).

The extension of trade arrangements to CEC was also considered opportune: although trade among these countries and between these countries and the CIS had already been drastically reduced, a further contraction would have had cumulative effects and would have exacerbated the difficulties of economic transition.

The model that inspired the discussion about a Central and Eastern European Payments Union (CEEPU) was the European Payments Union (EPU), a multilateral clearing system for international payments which operated in Western Europe from July 1950 until December 1958. EPU was successful in keeping high levels of trade in a period of acute dollar shortage, and in bringing participating countries smoothly to the external convertibility of their national currencies. When convertibility was declared (January 1959), EPU arrangements were wound up. Notwithstanding the important differences between post-war Western Europe and post-communist Central and Eastern Europe, arrangements of EPU type were considered a useful temporary device for countries in transition, where foreign exchange reserves are scarce and industry has to be deeply restructured before it can become competitive in international markets.

As soon as discussion started on a CEEPU, CEC called themselves out of the exercise and made an immediate choice in favour of trade liberalisation, integration in western markets and currency convertibility (Drabek 1992). Political reasons, connected with the desire to secure the irreversibility of transition, were not absent from this choice. The main arguments, however, were of an economic nature: trade liberalisation introduces from the outset strong competitive pressures into the economy and stimulates enterprises to restructure production towards the most viable and profitable sectors. This facilitates export growth and, making internal output more suitable to satisfy internal demand, contains imports. At the same time convertibility, based on stable and 'non-accommodating' exchange rates, introduces an immediate 'hard budget constraint' for the enterprises and forces them to cut wasteful use of resources and unnecessary imports; it also forces monetary and fiscal authorities to pursue sound macro-economic policies. Finally, liberal access to foreign currencies is an essential condition for attracting foreign investment. Acting coherently with this approach, CEC dismantled previous Foreign Trade Organisations which monopolised trade, lowered import duties and export taxes considerably, and abolished quantitative restrictions to trade. The most advanced tariff reductions took place in the CSFR and in Poland, where border protection became lower, more uniform and more transparent than that accorded by many OECD countries to their domestic producers in the late 1980s (Messerlin 1992).

Due to the closer economic integration of the former Soviet Republics, the idea of a payments union found more fertile ground in the CIS. Practical work on setting the foundations for a privileged trade area started in early 1992 and culminated in an agreement at the Minsk summit of CIS heads of state in January 1993. This agreement contemplated the creation of an 'Interstate Bank' which would have acted as a multilateral clearing institution using as unit of account the Russian ruble. Every transaction among participants would have been registered and cumulative balances settled every two weeks. Countries running a deficit within the system could have access to a credit line equivalent to one month of export receipts, after which payment would have to be made in rubles or

in convertible currencies. Russia was granted fifty percent of the votes in the Bank's governing body, where decisions had to be taken with a three-quarters majority.

The major attraction of a payments union for the CIS was that, in the absence of convertibility, it represented the best way of maintaining trade flows. Gros and Steinherr (1995) estimated that the Interstate Bank would have made it easier to sustain a volume of trade of around 3% of CIS GDP, with the benefits mainly accruing to countries other than Russia. This would not have been sufficient to reverse the decline in output, but would certainly have reduced its severity. Operation of the system would also have meant considerable savings of scarce foreign currency, whose use could have been concentrated on settling extra-union trade.

However, the fate of the Minsk Agreement turned out to be the same as so many other CIS documents; it was never implemented. The reasons for this failure are a combination of flaws in the design of the agreement and of broad political and economic factors.

A crucial and damaging decision was the one to use the Russian ruble as unit of account. Even strong advocates of the Bank's role had advised against this decision on economic grounds; Gros and Bofinger (1992) had warned that the ruble or any other republican currency would not be stable enough to provide international monetary functions in the former Soviet area. Secondly, there were legitimate doubts about the willingness and ability of the Russian government to support the Bank's operations. Russia, given the large trade surplus that it enjoyed with the rest of the CIS, had the least to gain in relative economic terms from the payments union. As guarantor of the system Russia was being asked to bear the costs of its establishment and functioning, yet the benefits of easier international payments would have been shared by all.

A third and related weakness was the inadequate credibility of sanctions for breaching the credit ceilings. Given the prospect of large Russian trade surpluses, this could have been a source of immediate tensions. Successful operation of the system rested upon the assumption that member states would value the medium term benefits of stable payments over the short term temptation to simply use up all available (Russian) credit. In the uncertain atmosphere of post-Soviet disintegration, this assumption was very fragile; combined with ineffective sanctions, this would have allowed Member States to 'free ride' on Russia's commitment to the preservation of the union.

Two further non-technical arguments were introduced against a post-Soviet payments union. The first argument was raised by some reformist figures who were worried that the introduction of the payments union would have prevented movements towards trade liberalisation and convertibility. There were concerns that an interim arrangement would become a permanent instrument for diverting trade towards the former Soviet area, which could hinder the long-term objective of integration into the world economy. The second argument was purely political: many of CIS, especially Ukraine and Moldova, were reluctant to participate in any initiative that risked to institutionalise Russian hegemony in the former Soviet area.

The comparison with the western European Payments Union (EPU) therefore loses some of its validity. This is not to say that a payments union for CIS would have been undesirable; on the contrary, a credible agreement to open trade according to the terms of a union would have encouraged restructuring while retaining the viable economic links within the system. The differences lie rather in the structural conditions of the two areas

at the departure and in the long-term aims of the entire exercise. Post-war Europe consisted of countries with long-established market economies based on sound institutions and rules of law; EPU was part of a broader process of European integration, with the ultimate goal of an ever-closer reciprocal cooperation. In the CIS, conditions were the opposite: the legal framework and market institutions were weak or absent, and the dominant paradigm was that of disintegration.

The failure to establish a payments union should have left trade liberalisation and convertibility as the main options for CIS governments, but these avenues were not taken. These governments have retained a high level of interference in foreign trade and in foreign exchange transactions: import tariffs, export quotas and other quantitative restrictions were not eliminated and are still present; access to foreign currency for importers is subject to controls and exporters are required to sell on the foreign exchange market all or part of their export earnings.

Slow progress in economic and institutional reforms have stifled other attempts to restore trade amongst CIS countries. Various trade agreements have been signed, at multilateral and bilateral level. However, key products are often excluded from such agreements; operation of the 'free trade' accord between Ukraine and Russia has been plagued by a high number of such exclusions. A more ambitious initiative is the customs union of Russia, Belarus, Kazakstan and the Kyrgyz Republic, but there are reasons to doubt that this forms an optimal trading bloc since the relatively high external tariff envisaged for this customs union will inevitably have 'trade diversion' effects.

2.3 THE NEO-PROTECTIONIST WAVE IN CEC: ORIGINS AND END

The preceding analysis shows that CIS and CEC entered into economic transition with different attitudes towards future trade regimes. But while CIS remained largely faithful to a policy of bureaucratic controls, CEC introduced - in the course of the last eight years - substantial changes in their attitude toward trade liberalisation. The initial slashing of barriers in 1990-91 was followed, in 1992-93, by a wave of neo-protectionism⁴, which was succeeded by a return to free trade policies from 1994 until the present. Political and economic considerations were at the base of the return to protectionism in 1992-93. Among the first, of paramount importance was the re-orientation of CEC societies towards some traditional communist values after the first painful effects of economic transition began to be felt. Even in countries like Hungary and the CSFR where the neo-communists did not achieve full control of political levers, there was a general tendency to lend a favourable ear to the requests for protection coming from the old industrial lobbies which had been hit hard by import competition.

Economic reasons for protectionism were essentially related to stabilisation and anti-inflationary concerns in CEC, which induced monetary authorities to keep relatively rigid foreign exchange rates after the initial strong devaluations of 1991-92 (IMF 1997). In the presence of stable or falling inflation, this policy implied a substantial real appreciation of the exchange rate, which hampered exports and stimulated imports. At the same time, the absence - in the early stages of transition - of adequate monetary and fiscal instruments of macro-economic control shifted the task of preventing excessive foreign competition and balance of payments crises onto trade restrictions. Fear of losing the sympathies of the EU, which in 1991-92 was elaborating plans for incorporating the CEC in a large European free trade area, was not a sufficient deterrent. In reality, the scope of

these plans was limited (see later about Europe Agreements), while the strength of the lobbies of producers and bureaucrats was very vigorous.

This neo-protectionist wave ended in 1994, when most of the barriers erected in the previous three years were gradually dismantled. The seeds of political involution had lost strength; thanks to the improved capabilities in managing the macro-economy, foreign exchange policy became more elastic; EU trade plans, albeit still scarcely generous in terms of trade concessions, started to be interpreted in a more constructive way, i.e. as a temporary and necessary step in the long march towards full European integration. Trade and payments liberalisation moved up the agenda again.

3. Trade liberalisation and economic performance

Table 2 shows a strong correlation between exports and GDP growth. In CEC, export acceleration after 1993 generated conspicuous rates of economic recovery for the whole area, and especially for Poland. In the CIS, developments were less favourable but they still show a link between export and economic performance: GDP contraction was much less pronounced in countries in which exports fared better (the only exception was Russia, where a fall in GDP was associated with a high rate of growth of exports; this is explained by the peculiar type of goods that constitute the bulk of Russian sales abroad; energy sources and raw materials with which the country has large endowments and for which foreign demand was buoyant).

Turning to unemployment and inflation (Table 3), we observe that these variables developed more favourably in countries with higher export growth. In CEC, support to aggregate demand from sales abroad was crucial in keeping acceptable levels of productive capacity utilisation and in softening the task of entrepreneurs to adjust labour/output ratios. In turn, higher labour and plant utilisation was essential in supporting labour productivity, in containing unit labour costs and in impressing a downwards trend to unemployment and inflation. In CIS, on the contrary, where export growth has been slower than in CEC, we observe rates of unemployment which are still rising. This is the sign that bureaucratic controls on trade and insufficient integration in western markets have delayed industrial restructuring and the inevitable adjustments in labour/output ratios: unemployment in CIS will have to increase further before it can fall thanks to the achievement of optimal long-term economic structures. The burden of high unit costs, due to 'excessive' unemployment and to the survival of obsolete plants, in turn explains the structurally high levels of inflation in CIS. The recent downward trend reflects sounder monetary management more than real improvements in the economic potential of these countries.

Shifting the analysis from macro-economic variables to the current account of the balance of payments, the picture changes. Table 4 shows for the whole area of CEEC a deficit of considerable importance which, in the years 1994-97 has increased nearly 5 times. Imbalances, however, are more pronounced in CEC, where - compared to GDP - they have reached worrying proportions: 10% in the Slovakia, 6.1% in the Czech Republic, 4% in Poland and 3.5% in Hungary. In CIS countries other than Russia deficits are smaller and practically compensated by the Russian surplus.

The dynamics of imports provide the first explanation for these developments: due to liberalisation they rose more than exports in CEC⁵, while, thanks to the bureaucratic

controls, they remained sluggish in the CIS. But, before we consider the different intensity of the deterioration of the current account of the balance of payments as the revenge of those who advocated a more gradual approach to trade liberalisation, we must analyse other important factors: 1) the trade policies adopted by CEEC's trading partners; 2) the role of foreign direct investment; 3) the size and quality of financial flows towards CEEC coming from official and private foreign sources.

3.1 EUROPEAN UNION TRADE ARRANGEMENTS WITH CEC

For countries in transition, changes in trade policies leading to an increase in export potential would be of little value of the markets if their main partners remained closed. 'Gravity models' of trade suggest that the EU will be their principal market (Gros and Steinherr 1995). With the *declared* intent of facilitating CEC integration in this market, the EU negotiated with each of them in 1991-92 a series of Europe Agreements (EA), whose main purpose is the establishment - after 10 years from their signature - of a free trade area for merchandise.⁶ In the interim period the EU extends the following concessions:

- agriculture: abolition of specific quantitative restrictions and inclusion of CEC exports into the normal 'import levies' system.

- industry: abolition of quantitative restrictions and gradual reduction of tariffs, with the exception of five 'sensitive sectors' (textiles, apparel, iron, steel, chemicals), for which a structure of quotas is maintained.

As counterpart to these concessions, the EA include: 1) a general 'safeguard clause' which allows EU member states to revoke liberalisation in case of "serious disturbances in any sector of their economies or difficulties which could bring about serious deterioration in the economic situation of a region"; 2) strong anti-dumping provisions; 3) strict 'rules of origin' which limit the above mentioned liberalisation to exports of goods manufactured with a high content of national or EU inputs (on average this content is equal to 60%, which limits inputs from non-EU sources to 40% of production).

These EA have been beneficial to CEC only in general terms: they have given formal support to the advocates of free trade in CEC and they have helped to generate confidence in the irreversibility of the transition process. But in practice they have not given CEC exports the boost that was expected and needed. Supplies of agricultural products were seriously hindered by the application of the infamous import levies system, up to the point of falling by 12.5% between 1991 and 1993. Exports of manufactured goods suffered from the fact that the most heavily protected goods (the 'sensitive' ones) accounted for up to 50% of global CEC exports. In total, between 1991 and 1993, CEC exports to the EU increased by 17%, while their imports from the EU increased by 26%.

These developments confirmed the impression, shared by many CEC and EU analysts immediately after the conclusion of the EA, that the EU gave a parsimonious welcome to its fellow Europeans from the East and that it remained very sensitive to any potential source of rapid import growth (Rollo and Smith 1993). In reality, as correctly observes Messerlin (1992), "...the EA may have aimed more at unifying EU trade policy vis-à-vis the CEC than at opening EU markets to CEC exports."

3.2 EUROPEAN UNION TRADE ARRANGEMENTS WITH CIS

In 1994-95 the EU and a number of CIS countries signed Partnership and Cooperation Agreements (PCA) which, in the domain of trade liberalisation, foresee the abolition in both areas of quantitative restrictions to imports and exports, with some exceptions for sensitive sectors. The PCAs, however, have failed so far to produce tangible results, essentially because of the slowness of CIS in implementing their liberalisation engagements, which prevents the EU from implementing its own trade concessions. The situation practically puts CIS trade with the EU in the same institutional conditions as those prevailing in CIS trade with the rest of the world.

3.3 REST OF THE WORLD TRADE POLICIES TOWARDS CEEC

Since the beginning of transition, trade policies of non-EU members of OECD have been based on the principle of non-discrimination: tariff levels are set according to the 'most favoured nation' status and many CEEC also benefit from the 'general system of preferences'.⁷ Membership in the World Trade Organisation has been extended to nearly all CEC, while Russia's and other CIS countries' applications are under examination. "Nonetheless substantial barriers, particularly import quotas, remain for many CEEC's exports of sensitive goods, such as agricultural products, iron and steel, textile and apparel and footwear, all of which are goods in which the transition countries would reasonably be expected to have comparative advantages vis-à-vis the advanced economies. Transition countries' exports also continue to be affected by anti-dumping actions, which often in effect penalise firms that are most successful at exporting" (IMF 1997).

3.4 FOREIGN DIRECT INVESTMENT IN CEEC

The ability of transition countries to encourage private investment is the key to how fast they will come to stable paths of economic growth. In particular, foreign direct investment (FDI) has the potential to accelerate transition by bringing fresh capital along with new technologies and sound management techniques. A consistent inflow of FDI was one of the great expectations of CEEC when they took the road to radical economic reform. These expectations were frustrated: Table 4 shows that FDI in CEEC has remained very modest, both in absolute terms and as a percentage of total FDI outflows from the main industrial countries; this percentage is also slightly inferior to the proportion of transition countries' GDP to world GDP. Moreover, the distribution of FDI among these countries is highly irregular: pointing to the two extreme cases, we can see that Hungary, with a population of less than 3% of the whole area, has attracted - between 1991 and 1996 - 30% of total FDI, while Russia, with nearly 40% of the population, has attracted only 15% of total FDI. This means that on a per capita basis Hungary has enjoyed an amount of FDI nearly 35 times higher than that of Russia (Figure 1).

The reasons currently invoked to justify the fact that FDI remained below the expectations and needs of CEEC are mainly related to internal problems of these countries; political instability, poor legal framework, unreliable bureaucracy, uncertain currency convertibility regimes, and corporate governance based on insiders' control. These problems undoubtedly exist, but they must not distract attention from other distortions for which the Western world is responsible. Among these distortions, of paramount importance is the reluctance to remove protectionist barriers, especially in sectors in which CEEC could be most competitive. The prospect of having to face barriers

for exports obtained by shifting lines of production to CEEC is a strong disincentive for potential investors. This seriously damages not only the growth prospects of transition economies, but also the optimal trans-national allocation of resources. With their endowment of skilled and relatively cheap labour, CEECs are ideally suited for manufacturing intermediate-technology goods, part of which can be used to feed the still undernourished internal market, while the other part can be sold competitively abroad. For the EU in particular, times are ripe for a strategy based on a gradual transfer of intermediate production to the East and on a concentration of EU resources in new high-technology sectors. This strategy is not unknown nor impracticable: it was theorised by R. Vernon in 1966⁸ and practised by the United States during the last thirty years.

3.5 FINANCIAL FLOWS TOWARDS CEEC

The complex machinery set up by Western countries at the start of transition for channeling financial flows towards CEEC was based on the following principles: 1) no “free lunch” of the type organised for post-World War II Europe by the Marshall Plan;⁹ 2) shift of official flows from bilateral to multilateral institutions, whose structure was reinforced by the establishment, in April 1991, of the EBRD; 3) enhanced role of flows from private financial institutions which would lend at market rates; 4) creation of a small grant component for ‘technical cooperation’ with funds to be managed by the Commission of the EU. Actual financial flows between 1991 and 1996 behaved according to these principles: Table 6 shows that bilateral lending is gradually disappearing, that multilateral institutions are gradually increasing their role (albeit only partially compensating for the fall in official bilateral financing); that private sector lending is becoming the principal provider of funds and that a certain amount of grants has been conceded.

These flows, however, remain quantitatively insufficient and qualitatively flawed. On the first aspect, the global amount of 160.9 billion US dollars represents, in relative terms, less than 10% of the flows directed in the same period towards developing countries. Some experts have tried to estimate the net flow of resources theoretically required by CEEC countries in order to reach standards of quality comparable to those prevailing in Western economies. The results of these studies differ slightly, but they all show a sizable resource gap. One of these studies - referring to CIS alone - indicates net resource requirements of 50 billion US dollars per year in 1998-2001; the gap would then diminish and reach negligible proportions in 2005 (Giustiniani et al. 1992). Even with all the caveats that necessarily accompany exercises of this type, it appears evident that resource requirements of this magnitude cannot be met *in toto* by the Western community.

One factor that might help in squaring the circle is technical cooperation, i.e., grants aimed at improving human capital and institutional infrastructure. Initiatives of this type can increase endogenous capabilities in CEEC, enhance the marginal efficiency of other financial flows and, in the medium term, reduce the size of the resource gap. Unfortunately, as Table 6 shows, grants for technical assistance do not yet constitute a very consistent part of total financial flows towards CEEC. These figures also point to a second qualitative shortcoming; the scarce support provided to the development of new and efficient physical infrastructures. This is the consequence of having put the burden of financial intermediation in favour of CEEC mostly on the shoulders of the private sector, and of having created an international financial institution (the EBRD) which cannot dedicate more than 40% of its investments to physical infrastructure. The World Bank, the classical

purveyor of infrastructure financing, invested in CEEC in 1991-96 only about 10 billion US dollars. Forcing the countries in transition - which have to absorb rapidly the principles and the rules of the market - to face private international investors directly and from the outset was not a wrong strategy; but it should have been clear that, without a substantial effort in favour of human capital and physical infrastructure from official multilateral sources, these countries would have been caught in a vicious circle: investors are discouraged by the lack of appropriate infrastructures, but the consequent low level of foreign financial flows prevents the economic progress needed for internal funding of these infrastructures (Miurin and Sommariva 1994).

The analysis conducted in this section has demonstrated that integration in western markets is the correct trade policy for the countries in transition. The serious balance of payments problems now faced by the countries which chose this policy are only partially due to the import surge that followed liberalisation and to delays in dealing decisively with the knot of industrial restructuring. The balance of payments problems can also be attributed to trade policies in the Western world - which were less generous than expected - and financial flows - which were quantitatively and qualitatively insufficient. In the next section we discuss the perspectives of East-West economic relations and we will propose some initiatives that might brighten these perspectives.

4. The future of East-West economic relations

When considering the prospects of East-West economic relations, it is first necessary to make a distinction between the CIS and the CEC. Without the prospect of membership or very close integration in the EU, the most promising policy for the CIS is to seek more intense and liberal trade relations with each other, in the framework of a more active participation in world trade. Membership in the World Trade Organisation would represent an important step forward by providing an anchor for sound transition policies and by facilitating access to international markets. A complementary approach is provided by the Partnership and Cooperation Agreements between individual CIS and the European Union. Although less ambitious than the Europe Agreements signed with CEC, they do contain a general commitment to future free trade. Relations between the CIS and the EU will also benefit from the progress in integration between the EU and CEC. By bringing the borders of the EU closer to the countries concerned, this progress will increase the interest of the EU in ensuring the security and prosperity of the whole region.

Important questions, however, remain about future patterns of trade and investment in CEC, particularly in view of the perceived implications for the EU of further market opening (linked or not to future membership). In the last years this area has been the subject of a variety of studies, whose conclusions differ widely about the potential dangers of increased competition from CEC for the mature and labour-intensive sectors still largely present in EU economies. The most recent studies, however, tend to converge towards a more serene assessment of these dangers. They are based on evidence that CEC are moving their industrial and export structure towards intermediate or higher technology sectors. This implies that the majority of trade between EU and CEC would be intra-industry trade, which tends to have fewer disruptive effects in terms of dislocation of economic activity than inter-industry trade (in which CEC would have clear advantages due to their lower labour costs). At the same time, in terms of increased competition on third markets

(which also is a consequence of closer integration in the EU), the risks are considered minimal because EU exports are concentrated in high technology sectors, where price competitiveness is relatively unimportant. All this would make the distributional effects widely dispersed and not concentrated in specific regions or sectors, thereby reducing the social and political resistance to trade concessions.¹⁰

It has, however, to be noted that these perspectives rest upon two main assumptions, neither of which can be taken for granted. The first assumption is that, after the initial leap forward, the CEC can continue to ascend the technological ladder. Using various indicators of technology and skill availability, Halpern (1995) comes to the conclusion that in the medium term there are no clear prospects of rapid catch-up and that the competitive advantage of CEC will remain concentrated in labour-intensive sectors. The second assumption is that the price sensitivity of the EU's exports is low. A recent econometric study concerning the most advanced 14 members of the OECD demonstrates that relative prices do matter: the overall price elasticity of these countries' exports is such that an improvement in prices of 10% can lead to an increase of 2.7% in their share of world markets. Moreover, the same study shows that exports of some high technology industries (like electrical and non-electrical machinery) have price elasticities above the average (Carlin et al. 1998).

The risk then exists that, at least in the medium term, present EU members would have to face increased competition from CEC, both on internal and world markets. The challenge here is not to try and eliminate the risk by delaying the opening of the markets, but to adopt initiatives that can transform the risk into new opportunities for both areas. These initiatives should be founded on the revitalisation of the flows of FDI towards CEC. Foreign direct investment operations can in fact improve the technological content of CEC production and exports, and, in so doing, confer a real intra-industry character to reciprocal trade. At the same time, FDI allows EU enterprises to 'occupy' the standardised sectors and to attain in this way the double goal of controlling competition on home markets and of increasing competitiveness on third markets (Vernon 1966).

Such an increase in FDI implies moving from the 'spontaneous' approach, which has prevailed thus far, towards an organic strategy for investment in central Europe. This strategy requires fundamental changes in the behaviour of three main actors. The *entrepreneurial class* in the EU must widen the scope of its relations with CEC up to the point of encompassing, on equal footing, trade and industrial cooperation. Only in this way can the short term benefits of larger markets be combined with the long term benefits of an optimal allocation of resources on a truly European scale. The *political classes* in both East and West have to do their part in providing, respectively, an improved legal/institutional framework and some specific financial incentives for FDI. The *international financial institutions* must concentrate their interventions in the areas where the market alone may not provide adequate resources. This means a new effort for financing physical infrastructure and technical assistance suitable to develop human resources. Only by complementing the efforts of the private sector, instead of duplicating them, can the international financial institutions play a vital role in the success of the transition process.

5. Conclusion

Even if investment is lagging behind, trade in Europe is gradually returning to 'natural' patterns after the collapse of communism. Those countries that have made the strongest progress in the transition to the market have also been those that have seen the most dramatic re-orientation of trade from East to West.

The question remains whether the international aspects of transition have been managed as well as they could have been. At least in the case of the CIS it is clear that numerous opportunities have been missed, in trade policy as elsewhere, to reduce the declines in output and welfare since 1991. The failure to create a mechanism for smooth international payments is one such example, but one that has been compounded by the incapacity to establish effective free trade arrangements and the unwillingness to part with the habits of state trading economies. In CEC, historically different industrial and commercial traditions, together with the encouragement provided by prospects of integration (leading to membership) in the EU, led to very liberal trade policies - more liberal than was expected by western analysts and in some cases also more liberal than would have suited countries in the initial stages of transition. The severe economic disruption that accompanied the start of transition in CEC was exacerbated by the radical way in which their markets were opened up.

It seems then that in both areas, CIS and CEC, the international aspects of transition could have been better managed. Without a doubt, however, the path chosen by CEC has produced better results. The shock of opening up to the world economy did not bring with it social unrest or political reversal, and exports now play an important role in supporting economic growth in CEC. These facts provide an important vindication of the choices made and a useful example to other economies in transition. They also constitute a challenge for the western world, which now has the responsibility to provide the sensible trade and investment policies that can accompany the further international integration of all these economies. ●

Glossary:

CEC	Central European Countries: Poland, Czech and Slovak Republics, Hungary, Baltic States, Romania, Bulgaria, Slovenia, Croatia, Bosnia and Herzegovina, Macedonia, Albania
CEEC	Central and Eastern European Countries: CEC and CIS
CEPU	Central and Eastern European Payment Union
CIS	Former Soviet Constituent Republics, excluding the Baltic States
CMEA	Council of Mutual Economic Assistance
CSFR	Czechoslovak Republic
EA	Europe Agreements
EPU	European Payments Union
EU	European Union
FDI	Foreign Direct Investment
IMF	International Monetary Fund
PCA	Partnership and Cooperation Agreement

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- The figure is not available

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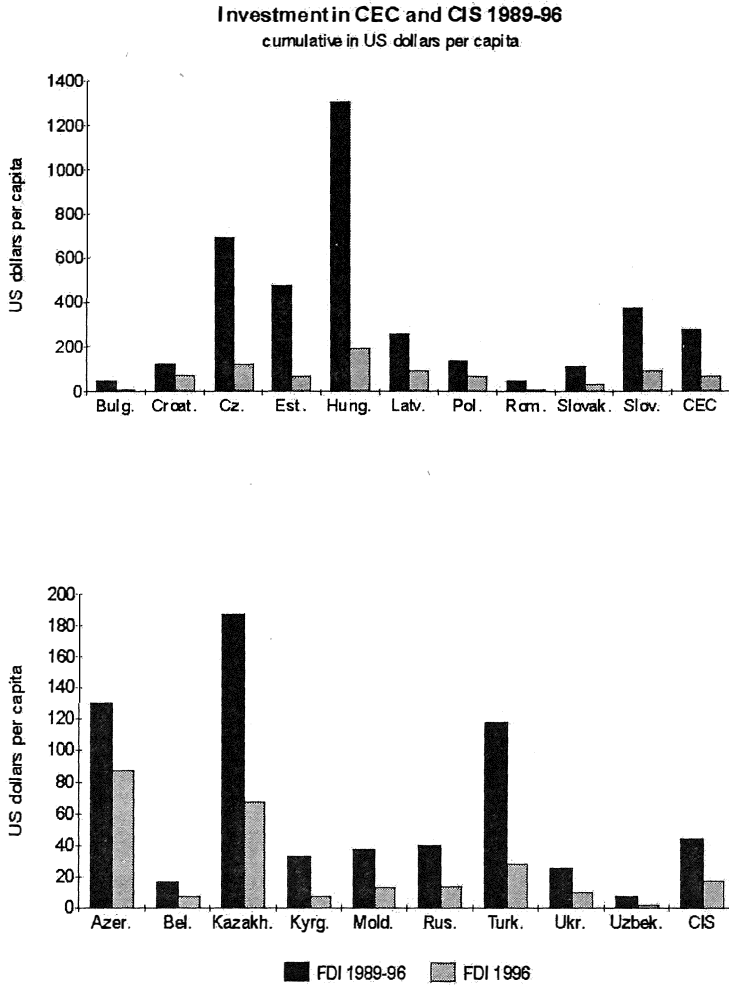
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FIGURE 1



Source: EBRD Transition Report 1997.

TABLE 1

Total Central and Eastern European Trade*(percentual change; imports and exports in 1970 US dollars)*

	USSR	EAST EUR.	Poland	CSFR	Hungary	Bulgaria
1970-79						
East	13.3	12.9	19.2	6.3	32.1	26
West	234	107.1	172.8	60.7	111.4	91.8
1979-89						
East	-30.1	-34	-33.1	-27.2	-38.5	-31.2
West	3	-5.1	-21.5	2	2.7	-2
1989-92						
East	-64.8	-46.8	-59.5	-47.2	-40.5	-65.9
West	-27.2	46.7	48.8	62.1	59.1	-24.2

Source: United Nations, Economic Commission for Europe, 1993

TABLE 2

Average Percentage Change 1994-1996 in GDP and Exports*(GDP at constant prices; exports in current US dollars)*

	GDP	Exports
Poland	6.1	22.4
Slovak Republic	6.2	18.4
Czech Republic	3.8	17.7
Slovenia	4.2	12.2
Hungary	2.1	11.7
Russia	-7.5	17.5
Uzbekistan	-2.2	12.3
Kazakhstan	-10.8	10.1
Azerbaijan	-10.2	6.7
Ukraine	-15	3.5

Source: Elaboration from EBRD Transition Report 1997

TABLE 3
Unemployment and Inflation

	Unemployment (% of labour force)				Inflation (end of year % change)		
	1994	1995	1996	1997	1994	1995	1996
Poland	16	14.9	13.6	-	29.4	21.6	18.5
Slov. Rep.	13.7	13.1	11.1	-	13.4	9.9	5.8
Czech Rep.	3.2	2.9	3.5	-	10.3	7.9	8.6
Slovenia	14.4	13.9	13.9	13.8	18.3	8.6	8.8
Hungary	10.4	10.4	10.5	10	21.7	28.3	19.8
Russia	7.4	8.2	9.3	-	217	132	22
Uzbek.	0.4	0.3	0.6	-	1,281	117	64
Kazak.	0.8	1.7	3.6	-	1,160	60	29
Azerb.	15	17	20	-	1,788	85	6
Ukraine	0.4	0.5	1.3	-	891	376	80

TABLE 4
Current Account of the Balance of Payments
(billions of US dollars)

	1994	1995	1996	1997*
Poland	-2.4	-2.3	-7.9	(-4)
Slovak Republic	0.7	0.4	-1.5	(-10)
Czech Republic	-0.1	-1.4	-4.1	(-6.1)
Slovenia	0.5	-0.1	-0.3	-
Hungary	-3.9	-2.5	-1.7	(-3.5)
Central Europe	-2.3	-4.1	-13.9	-15.8
Russia	10.4	4.8	9.6	3.8
Uzbek.	0.1	-0.1	-0.6	-
Kazak.	-0.9	-0.5	-1	-
Azerb.	-0.1	-0.3	-0.7	-
Ukraine	-1.4	-1.5	-1.3	-
CIS	7.4	1	4.5	-2.9
Total CEEC	5.1	-3.1	-9.4	-18.7
Africa (for comparison)	-11.4	-15.5	-7.7	-8.1

Source: IMF, World Economic Outlook 1997; EBRD, Transition Report 1997.

*Estimates; data in parenthesis are percentages of GDP

TABLE 5
Foreign Direct Investment
 (billions of US dollars)

	1991	1992	1993	1994	1995	1996	1991-96
Hungary	1.5	1.5	2.2	1.1	4.5	1.9	12.7
Poland	0.1	0.3	0.4	0.5	1.1	2.3	4.7
Czech Republic	..	1	0.6	0.8	2.5	1.2	6.1
Romania	..	0.1	0.1	0.3	0.4	0.6	1.5
Baltics	..	0.1	0.2	0.4	0.4	0.3	1.4
Bulgaria	0.1	..	0.1	0.1	0.1	0.1	0.5
Slovenia	..	0.1	0.1	0.1	0.2	0.2	0.7
Slovak Republic	..	0.1	0.2	0.2	0.2	0.1	0.8
Central Europe	2.2	3	4.2	3.8	9.5	7.2	29.9
Russia	0.1	0.8	1.1	1	1.9	1.6	6.5
Kazakhstan	..	0.1	0.3	0.6	0.7	0.9	2.6
Azerbaijan	-	-	-	..	0.3	0.6	0.9
Ukraine	-	-	-	0.1	0.3	0.4	0.8
Uzbekistan	-	0.1	0.1	0.1	0.1	0.1	0.5
CIS	0.2	1.2	1.8	2	3.6	3.9	12.7
Total CEEC	2.4	4.2	6	5.8	13.1	11.1	42.6
FDI outflows from main industrial countries	170	168	190	180	220	270	1,198
<i>Quota towards CEEC (%)</i>	<i>1.4</i>	<i>2.5</i>	<i>2.8</i>	<i>3.2</i>	<i>6</i>	<i>4.1</i>	<i>3.5</i>

Source: EBRD, Transition Reports 1995-1997.

TABLE 6

	1991			1992			1993			1994			1995			1996			91-96
	CEC	CIS	Total	CEC	CIS	Total	CEC	CIS	Total	CEC	CIS	Total	CEC	CIS	Total	CEC	CIS	Total	Total
Official flows	6.3	8	14.3	3.4	8.5	11.9	3.7	9.3	13	4.3	5.1	9.4	1.7	11	12.7	-	-	13.1	74.4
Grants	3.4	2.6	6	2.1	3.7	5.8	1.5	3.1	4.6	2.3	2.4	4.7	3.6	1.7	5.3	-	-	5.2	31.6
Loans	2.9	5.4	8.3	1.3	4.8	6.1	2.2	6.2	8.4	2	2.7	4.7	-1.9	9.3	7.4	-	-	7.9	42.8
Bilateral	0.3	3.8	4.1	0.6	1.9	2.5	0.2	1.4	1.6	0.4	0.6	1	0.4	0.2	0.6	-	-	2.9	12.7
Multilateral	2.6	1.6	4.2	0.7	2.9	3.6	2	4.8	6.8	1.6	2.1	3.7	-2.3	9.1	6.8	-	-	5	30.1
Private flows	2.6	..	2.6	12.7	1.1	13.8	12.5	1.8	14.3	6.4	2.5	8.9	19.4	1.7	21.1	-	-	25.8	86.5
Debt flows	-1.2	..	-1.2	8.4	0.1	8.5	3.6	..	3.6	-0.6	0.7	0.1	7.9	-3.6	4.3	-	-	8.6	23.9
FDI	2.4	..	2.4	3.2	1	4.2	4.2	1.8	6	3.8	1.6	5.4	9.5	3.6	13.1	7.2	3.9	11.1	42.2
Portfolio	1.4	..	1.4	1.1	..	1.1	4.7	..	4.7	3.2	0.2	3.4	2	1.7	3.7	-	-	6.1	20.4
Total flows	8.9	8	16.9	16.1	9.6	25.7	16.2	11.1	27.3	10.7	7.6	18.3	21.1	12.7	33.8	-	-	38.9	160.9

Source: Elaboration from IMF World Economic Outlook, May 1997.

¹In the classical socialist system the price elasticity of exports is negative: if prices of exportable goods are expected to rise, a lower volume of goods has to be exported in order to obtain the amount of foreign exchange necessary to pay for the planned volume of imports. This feature made export specialisation in manufacturing impossible (Winiecki 1988, Chapter 5).

²The CMEA was established in 1949 and dissolved in 1991. In 1990 the following countries were members: the USSR, Bulgaria, Czechoslovakia, Hungary, Poland, Romania, Cuba, Mongolia and Vietnam. For more details on the structure and functions of CMEA, see Kornai (1992) Chapter 14.

³Russia's price subsidies to other countries were estimated at 59 billion US dollars in 1990, of which 40 billion were for the other constituent Republics of the USSR and 18 billion were for other CMEA countries (World Bank 1996).

⁴In Poland, cuts in tariffs were suspended in September 1991 and soon afterwards increases in duties were instituted, particularly for agricultural products; in Czechoslovakia from January 1992 large groups of agricultural and semi-finished products and all consumer goods became protected by quantitative restrictions and by import levies; in Hungary "quality controls" for all imported commodities were introduced in October 1993 (Csaba 1994).

⁵A dramatic example of the effects of immediate import liberalisation is provided by the unification of Germany in 1990. When Eastern consumers experienced "free trade" within a united Germany and a 1:1 currency conversion rate, demand for East German goods collapsed in the face of West German competition. Industrial production declined more than 50% and unemployment surpassed 3.5 million, or more than 40% of the labour force (Koves 1992). East Germany is something of an exceptional case, but the effects of immediate import liberalisation were harsh also in CEC, notwithstanding the initial strong devaluation of their currencies (Oblath 1991).

⁶The EU's commitment to CEC membership came later, at the Copenhagen European Council of 1993.

⁷A system originally established in order to accord to imports from developing countries tariffs lower than those applicable under the most favoured nation regime.

⁸"*International Investment and International Trade in the Product Cycle*", Quarterly Journal of Economics, May 1966. For further works on the same theory see: W. Gruber, D. Metha, R. Vernon, "*The R and D Factor in International Trade and International Investment*", The Journal of Political Economy, February 1967; S. Hirsh, "*Location of Industry and International Competitiveness*", Clarendon Press, Oxford 1967.

⁹For an analysis of the relative efficacy of the Marshall Plan and of the post-1989 financial assistance to CEEC, see Harper (1998).

¹⁰See, among others, Faini and Portes (1995), Neven (1995), Kumar (1996), Kawecka-Wyrzykowska (1996).

Some Realities for Europe

David C. Acheson

It has become a settled article of U.S. foreign policy toward Europe, and hence part of the trans-Atlantic relationship, to encourage the integration of Europe. This was first manifested in the economic sphere back in the 1940s and '50s. More recently we see it in the security sphere in the form of U.S. cooperation with the Western European Union (WEU) and NATO's enlargement and Partnership for Peace. Such cooperation will surely continue as the European Union works toward a European Defense Identity and toward enlargement of EU membership. These are goals on which North Americans and Europeans generally agreed, though some differences remain about certain specifics. It is important not to let secondary differences obscure the common view of goals. NATO enlargement is a prime trans-Atlantic relationship. It should continue to move forward. Owing in part to the hesitancy of the EU, NATO enlargement has become the primary mode of integrating the trans-Atlantic community with central Europe. It does not matter as much what country is next to join as it matters that the process should recognize in a timely fashion the modernization and growing maturity of the nascent democracies. Some people say that we must never permit the Baltic republics to join NATO for fear of strengthening the reactionary forces in Russia. But is it not simply intolerable that we should carve out a sphere of influence for Russia that will be held back from the normal and desired relationships with the West? Are we really going to countenance the spirit of Yalta rising from its grave at the full moon?

In the future of the trans-Atlantic relationship there are several specific cases that will test our commitment to the consolidation of that relationship along the lines of democratic values. I will mention only two: former Yugoslavia and Turkey. The question of pacifying Bosnia and of civilizing Serbia and Croatia, when looked at from the near end, is heavily loaded with difficulties of history, religion, culture, logistics, resources and political will. Perhaps the military difficulties are the least difficult. The problems are far larger than Bosnia, of course, extending to the anti-democratic tradition in Croatia, Serbia and Bosnia itself, the political cynicism of the region and the low value it places upon human life. But when looked at from the far end, or the long run, it seems obvious that Europe cannot afford nor can it tolerate a sub-region of barbarism on its South-Eastern flank. As Europe becomes more unified, more prosperous, more sophisticated, the bloodstained, corrupt and backward slum comprising Tito's legacy will be increasingly intolerable to Europe and to the trans-Atlantic tradition. This is primarily a European

problem. North America should and will help, but the challenge is primarily to Europe. If the EU and its Defense Identity should turn away from this challenge, it will be in the position of a posh part of town that tries to ignore the high crime area on the other side of the avenue. Will western values be defied successfully by the new Visigoths? Is democracy going to prove too effete to deal with the South Slavs?

My other specific case is the question of Turkey. That country's evolution as a modern secular state is under attack both domestically and internationally. True enough, Turkey has a perverse way of making its problems worse and acting on bad public relations advice. But Turkey needs help. It needs help in resolving its Kurdish civil war, in adjusting to the democratic standards of a free press, and in achieving economic and political stability. That help must come from the west, that is, from Europe and North America. It is not constructive to deny Turkey the links with the EU that it so badly needs, or to decry Turkey's authoritarian lapses, or to exercise religious and ethnic prejudice toward Turkey. Trans-Atlantic values mean nothing if outreach is not a part of that tradition. Would the EU rather see a resentful and deteriorating situation next door in Turkey, or would it rather be part of the solution by engaging Turkey? If the aim is to have Turkey act more European, will that be made more or less likely by freezing Turkey out of Europe? Again, looking at this question from the far end it seems to me the clearly better course is to move toward integration.

In the few years just past, we have seen the economic and political goals of the trans-Atlantic community overshadow the perceived need for a common defense. This produces centrifugal forces that are becoming stronger and more obvious. Differences over trade, over economic sanctions and embargoes, and over styles of diplomacy are becoming more divisive than they were when a common threat pushed such differences into the background. It is unlikely that these divisive issues will diminish. Therefore, it seems to me imperative that the governments of the expanded Atlantic community develop ways of preventing our secondary and tertiary interests from obstructing the pursuit of our common primary interests. Let me mention a few specifics, and these must apply to all of us, my own country not least.

First, among allies prior consultation and consensus must be the rule. While it is tempting to go unilaterally for the preemptive press release, and while it is true that in some quarters - Washington not excluded - consultation is often viewed as a risk of leaks to the press, the larger risk is that failure of consultation will produce distrust and resentment. There is no repairing a loss of trust.

Second, after decades of observing efforts to apply economic sanctions to bad actors on the world scene, I have lost all faith in such sanctions. They do not punish governments or ruling elites. They are effective chiefly in three respects: sowing distrust and opposition among allies, punishing the poor and unprivileged in the population of the target country, and giving its rulers an external enemy to blame for the hard lot of the country. In dividing allies, sanctions in effect bet one's white chips against one's blue chips, to use poker terminology. They devalue allied cohesion and overvalue the symbolic gesture for domestic consumption. Only domestic politics provides any reason for this, but an important test of leadership is to resist such temptations and put the larger interest first.

Third, an appropriate prayer for statesmen and women might be, "Dear God, give me the strength to put my country's primary interests ahead of lesser interests and give me

the intelligence to know the difference.” National or allied security is clearly a primary interest. However, when a danger to national or allied security recedes, it can be difficult to assign priorities. Ultimately, G-8 foreign and finance ministers are tasked to review their respective policies and try to agree on what major interests they share, or on what lesser interests they differ, or at least that they might agree not to pursue mutually conflicting actions. Summits do not serve such a purpose for they are attended by too much publicity and necessarily produce lowest common denominator results.

Fourth, and this is closely related to my third point, foreign ministers, heads of government and parliaments, for that matter, must learn to accord greater tolerance toward differing views of friendly governments. In particular they must not meddle in the domestic affairs of other countries unless those actions pose external threats and they must not meddle in the relations of friendly governments with other states. My own country is gradually learning this lesson in its relations with China and I believe those relations are settling down to a more stable state of affairs. This has been brought about by the abandonment of shrill finger-pointing and the adoption of more mature conduct by both sides. I hope we may soon see our Congress retreat from its bullying intrusion into the relations of our allies with Cuba, but I am not able to predict when. The wise words of Disraeli come to mind, when he was pressed by certain parliamentarians to challenge Turkey over what, today, we would call human rights violations. He said, and this is only my recollection for I cannot trace the source: “I do not believe in a policy of scold.” Do not misunderstand me, I am not disavowing a policy of supporting human rights. We all want the world to be a better place. But in spite of much talk about globalism, we still live in a world of nation-states, and people live under the domestic laws and customs of their own country. Any national government that perceives its social order under criticism by foreign public opinion or governments is going to put its back up. If Castro and Jiang Zemin share any characteristic beside communist ideology, it is this.

What I have called the nascent European democracies have been the subject of much purple rhetoric in the past couple of years, rhetoric that depicts a new sunrise of democracy suffusing Europe and ushering in an historic age of enlightenment, peace and progress. I believe the reality is that some of those countries will face difficulties that will give us concern. We have seen Poland and Romania, and more recently the Czech Republic, suffer a backlash from reform, and we have probably not seen the end of this phenomenon. Democracy is hard, for it is commitment to a process, not to a result. If the result is unsatisfactory at a given time, it takes discipline and a deeply rooted democratic culture to say: “Well, I don’t like the outcome, but that’s democracy,” or to truly believe, as did Winston Churchill, that democracy is the worst form of government except all the others. When an entire generation has grown up in a command economy and a party oligarchy, the whole notion that in a democracy there will be winners and losers is hard to swallow, and for some intolerable. There is an understandable tentativeness on the part of the nascent democracies about total and irreversible immersion in the chilly waters of reform. Elections will inevitably reflect the shocks of this immersion. In your country and mine we are used to seeing the electorate punish governments that have fallen short of their undertakings, but that only involves party shifts within a democratic system, not a retreat from an entire political system. The West took fright when former communists took control of the Polish government two or three years ago. Before Constantinescu’s election we worried that Romania was waffling in its democratic course. There will be

more of this, in all likelihood, and the press will overplay its significance. The role of the established democracies is to be understanding, patient and helpful about the bumps in the road travelled by their emulators. Academics and journalists like to see things happen by the book, for they deal in words, and they tend to be critical of the constraints of real life, if you will excuse a rather broad generalization.

You have surely read a lot of rot in the press in the last six months about America being the only surviving superpower. The term, "superpower," a classic press cliché, brushes off the ambiguous realities, so we must be skeptical of it as we should be of other thought-stoppers. The reality is that international interdependence in the economic and security spheres is far too complex to be controlled by any nation. A quick look at the international terrain will quickly confirm that superpower status does not bestow immunities or the power to command. Look at some examples: American markets have been badly rattled by the poor management of lending practices, monetary policy and financial institutions in a number of countries in Asia and there may be more to come. American forces in Bosnia, even in cooperation with allies, have not been able to ensure the safe return of civilian refugees to their homes. The bussing to the polls of voters in the last elections there under armed guard - because their residences could not be protected by NATO forces - was a sobering reminder of the limits of power. The stalemate of the UN weapons inspection team in Iraq is another reminder. The common lesson is that power is limited by the will to use it and by the cost of using it. Judged by these pragmatic limits, America is not a superpower. I have long believed that the best definition of power in international relations is the ability and the will to influence the conduct of other states. When you think about the concrete cases - Bosnia, Israel and PLO, China, Iraq, all cases in which the United States and other friendly nations have significant national interests - you can readily see that pride in the appellation of "superpower" is not justified.

If we - and now I mean all of us - wish to influence the conduct of other states, those other states must be of like mind with ourselves. That presupposes common purpose, agreement on aims. In diplomacy this can only be achieved by consultation, persuasion, trade-offs, compromise, and mutual respect. All this must start with the recognition that your national interest and mine do not necessarily proceed from the same premises. Power, therefore, is a paradox. It can flow from humility and compromise. It is not likely to flow from unilateral *démarche* or dictation. One is reminded of the Aesop fable about the wager between the sun and the North wind as to which of them could force the traveler to remove his cloak. The sun won the wager, of course, because the harder the North wind blew, the more closely the traveler wrapped his cloak around his body. The sun, however, warmed the traveler to the point that his cloak became uncomfortable and he took it off voluntarily. The North wind is what we might call the Helms-Burton approach, and we can see that it is working no better in real life than it did in the fable.

With these reflections in mind let us consider a few simple rules for governments that seek to influence other states toward concrete action on whatever issue you please:

1. Identify the major goal or goals around which concert is sought. Make these aims as few and as cardinal as possible, since multiplicity of goals will multiply differences.
2. Identify secondary interests that will be divergent among the parties and plan the trade-offs for maximum leverage.
3. Do not go public with a position until allies and other states one wishes to co-opt are consulted and prepared to go public with their respective statements.

4. If there is any holy writ in seeking concerted action, it is “no surprises among friends.” Surprises are taken in diplomacy as efforts to pre-empt actions of other parties, the very opposite of consultation, and mutual trust is damaged thereby. In Harold Macmillan’s memoirs he leveled this criticism at John Foster Dulles.

5. Act upon opportunities to compliment your opposite numbers in office and to emphasize the positive aspects of your relationships, making your differences as small a target as possible for troublemakers in the press or the opposition. The great leaders are those who by generosity of spirit and far-sightedness command the respect of all those with whom they deal. ●

From Kosovo to Bosnia and Back

Pierre Hassner

Since 1991, a saying has repeatedly come up in conversations in the former Yugoslavia: "The war has started in Kosovo and will end in Kosovo." It is indeed true that the immediate source of the war was Milosevic's pledge to the Serbs in 1987 and his suppression of Kosovo's autonomy in 1989. While war and ethnic cleansing were raging first in Croatia, then in Bosnia-Herzegovina, Kosovo has remained deceptively quiet. The time was bound to come, however, when the Albanian population would no longer accept the immobile strategy of its leader, Ibrahim Rugova, based on non-violence and the building of an alternative society, but also on an intransigent demand for independence under a temporary international protectorate. Now the time of both violent confrontation and negotiation has come. The adversarial parties, as well as the outside powers, look to the lessons of Bosnia.

Indeed, there are obvious differences, namely, the much greater homogeneity of Kosovo, where the Albanians are an overwhelming majority, their even greater weakness *vis-à-vis* the Serbs, and the greater difficulty of finding military help and diplomatic support from outside. Yet, there are also many similarities: the contradiction between the principles of self-determination and of the inviolability of borders, the impossibility of clearly separating civil and inter-state war, and negotiation and military force (meaningful negotiations took place in Bosnia only when the balance was re-established by the Croatian and Bosnian offensive, the American bombing and the Franco-British Rapid Reaction Force). Similarly, the logic of escalation and that of negotiation are both at work between Serbs and Albanians in Kosovo. Student demonstrations and violent actions of the mysterious "Kosovo Liberation Army" have done more in a few weeks to hasten negotiations than Rugova's policy of relying exclusively on the good will of the International Community during the last nine years. But, they may also, by leading to Serb repression and Albanian popular mobilizations make the same negotiation impossible for a long time if outside powers are unable to stop the violence and pressure both sides into meaningful talks.

In this limited space, I would like to stress only two slightly less obvious lessons from Bosnia: the problem of different time-scales and the uses and abuses of ambiguity.

In Bosnia, the outside world was extremely slow in responding meaningfully, but, once it did, its main preoccupation was with deadlines and exit strategies. The slow timing

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of international decision-making and action contrasted with the quick timing of escalation on the ground. But after the peace was signed, the reality of supposed domestic pressures for a quick pull-out of American forces contrasted with the slow timing of economic, social, political and moral reconstruction and reconciliation on the ground. In Kosovo the international community has waited far too long (nine interminable years) before intervening. Once violence erupted it has been much quicker to react than in Bosnia; but, like there, the international community must realize that a real solution must take years and years of presence and pressure.

The same paradox applies to ambiguity. The lack of clarity and credibility of the declaratory policy of Europe, the United States and the United Nations has led to illusions on the Bosnian side about international intervention and to parallel illusions of omnipotence and impunity on the part of the Serbs. Yet the main virtue of the Dayton Agreement is its ambiguity: today Bosnia-Herzegovina is living under a contradictory regime which can be characterized as “half-partition” (prompted by local elites) and “half-protectorate” (prompted by the High Representative Mr. Westendorf and the United States). Similarly, in Kosovo, the ambiguity of international declarations that violence and ethnic cleansing will not be tolerated is extremely harmful; but the future status of Kosovo can only be based on ambiguity (for instance an independent Kosovo republic but within the Yugoslav federation), which is the only way of reconciling, at least for a time, the opposite claims and interpretations of the parties in the conflict. ●

In The Whirlwind of Change: NATO and Transatlantic Security

Marten van Heuven

While Europe is focused with hope and mixed uncertainty on the appearance of a common currency, the ratification of the protocols enlarging NATO by three countries has focused the American debate on the Alliance. Thus, it is appropriate to go back to the basic questions: what is NATO doing, and what are the implications?

First, NATO is enlarging. What a year ago looked conjectural is now becoming a fact, with bipartisan support in Congress. The almost certain accession of Poland, the Czech Republic, and Hungary in April 1999, on the 50th anniversary of the signing of the North Atlantic Treaty, will be a matter of profound satisfaction to millions of East Central Europeans. Without effective voice since World War II, these people see joining NATO both as a symbolic recapture of their Europeanness, as well as a practical step to assuage their historic security concerns. They instinctively share the position of NATO that enlargement will enhance stability in Europe.

Second, in 1994 NATO embarked on a Partnership for Peace (PFP). Initially, the Partnership opened the door to formal relationships between NATO and individual Partner countries. Key elements of these partnership arrangements were practical military cooperation and exercises. Over time, NATO developed a pattern of meetings with all PFP countries. The program has been highly successful. At present, there are 27 Partners. Last year, at Sintra, Portugal, NATO created a Euro-Atlantic Partnership Council (EAPC). The essential role of the EAPC will be to manage an enhanced PFP program. The EAPC charter is comprehensive. It is to "provide the overarching framework for consultations among its members on a broad range of political and security-related issues." These include but are not limited to "political and security related matters; crisis management; regional matters" and a list of other specific topics.

Third, NATO has taken on military and other duties in Bosnia pursuant to the Dayton agreements. Fifteen PFP countries are now contributing forces to the NATO-led Stabilization Force (SFOR) in Bosnia. Even Russia, a PFP member, has forces in Bosnia, under special command arrangements. These activities are a first for NATO. They amount to an out-of-(NATO) area involvement pursuant to an international agreement, with the

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approval of the UN Security Council. This is not merely a stop-gap arrangement. NATO forces have been in Bosnia for over two years. They are likely to stay for some time to come. The NATO force presence has made a significant contribution to peace and stability in the area.

Fourth, NATO is bringing Russia into European security arrangements. In the Founding Act on Mutual Relations, Cooperation and Security of May 27, 1997, NATO and Russia established a Permanent Joint Council (PJC). The central objective of the PJC is to build trust, unity of purpose, and cooperation. The mandate of the PJC, like that of the EAPC, is extensive. It will be the mechanism "for consultation, coordination and ... for joint decisions and joint action with respect to security issues of common concern." It will be the "principal venue of consultation" between NATO and Russia "in times of crisis or for any other situation affecting peace and stability." In rough parallel to the Founding Act and the PJC, NATO has also established with Ukraine a Charter on a Distinctive Partnership and a NATO-Ukraine Commission, focused on Ukrainian security.

These four activities are hardly business as usual for NATO. They represent new directions that even a few years ago would have been hardly conceivable. For each of these four activities, the year 1997 was a milestone: the signing of the enlargement protocols, the establishment of the EAPC and the PJC, and the decision to keep NATO forces in Bosnia (rebaptized from IFOR to SFOR). These NATO decisions point to the vigor of an organization that a few years earlier seemed to have run out of purpose and direction. However, these NATO actions also have consequences and raise new issues.

Enlargement will affect the politics of the Alliance. With still more members, consensus decision-making will not become simpler. This will be true even before the three invited members formally join. Moreover, given the state of their defense establishments, it is not yet certain to what degree these prospective "consumers" will also be "providers" of European security. Furthermore, the effect on Russia of the enlargement process will remain to be tested further. For now, Moscow will accommodate itself to NATO's eastward extension. Objectively, Russians know - or should know - that NATO is no more a threat to their country than it ever was to the Soviet Union in the days of the Cold War. However, the issue is largely one of perception, and perceptions can be changed in the course of Russian domestic politics. Finally, the strategic issue how far NATO enlargement can ultimately go is left open. This should not be a cause of concern now. In times of rapid change, flexibility can be useful. The answer to this question will be shaped as the situation in Europe evolves. Leaving the question open, however, will contribute to some sense of uncertainty, particularly on the part of the Baltic countries. They very much want to join NATO but worry that this day may be a long time off. Meanwhile, the active interest in their future on the part of their Scandinavian neighbors and the Charter of Partnership with the United States will substantially but not wholly assuage Baltic concerns.

EAPC will also affect the politics of the Alliance. Before, NATO dealt with each PFP country individually. Now, the group of 27 Partners outnumber the 16 members of NATO. This creates the possibility that, if organized, PFP countries as a group can exercise greater influence than they could individually. Also, while in the past NATO was in the driver's seat for PFP, enhanced PFP will have many masters in the EAPC. Furthermore, given the mandate of the EAPC under its charter to deal with European security issues in the widest sense, there is a potential for diluting the role of the North

Atlantic Council (NAC). To be sure, NATO has made it explicit that the new arrangements do not derogate from the competence of the Council as exclusive NATO agent to deal with issues of NATO security. Nonetheless, the new arrangements now put the EAPC alongside the NAC. And while Article 5 of the NATO Treaty commits only members to respond to an armed attack, nothing prevents a Partner from acting as if Article 5 also applied to it. Finally, how Article 5 should be applied in practice under the entirely new circumstances in Europe today is likely to be determined by the circumstances of each case. PFP countries will almost certainly have a role in this process.

The Bosnia experience has put NATO in a new role. For the first time, NATO is out-of-area, albeit close to NATO territory in Europe. However, the successful deployment of the NATO-led successive IFOR and SFOR - the NATO force has been crucial to setting the stage for implementation of the Dayton agreements - should not lead to the assumption that it will be a precedent. The current Kosovo crisis is a case in point. Long regarded as a potential flashpoint, Kosovo has now crossed the threshold of violence. NATO intervention, however, is unlikely, despite all the lessons that have purportedly been learned from the Yugoslav breakup. Bosnia was an internationally recognized state. Kosovo is a part of Serbia. The UN Security Council authorized NATO intervention. As of this writing, the Council has not acted with respect to Kosovo. Indeed, Kosovo is not even on the Council's agenda. In Bosnia, NATO forces entered to implement an international agreement. There is no such agreement with respect to Kosovo. Thus, the NATO deployment in Bosnia is not a precedent, nor a harbinger of future NATO deployments in and around Europe whenever there is a need to prevent or to quell violence. This conclusion applies *a fortiori* to any possible out-of-area deployments of NATO-led forces outside of Europe.

Finally, Russia now has a place in the European security system. In fact, it has several places: permanent membership in the UN Security Council, a long-standing membership of the Organization for Security and Cooperation in Europe, a seat on the Contact Group for Bosnia, membership in the new EAPC, and membership in the PJC. The issue is not whether Russia is part of the European security structure. It is. The issue is rather how Russia will play its role. This Russian role will be determined by a number of variables, key of which will be Russian domestic imperatives, and the Russian assessment of national interest. This is not to say that the United States and other Western countries are without leverage. Russia needs the West. Russia's role in European security, however, is hard to predict and will be situation-specific.

In conclusion, NATO has created new tools and set out in new directions. Whether or just how it will succeed will depend on many variables. Key among them will be NATO cohesion, leadership within the Alliance, the role of Russia, and the nature of the challenges that may lie ahead. Finally, the record so far suggests that, for better or worse, a leading American role will continue to be an indispensable ingredient to NATO success. ●

The EU Potential for Conflict Resolution in the Middle East

I. William Zartman

Now that the Albright missions to the Middle East has failed, it is important to examine alternative means to putting the Peace Process back on track.¹ Of all the third parties watching the compounding deadlock between the principal parties, the European Union (EU) is best placed to pick up the challenge; neither the Arab states nor Russia is in any position to play any mediatory role. But the momentary failure of the reigning mediator does not guarantee the success of its replacement. To the contrary, it highlights the difficulties that any intervenor will have to overcome. So it is not the quality of the EU as a world player with power and interests that needs emphasis and analysis, but its strategy in regard to the stalemate.

Let three premises be stated from the outset. The first is that a European alternative is worth discussing even if a common foreign policy approach is not assured. To be sure, a European foreign policy position toward the Middle East in competition with different foreign policies pursued by its members is wasteful, disuniting, and aggravating to both target and observing countries; but a European position that unites a large number of the member countries increases their impact, even if there are one or two dissenters. Obviously, any European strategy will have to be sold to EU members; agreement cannot be assumed from the start. On the other hand, the desirability of unity does not preclude different strategies by different members in service of the same policy; the “good cop, bad cop” routine is one of the most effective ploys even though everyone knows that they both work for the same outfit.

The second premise is that the “two cop” rule applies to US-EU relations as well. A European initiative brings in a rival matchmaker, a situation with obvious structural complications. Not only do both third parties want to succeed in a common goal - in making the match, but each wants to succeed in a competing goal - to enhance its own

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power and interests in the region. Experience and analysis show that a frequent undoing of mediation is the presence, not of too many, but of uncoordinated mediators. While keeping the integrity of their own *démarche*, European diplomats would need to communicate actively with the US and make major efforts to allay fears and calm rivalries. Whatever the case that can be made for an EU *démarche*, it is certain that the EU cannot arrive at its ultimate goal alone. Once it has gotten the Peace Process restarted, at most, it will need the active cooperation of the US to keep the restarted Process going. Carping and sabotage between matchmakers, as has too often been noted in the past, is counterproductive to both mediators.

But coordination means that there is something to coordinate, not simply that one party is following at a respectful distance behind the other. The only way for one partner to attract respect and cooperation from the other is for it to have its own policy integrity and autonomy. This is particularly true at times when American policy is weak or hamstrung by domestic considerations, leaving a policy vacuum and a role for others (Quandt 1991). The importance of the effort and the weight of a European position should not be underestimated. If there is any limitation on Europe's clout in regard to the Middle East, it is not produced by some inherent inferiority *vis-à-vis* the United States but by Europe's diffidence and disunity. Europe's propinquity, historic relations, current trade, especially in oil and gas, and demographic ties underwrite its interest in the Middle East. These interests are the basis of a policy that has both a right to stand on its own and a duty to coordinate with that of the US.

The third premise is that the Peace Process - based on UNSC/R242 of 1967; launched through the 1973-74 disengagements, the Camp David Agreements (1978), and the peace treaties between Egypt and Israel (1979) and between Jordan and Israel (1994); revived through the Madrid process (begun in 1991) and its offshoot, the Oslo Agreements of 1993 and 1995 (including the Hebron Agreement of 1997) - has neither ended nor is irrelevant (Quandt 1993). Although some have suggested that the step-by-step nature of the Peace Process has ended its usefulness (Kissinger 1997; Krauthammer 1997; Siegman 1997), there is a confusion in these comments between the fact that the Process is now approaching vital issues and the judgment whether step-by-step is the best way to handle them.

The Peace Process is arriving where it was supposed to: at the core decisions over statehood, borders, and security arrangements. As a process, it was to create mutual confidence along the way to its destination. It has not done this, at least not as completely as was expected. But the parties are looking each other in the face and recognizing each other's existence and legitimacy, whether they like it or not, and doing so under the extremely destabilizing conditions created by an extremist, rejectionist minority on both sides. To propose to use a momentary downturn in that *rapprochement* process to skip the remaining steps and jump to a final settlement is to replace a chance at a lasting solution with a momentary tactical advantage for one side (or for one view of one side).

The Palestinians are and should be uninterested in a final agreement at this time because they do not feel they can get a fair deal. None of the proposals for a final jump deal with this problem; indeed, none of them indicate how they would overcome the blockage and change in formula posed by the present Israeli government that constitute the current problem in the first place. In other words, it is precisely because the Peace

Process has not completed its work that a jump to final negotiations is unwarranted at this time.

But for the current argument, this does not matter. The following discussion aims at the applicability of any sort of process. Since the purpose of a European *démarche* would be to get a process restarted, it is not particularly dependent on the type of process it would begin.

Assessment

To start with the obvious, there is a deadlock in the Peace Process, but - paradoxically - not a stalemate. The Process has been stopped, although probably not yet irrecoverably destroyed. The situation is Sartre's Hell - No Way Out (*Huis clos*). Palestine is the problem. Israel has the solution. Palestinians cannot impose the solution, they can only augment the problem. In withholding the solution, Israel only augments the problem.

But the blockage is one-sided. One side - Israel - is not stopped at all, but is moving ahead, making new facts on the ground - expanding settlements, changing attitudes, so that reconciliation becomes harder. There is no agreement among observers whether the Israeli government of Benjamin Netanyahu has a plan or is simply moving from moment to moment, animated by the need to stay in office. If there is a plan, it is to pursue a number of disparate objectives - build settlements, engage the Palestinian Authority (PA) in an anti-terrorist strategy, weaken the PA by withholding payments and other measures - to the point where a popular reaction of frustration explodes and the Palestinians show by their actions that the Peace Process is dead and that security requires a policy of repression, not of reconciliation. If there is no plan, the same disparate objectives are being pursued for their own sake alone, with the same result which is, however, not planned as a causal sequence.

The other side - the Palestinians' - is indeed blocked. It is a policy-taker, having the choice of either going along with Israeli policy, or going along with it in different ways.² If, as an alternative to accepting Israeli policy, it resists, it will merely reinforce the Israeli policy by dismantling peace and reconciliation, by changing attitudes in responding to the provocation, and by making it even more difficult to restart the Process. The PA is obliged by the situation to resist following the Israeli policy lead as much as possible, lest it show its weakness and cede its place of leadership among its people to Hamas or other hard-line rivals. The survival instincts of Chairman Arafat reinforce this calculation.

While it is true that the Peace Process is a diplomatic activity very much in the ultimate hands of the respective populations, neither side is doing anything to appeal to the other's population to move the process forward. A pre-negotiation analysis shows it should (Stein 1994). Indeed, the Oslo Agreements themselves suffered from reentry problems and from their failure to provide for a public relations campaign and grassroots dialogue back home. As one Israeli negotiator at Oslo has stated, "Oslo killed Rabin and Hamas elected Netanyahu" (Pruitt 1997, p 139). The latter's tactics have continued to nurture that relationship. It is now very difficult for the Palestinian population or its leadership to adopt a strategy of trustworthiness in the face of Israeli government tactics without looking like a patsy - particularly in the light of its widespread view that it is worse off after Oslo than before, just as it is difficult for Israeli doves to appeal to the Palestinians in the context of Israeli government policy.

Terrorism, it should be recognized, is a side product of the Peace Process and can be caused by both progress and non-progress. As an evil, it need be separated from the Peace Process and treated on its own, by appropriate security measures. The great trap of terrorism, into which many governments around the world have fallen, occurs when governments adopt measures that treat all of the opposing population as if they were terrorists, thus forcing them into a self-proving hypothesis that makes them allies of the agents from which they should be separated. Israeli measures have done this not only to the Palestinian population but also to the PA itself. Instead, assuming it is interested in the Peace Process, the Israeli government should be giving the PA incentives for distancing itself and its population from the terrorists by showing progress in the Peace Process. It does the reverse.

This is not a ripe moment. The classical components of ripeness are a mutually hurting stalemate (MHS) (optimally strengthened by a recently avoided or impending catastrophe), valid spokesmen, and the perception of a way out (Zartman 1989). None of these exists today. In the current deadlock, hurt is not mutual; there is a struggle for the role of valid spokesman, on both sides but particularly for the Palestinian side; and the perception of a formula for a solution to the conflict is being contested and destroyed. The Oslo Agreement set up a process that was moving gradually toward a two-state solution under conditions of security to be worked out to the satisfaction of both sides (according to the 30-year old formula of "territory for security" (UNSC/R 242)). However, that outcome is being removed from the agenda by the Israeli government with no clear replacement in sight. Just getting talks restarted in such conditions is a pointless illusion, since the conditions for talking are not present.

There is an alternative to the push of ripeness as defined by a mutually hurting stalemate, and that is ripeness marked by its positive equivalent, a mutually enticing opportunity (MEO) (Zartman 1995, 1997). Such "pull moments" are rare. The initiation of the Madrid Conference in 1991 (by promising improved relations with the US mediator if the two parties would attend) was a possible example. Good relations with the US are not as much of a drawing point at the end of the decade, but if this constitutes an opening for Europe, it will have to be manufactured with much less ready raw material. MEOs often occur in the midst of a soft stalemate, a bearable, if costly, deadlock, or a "grinding crisis" such as exists in the Middle East. Mediation in such contexts is necessary to help the parties out of their bind but it must create its own entry point.

Policy

"Ripeness theory" indicates that when moments are not ripe, interested parties can either work to ripen them or position themselves for a later moment when ripeness occurs (Zartman 1989; Haass 1990). Positioning should be treated as a fall-back, so that any efforts at ripening do not destroy the possibility of staying in the action if they fail. Ripening would involve producing a perception by both parties either of an enticing opportunity which would pull them off their deadlock, or of a mutually hurting stalemate that would push them to look for a way out attractive to both sides. The opportunity could be in regard either to the problem or to relations with the mediator.

For the Peace Process to move ahead, the structural imbalance of the sides needs to be redressed. The Palestinians will always be the *demandeur* and the policy-taker but

need to be strengthened so as not to be at the mercy of the other side in the negotiations. Assistance in redressing the imbalance removes the temptation to resort to violence in an attempt - doubtless unsuccessful - to achieve the same end. A number of measures can be taken to provide internal resources for the Palestinians and reduce their dependence on Israel. The PA is dependent on Israel for remission of the taxes that make up about 60 percent of its budget, a situation that dramatically symbolizes the structural imbalance. European aid payments to the PA to replace these withheld funds on an urgent basis would restore the PA's ability to carry out its own internal duties toward its citizens and would free it from an element of dependency on Israel. The payments, which do not involve large amounts, could be made on an interest-free loan basis, until complete Israeli payments were made, or could be subtracted from any European countries' aid payments to Israel if there are such.

In this situation, it would also be appropriate if the international aid and investment discussed in the 1994 donors' conference were forthcoming in the promised amounts. EU members who have not filled their quotas would, without any offence to Israel, strengthen the Palestinians and redress the imbalance by investing in the West Bank and Gazan economies and by providing aid for development projects that the territories so desperately need. Health, education, and development (investment) are three areas of depressed activity in the Palestinian territories due to lack of money (Sneth 1992). Interestingly, all three are areas where private activities and civil society can play a crucial role independent of government, so that aid and investments can be offered from abroad to government or non-government agencies to foster socio-economic well-being.

Such economic measures have a number of important effects, beyond diluting Palestinian dependence on Israel. They would also strengthen Palestinian civil society, enabling it to deal with the PA as a partner and a control, which in turn would strengthen the integrity and the performance of the PA. In addition, they would also undercut the message of Hamas and other rejectionists by showing the tangible effects of the Oslo process in improving people's lives and at the same time demonstrate the faith of the outside world in the promise of that process. There is no end of studies on the measures and opportunities necessary for Palestinian development and, beyond that, for Palestinian-Israeli(-Jordanian) economic cooperation (e.g. Fischer, Hausman, Karasik & Schelling 1994; Fischer, Rodtic & Tumaç 1993) - all waiting to be implemented.

A third measure to weaken Palestinian dependence involves the development of direct access to Palestinian territory unmediated by Israel. This means above all the construction of a seaport at Gaza, as outlined in a Tel Aviv University feasibility study. The major ingredient required is cement, which has been barred by Israeli restrictions on commerce between Israel and the territories. Physically, there are other directions than from the north and east from which cement could arrive in Gaza, either from Egypt in the south or by direct landings on the coast to the west. There is little wonder that Israel has refused to authorize the port construction or the importation of cement: "authorization" and "refusal" are words of dependency and epitomize Palestinian dependence on Israel, and the completion of the port would provide unmediated communication between the Palestinian entity and the external world. The EU and its members are in a fine position to make this access possible.

Similarly, a desalinization plant at Gaza would be another crucial contribution to the mitigation of Palestinian dependence on Israel. At the same time, it would make a

positive contribution to the knotty problems of interdependent water shortage in the area, in effect reducing the burden that the Gazan population places on the Israeli water system. From this point of view, construction of a desalinization plant should be welcomed by Israel, although, of course, other views of Israeli interests would suggest opposition.

It would also be appropriate in this situation to indicate displeasure with the hard-line measures practiced by the current Israeli government, as another means of equilibrating the relations between the parties. Secretary Albright specifically mentioned objectionable measures - "provocative expansion of settlements, land confiscation, home demolitions, and confiscation of ID" (NY Times, 12 Sept. 1997) - without much effect; more tangible expressions of disapproval could be made. Prime Minister Netanyahu has made a number of foreign visits while these measures have been implemented, sometimes even apparently to avoid being on the scene during initial reactions (as, for example, during the opening of the tunnel along the temple wall). Refusal by EU members to receive such visits, even if they are unrelated to Israeli-Palestinian relations, would be an appropriate sign of disapproval (actions of this type by President Clinton and the German government in October 1997 are examples). Other such signals can be envisaged.

Finally, on the direct policy side, an EU declaration against leaping to a final solution would be an important contribution to maintaining the step-by-step process. The fact that the process over the past two decades has not built up the necessary confidence between the two sides is not a condemnation of the process but a testimony to the need for its continuation. Like terrorism, the current Israeli measures are designed to further destroy confidence, to the point where distrust becomes irreversible. The difference between the two sets of activities is that terrorism (on both sides - it was not a Hamas member who killed Rabin) is not the work of the official representatives of either side, whereas the measures against the Palestinians are official Israeli government policy. A European statement focussing on the reconstruction of confidence and condemning measures that destroy confidence and that seek to take advantage of its destruction would also help mitigate the structural disequilibrium between the two sides and would focus the process on the directions it must take to remain alive.

In coda, while governments position for a riper moment and help the ripening process, it is important to underline the contribution that can be made on the unofficial side by a spectrum of "track two" activities (Kelman 1979, 1987, 1993; McDonald 1991). Conferences, colloquia, dialogue groups, and joint projects can build networks of bridges required for the preparation of official negotiations (Stein 1991). These bridges need both to give confidence to the "doves" on each side and to work on the conversion of "hawks" into "doves." They need also to cross the line between the two sides and build support within the other side for the Peace Process and confidence in its popular support on the originating side. Even in times of official support, politicians may be too busy selling their policies to their own reluctant followers and not be able to pay enough attention to selling those policies to the supporters of their partners or adversaries on the other side. As noted, this was the failing of the post-Oslo period, and lessons should be drawn from that failure for the future of the process.

General Considerations

In considering the general approach put forward here, it is important to return to some of the initial assumptions. The equilibrating *démarches* suggested would work best in close conjunction with an American policy which also maintains its announced commitment to the Peace Process and the Oslo track. This would put the two Western allies in the classical “good cop, bad cop” (or, “bad cop, good cop”) relationship to the two parties in the Middle East. Such tactics can be very successful, particularly if the policies of a Europe less powerful in the region were to drive the parties into the waiting arms of the usual American mediator equally committed to the same process. The assumptions of this strategy, which need to be underlined in red, are quiet coordination between the two Western partners and joint commitment to the same step-by-step process. If coordination and common orientation are missing, the activities of either party become merely a display of weakness and a target of scorn before the extremists of both sides.

The above analysis and proposals may appear to be insufficient because they do not go on into direct mediation strategies and measures for taking the next steps. That lacuna is only apparent. On one hand, what is now necessary is not an idea for reopening talks but measures for restoring some balance between the two sides so that profitable negotiations - however opened - can take place. Repeated studies indicate that negotiation needs to take place best between approximate equals and that imparting a sense of equality facilitates negotiation (Rubin & Zartman 1996). The manifest inequality and dependency that characterize the structure of relations between Israel and Palestine constitute a serious hindrance to any fruitful negotiations. The Oslo negotiations involved a number of trades over time so that the step-by-step process could create greater equality between the parties (Pruitt 1997). In the current situation efforts to create greater equality are necessary to the revival of the process, whatever its subsequent path.

On the other hand, that path is already indicated, and it would be a wasteful diversion, costly in confidence, to try to invent a new one. The Oslo Accords provide for successive negotiation stages for the transfer of authority, stages which are designed to build competence and confidence at the same time. No alternative proposal aired to date has indicated any process which provides either the same or substitute advantages, and all proposals for a single final negotiation simply assume the existence of pro-negotiation conditions (Stein 1994) whose provision only the step-by-step process addresses. The challenge to any *démarche*, European or other, is to get the Oslo process back on the track to completion. Eventually, a new round of negotiation needs to be scheduled, less secretly than Oslo but much less under the glare of expectant publicity than previous negotiations. Possibly a prior discussion of the general shape of results in a EU-Israeli-Palestinian forum could lay the groundwork for an official diplomatic meeting that would finalize and officialize details.

Finally, let it be noted that a focus on establishing a certain equality and autonomy between the parties is not a pro-Palestinian policy. It is a pro-peace policy. There is no need to go into the catastrophic failure of the policy of dealing with the Mideast situation by war, by mutual denial and by military balance over past decades. The need to proceed with negotiations implies the need to create the conditions for negotiations and the need to look to envisage an equitable outcome toward which such negotiations should advance. An ostensibly small European role in that effort can have important implications for a process that benefits both parties. ●

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¹This is not the place to debate this judgement. The mission obviously had positive elements, beginning with its very occurrence. The statement is made to counter the second-breath hype that tried to assert its success, and because of its inability to change the current elements of deadlock, two good reasons to call it a failure.

²The Palestinians as an ensemble will be referred to by that name. When specific Palestinian parties are referred to - Palestinian Authority (PA), Palestinian Liberation Organization (PLO), Yasir Arafat, Hamas, or others - they will be mentioned by name.

Defence and Security: the Role of Europe's Smaller Countries

Joris Voorhoeve

All Western European countries, be they large or small, are subject to powerful external international forces which they cannot control by themselves. Both large and small countries therefore have the same need for strong international organisations to collectively defend the interests and values of Western Europe.

It is not always possible to draw a distinct line between small and large countries. To take the Netherlands as an example: in geographical terms it is a very small country, if we look at the size of the population it is average for a member of the European Union, and in terms of economy and finance it is a medium-sized country, particularly with regard to its very large investments abroad. I therefore sometimes refer to the Netherlands as a "pocket-size middle power."

In general terms, Germany, France and Great Britain are thought of as the large countries of the European Union. These countries are distinct from the other member states on the basis of a combination of factors such as their international political position, geographical size, population, economic weight and military power. In a broader perspective, Italy and Spain may also belong to the group of large countries. But, the differences between these two countries are considerable: the Gross National Product of Italy is, at 1,100 billion dollars, almost twice as high as that of Spain (582 billion dollars).

The common denominator for the smaller countries in Europe is the fact that they have to protect their interests with limited means of power. To this end, they have joined international cooperative organisations such as NATO and the European Union. Certainly for all countries, it is an interest, in itself, for these international organisations to function well. This certainly applies with regard to the new international relations which have taken shape since 1989: the familiar threat of a large-scale offensive with a short response gave way to a much less distinct security situation, which, however, is not without serious risks.

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Reorganisation of NATO

In June 1996 in Berlin, the North Atlantic Council decided that the adaptation of the allied structures should contribute to the creation of a European defence and security identity within NATO. The development of the Combined-Joint Task Force (CJTF) concept should, among others, enable the use of "separable but not separate military capabilities" in WEU-led operations. Efforts to bring about a European defence identity should go hand-in-hand with preserving and reinforcing transatlantic relations.

The French *rapprochement* with NATO deserves special mention, as it has been crucial to the development of a European defence identity within NATO. A European defence that extricates itself from the Americans is not possible, nor a European defence without the French. Hopefully, further *rapprochement* with France will lead to a return of France to the integrated command structure in the years to come.

Over the last few decades it has often been said and written that further-reaching European cooperation would ultimately clash with healthy relations with the United States. "Berlin," however, offers the possibility of reconciling the two.

There are more reasons for regarding NATO's new approach in a positive light. NATO is a tried and tested organisation, and is the most suited to lead larger and more complex operations. From a political, military, and financial point of view, it would be bad politics to create an entirely new politico-military organisation for European operations.

We must not blithely assume that the American involvement in peace and security in Europe will always remain as close as it has been in recent decades. Domestic political discussion in the United States sometimes shows a certain amount of disaffection with Europe. We must make an effort to promote lasting American involvement. This is another good reason for continuing to use NATO wherever possible.

Effectiveness of the EU and WEU

Effectiveness, or capability to act, is a subject that is discussed extensively in the European Union and the Western European Union. And rightly so, for this aspect is in urgent need for improvement. One of the solutions in the European Union may be more decision-making with majority voting. Thus far this has not proved to be the solution for the common foreign and security policy.

Whatever the case, such a development is certainly not possible for defence: no member state would permit the erosion of its sovereign rights in this aspect. A certain amount of flexibility must apply at the military level: countries not wishing to participate in an operation cannot be forced to do so; in turn, they cannot prevent others from doing so. These are what are known as "coalitions of the willing and able."

Both the common foreign and security policy and the WEU would certainly benefit if the largest member states agreed with each other more often. This would also be in the interest of smaller member states, which have an equally great need for well-functioning international organisations. However, accord is all too often out of reach, regarding both foreign policy issues and the possible deployment of military personnel. Last year, a role for the WEU in Albania was initially not even raised for discussion in the WEU, for fear of discord. Only after endless talks did a small police advisory mission come into being. The WEU could play a useful role for this very type of limited operations. If we also look at the European response to the crisis with Iraq regarding UNSCOM, and at the violence

and tension in Kosovo, what we hear are usually the interpretations and opinions of individual European countries. Because these interpretations and opinions are rather diverse, the European Union does not assume a clear standpoint in such matters.

As long as Germany, France and Great Britain fail to agree with each other a great deal more than is currently the case, the prospect of a European security and defence policy will remain poor. For the time being, it would be better for the WEU to concentrate on the common implementation of none too complex tasks, which require relatively few resources. The most important way of giving more shape to European security and defence politics is still the NATO framework, as brought up to date by decisions taken in Berlin.

Smaller Countries as Brokers

Acting as a type of diplomatic broker, some of the smaller countries can sometimes play a useful role, also in the field of defence. Over the last few years, the armed forces of the Netherlands have entered into a large number of bilateral and multilateral cooperative frameworks, with, in the first place, the German-Netherlands Corps. It is important to note that the Dutch armed forces have not limited themselves to one cooperative partner. In recent years there have been various initiatives which, apart, from Germany, have been focused on Great Britain, France and Belgium in particular.

An agreement has been entered into with Great Britain, that provides for structural cooperation in preparing for and conducting crisis management tasks. A number of Dutch officers have for some time now been working at French headquarters. This is important if we are to become familiar with the ways of thinking and working within the French armed forces. The integrated Belgian-Dutch naval headquarters is now functioning in the Dutch naval base at Den Helder. The Belgian and Dutch air forces are also cooperating in the Deployable Air Task Force, which has led, among other things, to a combined detachment in Villafranca. Furthermore, the Netherlands is participating in new international initiatives, such as the setting up of SHIRBRIG, the multinational high readiness brigade, which can be deployed within 10 to 20 days for operations under Chapter VI of the UN Charter. Smaller countries are capable of flexible participation in a diversity of frameworks. In this way, they are sometimes able to bridge gaps between larger countries.

Smaller countries can also play a broker's role in the preparations of Central and Eastern European countries for NATO membership. Smaller countries are valued discussion partners, as they are not assumed to be working towards reinforcing reinforcing their own base of power.

The same holds true for peace operations, for example being the Belgian role of lead nation of UNTAES in Eastern Slavonia. Several years ago, in 1995, the Netherlands participated in the setting up of the Rapid Reaction Force allocated to UNPROFOR, together with France and Great Britain. The strong military actions of the RRF against Bosnian Serb military targets paved the way for the Dayton peace agreement and for IFOR.

This and other examples illustrate clearly that smaller countries are not consigned to simply wait and be subject to whatever larger countries may decide. Indeed they, too, can give shape and direction to security and defence policy within the EU and other cooperative frameworks.

The required resources

If smaller countries want to continue to play their role well, they must have the necessary resources and sufficient numbers of well-educated and well-trained people. This applies not only to diplomacy, but also to the armed forces. It also requires a certain financial effort. It is not an easy task to objectively determine what would be reasonable. In the Netherlands defense expenditure amounts to 1.9 percent of Gross National Product. The average for European NATO-members countries is 2.2 percent. This is an important indicator in order to determine that, after years of cutbacks, we must try to keep pace financially. Smaller countries should also contribute *pro rata* in promoting global peace and security.

Conclusion

Well-functioning international organisations are vitally important, particularly for smaller countries: without the international rule of law and international organisations to uphold it, they would be at the mercy of the law of the jungle. Leadership by one or more larger countries does not appear to be a luxury. Yet for smaller countries there are still possibilities for exercising constructive influence. What they can and must do is to keep their defence effort up to the required level, enabling them to make a good contribution to the common defence and peace operations. The role of broker is also a good opportunity for smaller countries to help give shape to security policy. Bringing large parties together: today's world is certainly in need of this. ●

The EU in the 21st Century: Taker or Shaper?

Jacques Santer

Is the European Union set to be an important player in the next century and make its voice heard? Or, lacking both self-confidence and the necessary decision-making mechanisms, is it to get bogged down in internal wrangling and contradictions? Is it simply to grind to a halt when faced with situations that strike at the very core of its fundamental values?

In the 21st century how will the Union assert its interests on the world stage? How will it foster peace, which was the motivation behind this shared enterprise? Why should the Union's ability to act be expanded, and how?

I. International Relations in the 21st Century Will Be Reshaped Around New Challenges and New Poles

The two ideologically opposed blocs that shaped our reference points during forty years of Cold War have given way to a more disparate world with less distinct reference points, where the concepts of economic power, military power and cultural influence no longer necessarily coincide.

Globalisation is now reorganising the world into large economic regions, characterised by economic and cultural affinities. The power of these regions is based on cohesion and interdependence. They constitute the skeleton of the new world order.

A further development is the increased risk of local conflicts as a result of the geopolitical instability that has followed the end of the two-bloc world.

The relaxation of ideological oppositions, the weakening of State structures and increased economic interdependence will bring new conflicts in their wake. These will basically be the product of uneven development, demographic imbalances, environmental issues and the flouting of human rights.

To date the international community has not been sufficiently able to find a coordinated response to such conflicts, let alone prevent them. This is a global challenge that has to be met by all the countries of the world. And by Europe in particular: Europe

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cannot remain aloof as an island of stability in an ocean of distress. Europe will not be able to remain a pole of stability, unless it asserts itself as an organisational power in its immediate vicinity and worldwide.

In a global and disparate world, military domination cannot provide sustainable solutions. What is needed is influence based on universally acknowledged legitimacy. Peace can only last if it is founded on the values of pluralism and cooperation, sustainable development and the steadfast promotion of fundamental rights.

This new context calls for a new, more complex type of diplomacy operating on two fronts:

(1) the ability to manage crises collectively;

(2) the proper development of a policy of crisis prevention, based on economic security, cross-border cooperation and the legitimacy that comes from defending pluralism and justice.

The security of tomorrow's world cannot be left up to a single power. This would not be a good thing, either for the Americans, from whom too much is expected, or for the rest of the world, which sometimes feels over-dependant on the United States.

II. The European Union Is Better Equipped Than Any Other Player on the World Stage to Meet the Challenges of the 21st Century

The European Union is often seen as an enviable model of regional integration. The challenge was to reconcile feuding nations by creating the practical conditions for peace rather than just legislating for it. Illustrations of this are the single market, the growth in intra-Community trade and the forthcoming single currency.

Reconciliation in the West is now sufficiently consolidated to serve as an inspiration for others. This process is still to be completed in the East. This is the purpose of the forthcoming enlargement which offers us a historic opportunity to unite a continent in peace. We must work to create the conditions that will eliminate the spectre of war between those nations that have already suffered so much.

The Union's 35 years of experience has given it a certain know-how based on practical negotiations and bringing interests and values closer together.

A second advantage that the European Union has for operating on the world stage in the 21st century is the fact that it has already developed relations with all the regions of the world. These relations are complex, respecting diversity and covering not only trade, and technological research and development, but also culture and, naturally, development aid.

The European Community and its Member States are particularly active and influential in dealing with less developed countries. EU Member States provide half of all bilateral development aid in the world. The Union benefits from the cultural and human relations enjoyed for historical reasons by its different Member States and has helped to cast off the colonial mentality and modernize these relations in a spirit of cooperation based on solidarity rather than domination. The Community now has special relations with regions that will represent more than 80% of the world's population in the 21st century.

Community cooperation policy has, from the outset, operated in terms of regional development. The countries involved in the first Yaounde agreements, which became the Lome Convention, are aware that this was not the easiest route to take. Nonetheless, it contributed to the development of a way of doing things that is now being tried out elsewhere.

As the largest economic and trading power in the world, the EU is present in the Middle East, providing 50% of the aid to the autonomous territories, as compared to the United States' 9%. It provides 60% of the aid to Russia and the countries of the former Soviet Union, whereas the United States provides only one quarter. It is providing 40% of the funding for reconstruction in Bosnia.

These are just some of the figures and do not take account of the close ties the Union has established with other regions too. In 1995 the Union gave a new thrust to its policy towards the Mediterranean countries. At the Euro-Mediterranean conference in Barcelona in November 1995 the Union negotiated agreements with the majority of the countries in the region and the policy was backed up by considerable financial commitments.

The 11th Europe-Asia Summit was held in London on 3 and 4 April 1998. The EU is currently heavily involved in Asia, which is undergoing a serious financial crisis. The EU was quick to act from the outset, through the International Monetary Fund and the World Bank. It is providing 30% of the World Bank and IMF money as compared to the United States' 18% and Japan's 6%. But EU support does not stop there.

The Union has managed to develop trade relations with all the regions of the world in the context of trade agreements and the development of a multilateral framework.

These facts and figures are proof of the Union's strength and yet they are not that widely acknowledged. In other words, the Union has yet to learn how to translate its actions into a genuine European influence.

European identity is a further plus-point. This is sometimes doubted within the Union, but its value is acknowledged outside. The diversity within the Union, whether cultural, economic or religious, is rightly viewed as a gauge of pluralism and openness to dialogue. Despite the hiccups along the way, solidarity between countries with different levels of development is seen as a source of hope in a world of harsh inequalities. Respect for fundamental rights is an integral part of our shared heritage. Making sure that they are safeguarded within our borders is now part of our shared agenda.

But if the European Union has all these assets, how come our common foreign policy has achieved so little? It is because our weak points are as real as our strong ones. But these weak points have less to do with institutional shortcomings than with a lack of political will to act jointly. We are an influential trading power that either does not know how to or does not want to make use of this politically. The Member States are highly attached to the perks of national sovereignty and have not yet realised the benefits of acting to defend the general interest of the Union.

III. The Amsterdam Treaty Has Brought the Necessary Changes a Step Nearer

Since the Union has opted to take in the countries of Central Europe, we already need to be considering what this means institutionally speaking. What was difficult to do with fifteen members is going to be even more so with twenty. The Intergovernmental Conference set out to achieve some genuine reforms.

What do these reforms mean for the Union's external identity? Shaper or taker? Four points were prioritized to make the most of the Union's assets.

The first priority is strengthening the economic dimension of our external relations.

Here the primary factor to be taken into consideration is the introduction of monetary union. This will give the Union greater monetary independence, making it less prone to the fluctuations in the dollar that cause so much instability in our economies. The Euro will soon become a currency used for reserves and payments worldwide. I still believe, as I did when I first became Commission President, that the single currency will come into being on 1 January 1999 involving a large number of Member States. This will give the Union more clout with the rest of the world.

We can and we must make progress on common commercial policy. What are the relevant considerations here? It is no longer trade in goods, but in services, intellectual property and direct foreign investments that is today the main concern of international trade negotiations. And yet the Community still has no proper arrangements for negotiating on these issues with a single voice. The powers it does have are often too weak and all too often give rise to procedural disputes between the Community and its Member States. Trying to reach unanimity is a far too demanding condition nowadays. It weakens the defense of our commercial interests. Unfortunately, the Intergovernmental Conference failed to provide the Commission with the means to defend our positions more effectively so that the Union could speak with a single voice in international trade forums. This is an issue that will have to be returned to.

The second priority is to forge a much more explicit common foreign and security policy, which is absolutely crucial to projecting a proper external identity for the Union.

This obviously requires procedural improvements. Nonetheless, even the most perfectly framed procedures would be useless without clear political will. This will need to be shown by the Member States. It is, therefore, up to them to set clear objectives and show their determination to achieve them.

Our third priority will have to be organising the various elements involved in external relations in a more effective way. This is because the economic aspects of foreign policy are set to come increasingly to the fore and while the European Union is currently very financially active on the world stage, it has not yet managed to translate this into political influence or give it the political visibility it should. External relations activities should all tie in with each other in a way that guarantees consistency and continuity.

This should take two forms. First, we need a better analysis of our external relations as a whole, an analysis which is shared by everyone, both the Member States and the Commission. The setting up of a policy planning unit, bringing together experts from the Member States and the Commission, will make a concrete contribution to bringing our positions closer together and arriving at a shared approach for our common foreign policy.

Second, the new Troika, made up of the Presidency, the Commission and the Council's General Secretariat, will help the Union to act with greater consistency and effectiveness so that our economic and commercial achievements are not wasted when it comes to external political action.

Our fourth priority, which is to strengthen our ability to take and act on decisions, needs political will to be a success. Here there have been two helpful developments.

First, there is now greater scope for decisions to be taken by qualified majority, thanks to the introduction of the concept of constructive abstention.

It should be possible for decisions adopted by the Council to be put into effect in a variety of ways depending on the circumstances and the subject matter. This is to be done through the Presidency and the Commission acting together in accordance with their respective powers. The same applies to the external representation of the Union. The appointment of a "Mr PESC", as the French call him, will help give our external activities a more visible political profile.

Second, there is the military aspect. Recent experience in the former Yugoslavia has shown us that some foreign policy actions need to be backed up by military means in order to be credible and effective. This means that it is absolutely essential for the European Union to have a military identity, if we are serious about being players on the world stage and on our own continent. The Amsterdam Treaty made a step forward by acknowledging the Council's power to take political decisions relating to the Petersberg Tasks, as well as opening up the way for the Union to make use of WEU.

This is the first step on the way to redefining the place and the role of WEU with a view to incorporating it into the European Union. Setting out to do this will be the ultimate proof that the European Union is serious about equipping itself to play a world role.

Conclusion

It is true that whether we succeed in being proactive or are condemned to being reactive in the 21st century will depend on the arrangements we will have jointly managed to put in place. However, it would be wrong to see this as just an institutional matter. If we are honest, it is ultimately the Union's confidence in itself and the Member States' confidence in a shared vision of the future that will determine the Union's ability to act and influence the world.

The Union needs to be closer to its citizens, as the governments of all the Member States keep telling us. We need to learn from how the public reacts to the dramas being played out outside our borders. We will not succeed in building a Union that is close to its people, if the people are unable to take pride in the Union's image on the world stage. By the same token, if the Union is unable to inspire confidence and guarantee the security everyone needs, it will not be effective in defending its interests in the world. This means that the internal and external challenges of European identity are inextricably linked.

The 21st century needs a European union that is strong and capable of acting on the world stage. It needs to continue equipping itself with the means to do this and strengthen its will to actually use them. ●

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The staff would also like to thank the following people for their invaluable advice and assistance: Gail Ackley, Alexander Barrasso, Fabrizio Casalini, Linda Marion, Sheila Murphy, Alessandra Nervi, Thomas Row Ph.D., Francesca Scassellati-Sforzolini, and Dr. Robert Evans, Director of the Bologna Center.

The editorial staff of the *Bologna Center Journal of International Affairs* gratefully acknowledges the essential financial contributions from the following organizations:

JHU ALUMNI ASSOCIATION (BALTIMORE)
BOLOGNA CENTER STUDENT GOVERNMENT
THE BOLOGNA CENTER

The editorial staff would also like to thank the

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Published at the Bologna Center
The Johns Hopkins University
Paul H. Nitze School of Advanced International Studies