Saturday 13 November 2010 - Summary of the meeting of the Economics and Security Committee

Conference Room, Hotel of Deputies, The Sejm & Senate of the Republic of Poland, Warsaw, Poland

I. Opening Remarks

1. The Chairman, Hugh Bayley (UK), declared the committee meeting open and welcomed the members and speakers. He thanked the staff of the Polish Parliament for hosting the meeting. The draft Agenda [214 ESC 10 E] and the summary of the meeting of the Economics and Security Committee held in Riga, Latvia, on Saturday 29 May 2010 [150 ESC 10 E] were adopted without comment. The Chairman then explained the procedure for submitting amendments to the draft Resolution Building a More Stable and Prosperous International Order [243 ESC 10 E].

II. Presentation by Frank Boland, Director of Force Planning Directorate, NATO Defence Policy and Planning Division, on Trends in Defence Expenditure Following the Economic Crisis

2. Frank Boland began his remarks by discussing NATO's Planning and Review Process and the ways in which member and partner nations participate in it.

3. Mr Boland then went on to review the changes of members' defence spending from 2008 to 2010/11. On average, the defence spending of NATO's European members have been declining in absolute and proportional terms since the onset of the financial crisis. In the United States, by contrast, defence spending has been increasing year-on-year but at an admittedly much slower pace since the financial crisis struck that country. However, it is important to note that these summary figures require greater analysis of the country-specific contexts. Nevertheless, as it stands now, only five of NATO's 28 members are meeting the collectively agreed defence-spending target of 2% of GDP.

4. Mr Boland pointed to several broader trends that could be observed in the numbers. Most apparently, defence spending is falling across the Alliance, which ultimately raises questions about member nations' capacity to meet current and future commitments. Efforts are underway, however, to minimize the impact of these fiscal pressures. Procurement projects, for example, have been postponed but relatively few projects have been cancelled outright. Because defence outlays tend to have a longer time horizon, revisions to defence expenditures often take time before their impact is made apparent. The danger, the speaker suggested, is that the Allies may regard these new, lower levels of spending as the new normal. This could have an impact in the context of NATO's new commitments that will come out of the forthcoming New Strategic Concept.

5. Finally, spending reductions have led many to question the Alliance's solidarity in the coming years. Specifically, there have been questions about whether or not the Americans will see their security investments reciprocated by other NATO members. Paraphrasing former French Minister of Defence, Hervé Morin, Mr Boland described a worst case future scenario in which Europe becomes the equivalent of a protectorate state, effectively denying itself international influence. While this is not likely, Europeans need to understand the correlation between political influence and military capabilities.

6. Committee members questioned Mr Boland on the prospect of obtaining greater efficiencies though joint procurement procedures in Europe. The speaker noted that NATO has promoted such projects for some time; but political obstacles persist. Countries use defence procurements to bolster employment and technological development. Defence and military bureaucracies are particularly reluctant to concede to eliminating national capabilities in order to focus on those areas in which they have comparative advantages. He cited Denmark's decision to phase-out its submarine programme, which was met by heavy resistance from the Danish navy.

7. The idea of reinforcing pan-European procurement efforts was also discussed. This could help reduce defence redundancies in Europe, but Mr Boland noted that this is a matter for national legislatures to agree to. Again, the political economic benefits of national procurement and institutional inertia will cause problems in this field. Finally, Mr Boland noted that Europeans have come to depend on high US defence spending, and that it will be difficult to stop receiving a free lunch after 50 years. The risk, he suggested, is that "the restaurant may not stay open."

III. Presentation by Leszek Balcerowicz, Professor at the Warsaw School of Economics, Former Deputy Prime Minister of Poland and Minister of Finance, and Former Governor of the National Bank of Poland, on How to Avoid Another Serious Financial Crisis

8. Leszek Balcerowicz challenged the notion that Western financial crises are hardly the worst kind of crises that countries might endure. Indeed, crises in socialist countries were typically much more severe – ranging from devastating food shortages to the outright slaughter of civilians. The real problem, he suggested is the concentration of political power. Mr Balcerowicz noted that there remain "quasi-socialist countries" such as several Arab countries or crony capitalism as in Suharto's Indonesia which are more vulnerable to such profound crisis. In capitalist Europe and North America there are also "pockets of socialism" in the form of government-backed or –owned enterprises. He argued that these represent potentially risky sources of crisis, all the more so because their reach is global. The current crisis, in fact, originated in the United States and its reach has been

global.

9. Mr Balcerowicz then moved on to his precise views on sources of the current crisis. The proximate causes are what have largely been discussed in the media and by most academics, essentially the fast growth of credit followed by its rapid contraction. While avoiding such booms is the best preventative measure, there is little agreement on what contributes to the frequency and depth of credit booms beyond investors' psychological proclivities. He cited the work of Calamiris who suggests the ultimate cause lies in poor public policy.

10. Mr Balcerowicz noted that in the United States, and elsewhere, interest rates were excessively low which pushed down housing credit to a level that created a credit bubble. Prior to this, the political pressure to extend housing credit to previously excluded and marginalized people in the United States led to the extension of sub-prime loans that otherwise would not have been commercially feasible. Regulations were insufficient, particularly the Basel I accords, which encouraged excessive securitization of such loans. Similar problems were evident in other countries, but the collapse of the US financial markets caused a global meltdown simply due to the sheer size of the US market and its myriad links to other markets.

11. The new regulations that are currently under discussion appear to be focused in the right direction (i.e. greater capital requirements, more macro-prudential oversight, etc.) but details remain sparse – and the devil always lies in the details. Mr Balcerowicz argued that other policies under consideration are less logical. He suggested that taxes on banks, for example, are politically popular but are in conflict with the need for banks to raise extra capital. Finally, he argued that other initiatives are needed to stymie credit booms. In all of these areas many of the crucial details still need to be worked out.

12. Finally, he noted that the boom-bust cycle reflects a spending cycle that tends to bottom out when excessive credit is wiped out. The depth of the resulting recession depends very much on market rigidities, especially those in labour markets. Whereas the UK and Spain had very similar financial crises, only the latter has experienced very high unemployment because of excessive labour market rigidities. In sum, Mr Balcerowicz said that the frequency, magnitude and longevity of crises and recessions are best explained by the very nature of public policies.

13. Committee members asked what politicians could do to ensure that future crisis were avoided. Mr Balcerowicz responded that many of the factors mentioned (poor performance of credit rating agencies and the behaviour of hedge funds) are symptoms rather than causes of the crisis. Indeed, credit rating agencies were systemically important because of regulatory mandates upon which financial institutions rely, and; hedge funds, in his estimation, are among the most highly regulated financial sectors. Thus, greater market flexibility would lessen the risk of crises. However, when asked about the fact that large financial institutions have oftentimes been directly involved in the writing of their own regulations, Mr Balcerowicz simply said that this was indeed the case, but this was too complex a matter to discuss in this particular forum.

14. The discussion then moved on to the appropriate policy responses for governments, specifically in regard to fiscal stimulus. Mr Balcerowicz was broadly in favour of stimulus measures but noted that their appropriate use was highly contingent on the country's structure and situation. Moreover, if there is no room for expansionary fiscal stimulus then engaging in it can be disastrous. To this end, he addressed concerns about the European social model, noting that it could not be sustained in its current form. Raising retirement ages will be essential and it is best done now and not in response to the next crisis.

IV. Summary of the future activities of the Sub-Committee on Transatlantic Economic Relations, by John Sewel (United Kingdom), Chairman of the Sub-Committee

15. John Sewel (UK) discussed the Sub-Committee's visit to Ethiopia at the end of October 2010 which had been made possible with the support of the World Bank. This was a very successful and useful trip for the members to gain greater knowledge of the problems of poverty and human security in Africa. In the coming year the Sub-Committee is planning a visit to Afghanistan on the subject of development and security. A visit is also planned to Canada. There are also tentative plans to participate in a proposed Rose-Roth seminar in London next autumn.

V. Summary of the future activities of the Sub-Committee on East-West Economic Cooperation and Convergence, by Petras Austrevicius (Lithuania), Chairman of the SubCommittee

16. The Sub-Committee visited Sofia, Bulgaria, in April to discuss the political economic situation there with military personnel and local politicians. During a second visit to Prague, Czech Republic, the members discussed that country's economic response to the global financial crisis. Petras Austrevicius (LT) thanked those two host countries and noted that in 2011 the Sub-Committee is planning a joint trip with the Committee on the Civil Dimension of Security to Bosnia, and will also visit Washington DC with the Political Committee.

VI. Consideration of the draft Report of the Sub-Committee on East-West Economic Cooperation and Convergence The Impact of the Financial Crisis on Central and Eastern Europe [217 ESCEW 10 E] by Attila Mesterházy (Hungary), Rapporteur, presented by Petras Austrevicius (Lithuania)

17. Mr Austrevicius presented the Sub-Committee's draft Report and provided an assessment of the various economic policies adopted by Central and Eastern European governments in the runup to the crisis. He noted that it was appropriate that this

year's two sessions had taken place in the Alliance's best performer (Poland) and its hardest-hit member (Latvia) during the financial crisis. Drawing on this contrast, he suggested that the key differences between them were: their respective exchange rate policies; the magnitude of capital flows; fiscal discipline during the boom period, and; domestic market size. In three of these four areas Poland appears to have been better positioned that Latvia.

18. The external flexibility of the Polish zloty helped limit capital inflows, and a depreciating currency during the shock helped maintain exports. During the crisis capital inflows slowed down, the zloty's value fell and this accorded exports a competitive edge. The tightly-pegged currency of Latvia meant that devaluation there was not an option. This led to an 'internal devaluation' after credit markets collapsed. While Poland ran larger fiscal deficits than Latvia during the boom period, it enjoyed more options to engage in counter-cyclical stimulus than did Latvia. And while Poland and other nations still struggle with excessive deficits, these have proven to be less important than macro-prudential policies before and during the crisis. Finally, Poland was aided by its large internal market that helped it absorb some of the extra supply created when traditional, Western export markets contracted. While there are costs and benefits to both macroeconomic approaches, it is clear that for any country 'finance-led' growth leaves a country vulnerable to rapid changes in market sentiment.

19. Mr Austrevicius concluded with a call for all countries to learn from the plight of Central and Eastern European countries. Among the lessons learned is the need to strengthen financial and prudential oversight at the national and international level; to bolster international co-ordination, and; to engage in more prudent fiscal management. He also noted that members should consider the potential value of limiting capital mobility to reduce the likelihood of financial crises. Finally, he called on members to consider ways in a more stable global monetary and exchange-rate order could be constructed.

The draft Report of the Sub-Committee on East-West Economic Cooperation and Convergence on The Impact of the Financial Crisis on Central and Eastern Europe [217 ESCEW 10 E] was adopted.

VII. Consideration of the draft Report of the Sub-Committee on Transatlantic Economic Relations Global Recession, Poverty and Insecurity in the Developing World [216 ESCTER 10 E] by Jeppe Kofod (Denmark), Rapporteur, presented by John Sewel (United Kingdom)

20. Mr Sewel updated the committee on the recent surge in commodity prices that occurred during the summer. He cautioned that the continued price volatility in food prices has increased the risk of social instability in the developing world where people spend a large proportion of their incomes on basic foodstuffs. Mr Sewel noted that protectionist measures – such as Russia and Ukraine's restrictions on grain exports – only served to heighten this volatility and the attendant social risks. On this basis he made a call for greater commitments to free trade through the framework of the WTO Doha negotiations.

21. Following the committee's discussions in Riga a section had been added on China's development role in Africa. Mr Sewel argued that the interactions of China and African states are highly complex and represent both a challenge and an opportunity for that continent. Indeed, during the Sub-Committee's visit to Ethiopia members observed the Chinese construction of the African Union's new headquarters in Addis Ababa. While this is a welcome investment, many Ethiopians have criticized the project for its excessive reliance on Chinese labourers. Moreover, the resource-for-infrastructure deals in places like the Democratic Republic of Congo, Nigeria and Angola are not transparent. That said, there are nascent signs that China is beginning to change some of its developmental practices in response to critiques from traditional donor organizations.

22. Finally, Mr Sewel said that the report calls for Western governments to maintain their commitments to development assistance, including the Millennium Development Goals, the Paris Club Agreement and the G8 commitments made at Gleneagles, Scotland, in 2005. He argued that even in this so-called 'age of austerity', fulfilling commitments made to the world's poorest must remain a top priority. He recognized that this is increasingly difficult for Western voters to accept, but in a highly integrated world we cannot pretend that the fragility of other countries will not have ramifications for wealthier countries.

23. During the discussion, one member took issue with the labelling of commodity prices as 'too high'. Indeed, price rises could be a benefit for developing countries that have a competitive export advantage in agricultural and other commodities. The members noted that the real problem is price volatility, which is to no one's benefit.

24. Members were sceptical that there is any evidence of China reforming its development practices to bring them more in line with international standards. Mr Sewel countered that this change is still emerging but it has indeed been noted by academics such as Oxford's Paul Collier. All agreed that there should be greater transparency on the part of China if such concerns are to be allayed.

The draft Report of the Sub-Committee on Transatlantic Economic Relations on Global Recession, Poverty and Insecurity in the Developing World [216 ESCTER 10 E] was adopted.

VIII. Consideration of the draft General Report Long-term Economic Change and the Shifting Global Balance of Power [215 ESC 10 E] by Simon van Driel (Netherlands), General Rapporteur

25. The General Rapporteur, Simon van Driel (NL) referred the committee members to his remarks made in Riga, Latvia, in May and turned to the draft Resolution, which draws heavily on the analysis and conclusions of the General Report. The draft Report and the draft Resolution are premised on the observations that economic strength is a fundamental component of state

power. On this basis it clear that the global financial and economic power has hastened the shift in power from West to East. This is evidenced by India and China's return to rapid economic expansion, while the West remains mired in slow growth and high unemployment.

26. The signs of serious economic crisis are evident across a range of economic indicators. These include large fiscal deficits and major spending cuts in defence spending that could erode Western political and military power. Furthermore, Mr Van Driel said that the crisis has led to great strains in the international monetary order and political fractures. Although Western corporations have had a very profitable year in 2010, many are hoarding capital because of the low demand in major consumer markets. Another area of concern is the demographic decline or weakening of many NATO countries. The increasing average age of Western populations is putting ever-greater pressure on pension systems, leading many to question their long-term viability. All these critical economic trends must be addressed.

27. On the positive side, Mr Van Driel noted that, as democratic countries, the Alliance members pose flexibility unmatched by other political systems. This can and should translate into creative ways to resolve these challenges and to engage rising powers. There are already effective multilateral frameworks that form the basis for amicable engagement, which will help continue the trend towards greater trading relations and more open societies. It is clear that the countries of the Alliance will have to develop even deeper co-operation with rising powers such as Brazil, South Africa and India, all of which share democratic values and vested interests in global stability.

28. Given this new reality Mr Van Driel argued that it is essential that the Alliance not squander its resources on distractions that could prove costly. Moreover, he reiterated the earlier call for greater defence co-operation – especially in the area of procurement – in order to maximize pooled resources of the Alliance. However, co-operation should not end here. There needs to be a more integrated approach to terrorism, nuclear proliferation, climate change, overpopulation, food and water security, and in meeting the energy needs of the Alliance.

29. The lively discussion amongst committee members focused on improving the comprehension and understanding of different members' political-economic challenges. With the recent announcement of the US Federal Reserve's second round of quantitative easing (QE2) many were concerned that the transatlantic political fractures ahead of the G20 meeting in Seoul, South Korea were unjustified. European and American members defending the Fed's action, noted that it was absolutely necessary for the US to defend itself against China's currency manipulations. Indeed, the euro zone will need to do the same, in the view of some members, but the European Central Bank (ECB) is powerless to do so, given its mandate.

30. In the areas of current account imbalances and the so-called 'currency wars' members called for greater solidarity in confronting China on its economic policies. Moreover, China's rise has been made possible by Western investments and transfers of technology to this once endemically impoverished country. On this basis, it does not seem unreasonable to seek some flexibility on China's part. The members adopted a statement calling on the Political Committee to raise this issue during its upcoming visit to China, if it has the occasion to meet the relevant authorities.

The draft General Report on Longterm Economic Change and the Shifting Global Balance of Power [215 ESC 10 E] was adopted.

IX. Presentation by EJ Hogendoorn, Horn of Africa Project Director, International Crisis Group, Nairobi, on The Economic Dimensions of Conflict in Somalia

31. EJ Hogendoorn emphasized that it is much better to consider the Somali conflict in terms of its political economic dimensions rather than in ideological terms. Al Shabaab's prominence in Southern and Central Somalia has little to do with its political message and much more with its control over key resources. There are three Somalias: the unstable south and central region; and the relatively peaceful and stable northern regions of Somaliland and Puntland. In these northern regions most people lead a pastoral way of life and have utilized traditional methods of conflict resolution to maintain peace and stability. These appear to have been working well.

32. In Somalia money purchases arms which purchase power. Mr Hogendoorn noted that there is a vibrant arms market in Somalia, and many of these weapons are imported from Yemen. The cost of a day of fighting in Somalia is estimated to be about US$60,000 which is no small sum in this very poor country. Mr Hogendoorn also said that negotiations have often proven difficult because of the cultural attention to relative rather than absolute gains.

33. The conflict in Somalia has raged for over two decades, but its political and economic roots have shifted dramatically over that time. When the state collapsed in the early 1990s many of the warlords gained power through asset striping and looting. Military factories were looted for arms, and power lines were torn down so that the copper could be melted for resale. During this time the large inflows of humanitarian aid were essentially taxed by these warlords. Once these leftover resources were drained, political power was derived from those who ran their operations like successful businesses. Control and taxation of transportation was a key source of revenue – this included ports, roads and airstrips. Overtime these warlords needed a modicum of stability and order and thus established and funded courts based on Islam's Sharia law. Over the coming years these courts gained in strength, eventually becoming the source of political power in the capital Mogadishu. The courts then pooled their resources to create the Islamic Courts Union (ICU). They soon spread their legal power across the whole of Somalia and for six months they brought order and stability to the country. However, the leaders of the ICU began to make pronouncements about regaining control of the Ogaden region, which Somalia lost to Ethiopia in the 1970s. This led Ethiopia to attack Somalia and occupy the country. In resistance to this external power's occupation the Al Shabaab movement gained

prominence, funded by the huge Somali diaspora that saw Al Shabaab as an independence movement rather than as an ideological one. This is the situation in which Somalia currently finds itself. Al Shabaab controls the central and southern region, while the two autonomous northern regions are largely separate from this insurgent force.

34. Mr Hogendoorn then spelled out the main peacekeeping challenges in Somalia. First he noted the lack of a comprehensive strategy of the international community, including the UN, the African Union and bilateral donors. Secondly, he pointed to the excessive focus on the transitional government that is confined to a small area of Mogadishu. This government sees itself as more beholden to the international community than to Somalis themselves. Thirdly Somalia's unstable neighbourhood only heightens the security dilemma as the surrounding states tend to be easily threatened by rivals and are disposed to plan worst case scenarios that can be self-fulfilling. Finally, the international community is reluctant to engage itself fully in the region. The political will is simply lacking. Mr Hogendoorn suggested that the cost of fighting for one year in Somalia is equivalent to two hours of fighting in Afghanistan. He questioned why piracy appears to be the only priority for NATO and EU.

35. Mr Hogendoorn noted that the core problems of Somalia cannot be solved militarily or even through humanitarian aid. Somali piracy is a question of governance on land. Puntland and Somaliland are quite similar in socio-economic terms but the former has produced the pirates. By contrast, the Somaliland leadership has been trying to be recognized as a sovereign state and thus has not allowed piracy to be conducted from its territory. Puntland, on the other hand, has no such aspirations and is controlled by three different groups that vie for power amongst themselves and use piracy to bolster their economic positions.

36. Turning to Somaliland's bid for sovereign status, Mr Hogendoorn said that this was an unlikely prospect as the AU leadership has been wary of setting such a precedent. Committee members asked about the logic of 'constructive disengagement' which seems to contributed to a modicum of stability in the northern regions. The speaker, however, was decidedly opposed to this approach as regional actors would not disengage – their lack of trust in one another and in Somalia's central government means that they have an incentive to keep the region weak and destabilized.

37. Finally the committee asked Mr Hogendoorn to comment on the upcoming referendum on southern Sudan's independence. He said that the process has not been smooth and that many difficult issues have yet to be solved. Among these are the demarcation of a new border, a modus vivendi for sharing out oil revenues, a sharing out of the countries external debt, the issue of US sanctions on Khartoum and the outstanding ICC indictment on Sudan's president Omar Bashir. Ostensibly, all of these problems should be resolved before the vote is held on 9 January 2011, but prospects for this appear rather dim.

X. Consideration of the amendments and vote on the draft Resolution Building a More Stable and Prosperous International Order [243 ESC 10 E] by Simon van Driel (Netherlands), General Rapporteur

38. The Committee considered the draft Resolution proposed by the General Rapporteur, together with the amendments proposed to it.

The draft Resolution [243 ESC 10 E] Building a More Stable and Prosperous International Order, as amended, was adopted.

XI. Election of Committee and Sub-Committee Officers

39. The Chairman announced the procedure for the election of Committee and Sub-Committee Officers for 2010-11. The following candidates were elected by acclamation:

Economics and Security Committee

Vice-Chairman Philippe Mahoux (Belgium)
Vice-Chairman Jean-Luc Reitzer (France)
Vice-Chairman Gianni Vernetti (Italy)

Sub-Committee on East-West Economic Co-operation and Convergence

Vice-Chairman Francis Hillmeyer (France)
Rapporteur John Sewel (United Kingdom)

Sub-Committee on Transatlantic Economic Relations

Chairman Leon Benoit (Canada)
Vice-Chairman Peter Bottomley (United Kingdom)
Vice-Chairperson Melita Zupevc (Slovenia)

All re-eligible Committee and Sub-Committee Officers were re-elected.

XII. Any Other Business

40. The Chairman thanked the Committee for its hard work and reminded members that the next meeting would be in Brussels in February 2011, followed by their annual trip to the OECD in Paris. He thanked the interpreters, committee staff and the Polish hosts. The meeting was then declared closed.