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CONFRONTING A DIFFICULT BUDGETARY ENVIRONMENT: ECONOMIC CRISIS, FISCAL CONSOLIDATION AND THE RISK OF EUROPE'S STRATEGIC IRRELEVANCE

DRAFT GENERAL REPORT

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* Until this document has been approved by the Economics and Security Committee, it represents only the views of the Rapporteur.

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I. INTRODUCTION

1. Over the last three years the global economy has undergone the worst recession since the end of World War II. The impact has been profound and the fall-out from the crisis is likely to endure well beyond the recovery, which is now tentatively underway in most Western economies. Virtually all members of the Alliance have suffered what might be called structural damage to their economies, and this is manifesting itself in economic performances significantly below pre-crisis projections, and in several cases, sovereign debt crises.

2. There is a tendency to approach recessions as purely economic phenomena, but history provides ample evidence that they are also inherently political and strategic in their implications. This crisis has been no different. The apparent effect of the downturn on defence budgets is already obvious. But other effects may take years to register fully. It is likely, for example, that that the growth trajectory of emerging economies like India and China will remain highly robust while most Western countries settle into lower growth orbits. Low growth and high unemployment could upset the social and political consensus that has been the very foundation of Western economic dynamism, global leverage and power. At the end of the day, to paraphrase Mao Tse-tung, power grows not only out of the barrel of a gun, but also from the dynamism and sustainability of an economy.

3. Large budget deficits and soaring levels of public debt constitute another legacy of crisis. Here too, the degree of the challenge and the policy response to it vary considerably across the OECD. Many developed countries are approaching unprecedented deficit and debt levels that are unsustainable and that consequently abound in strategic and political implications. If they are not addressed comprehensively and in a timely and coherent fashion, they risk weakening the security posture of the Atlantic Community of nations. Addressing these problems could have immediate as well as long-term political and strategic implications. Indeed, fiscal consolidation could constitute the single most serious challenge facing parliamentarians from many OECD countries. If not adequately addressed, fiscal problems threaten to undermine the nascent recovery, induce structural damage to key economies, and exacerbate a range of social, economic, political and strategic quandaries.

II. THE EMERGING FISCAL CRISIS OF THE WESTERN STATE

4. Although fiscal problems have been mounting in some countries over a long period of time, the recent crisis has clearly exacerbated structural problems while creating conditions for new ones to emerge. OECD government spending, for example, increased substantially as a response to the global recession. This can be traced both to expansionary automatic stabilisers and discretionary policies designed to counter the impact of recession. Automatic stabilisers are spending cuts or increases that automatically kick in when an economy either shrinks or grows. Automatic stabilisers might include, for example, the payment of unemployment benefits to laid off workers which are guaranteed by law. Taxes on corporate profits can also assume this function, if they mechanically decline as a recession begins and when profit declines exceed falls in corporate turn-over. Discretionary spending responses to a recession might include Keynesian style stimulus packages and other extraordinary injections of liquidity designed to counter the impact of recession on aggregate demand.

5. At the same time, recessions have a powerful negative impact on government receipts. As personal and corporate incomes fall, tax intakes plunge. Budget deficits rise and governments are compelled to turn to credit markets to finance the shortfall. Budgets deficits, which in accounting terminology might be characterised as “flows” thus rise, and in so doing, increase the “stock” of national debt.

6. This is precisely the dynamic that has been underway in many developed countries. Over the past year, in particular, rising deficits and debt levels have become a serious source of international concern. Average OECD debt levels are now approaching 100% of GNP. By 2012 Greece, Italy, Iceland, Belgium, the United States, Portugal, France, Great Britain and Hungary, will be among the OECD's highest debtor countries in GDP terms (OECD Outlook No. 88). The levels of debt these countries are accruing are not sustainable and, if not countered effectively, promise at a minimum to pose a long term drag on economic growth. In the more severe cases, default is a real possibility. Debt burdens are also sure to have important spill over effects beyond national borders. High levels of US borrowing, for example, have very serious implications for global credit markets simply due to the size of the US market. Greece and Portugal are small countries, and unlike the United States, they are "price takers"; yet, their debt crises have inspired a general crisis of confidence in the euro area and are a factor in Europe's low level of economic confidence and relatively slow rate of recovery.

7. Governments have thus sought to counter the effects of deep recession through loose fiscal policies, while central bankers have employed varying degrees of monetary easing to boost demand and keep credit markets alive. Because the recession was so deep, the initial risk to inflation was low. Economies in the OECD area were operating far below capacity, and this provided some space for accommodative monetary policy. Monetary expansion was generally deemed essential in the early phase of the crisis when credit markets were on the verge of seizing up. Soaring commodity and energy prices and signs of growth in Northern Europe raised renewed concerns about inflation. But we now may be in the midst of a second economic down turn and the risk of inflation has again retreated (OECD Main Economic Indicators Database).

8. Eurozone inflation rose above the European Central Bank's 2% target in December 2010 at 2.2% and was higher in the UK (Harding and Giles). Central Bank authorities in Europe therefore recently raised interest rates to prevent a potentially disastrous spike in prices from developing. The problem is that economic growth remains fragile and confidence, already somewhat jittery, has been further rattled by the tsunami in Japan, civil war in Libya, an increasingly unstable MENA (Middle East and North Africa) region and a spreading sovereign debt crises in several euro member states. Higher euro denominated interest rates will only add to their burden. The policy options are hardly enticing, particularly given the significantly varying rates of economic recovery across Europe. Spain will likely only grow at a rate of 0.9% in 2011, the United Kingdom at 1.7, Germany at 2.5, the United States at 2.2 and the euro area as a whole at 1.7%. Turkey, however, is booming with growth approaching 11% in the first quarter of this year, while China is growing at 9.7% - one of many signs that emerging economies are pulling out much more quickly from the global crisis. Finding multilateral policy solutions in the face of such diverse economic conditions is proving very challenging indeed.

III. FISCAL CONSOLIDATION AND MONETARY IMBALANCES

9. Global monetary imbalances constituted one of the root causes of the crisis. American overspending and Chinese over saving have been expressed in the persistently under-valued Renminbi (RMB) and excessive credit flows from China to the United States to underwrite US current account and fiscal deficits. These imbalances helped finance the credit bubble in the United States, which built up over much of the past decade and eventually struck the housing and banking sectors, in part, because of an exceedingly lax regulatory environment. Indeed, easy credit conditions persisted far too long in the United States, partly because of Chinese lending and a lack of Central Bank (Fed) vigilance. This influx of cheap capital muted all the warning signals about the imminent collapse of US real estate markets and the underlying fiscal and monetary problems of which they were just one expression. It is important to recognise here the clear link between fiscal imbalances and international monetary relations. The undervalued Renminbi, in fact, is the mirror image of high levels of US borrowing to underwrite its deficits and service its

rising debt. The Chinese are a major lender to the United States, but by purchasing US paper, they have also lowered the value of the RMB on foreign exchange markets while advancing their position in global export markets.

10. This essentially unhealthy tango between these global economic powers has been a key source of global financial instability and uncertainty. Indeed many economists now argue that the roots of a second major global crisis can be discerned in the failure of China and the United States to correct the underlying monetary and fiscal imbalances that have come to define their commercial and financial relations. American borrowing rates are unsustainable in the long run, while China's high savings and undervalued currency are leading to overinvestment in its export sector.

11. The Chinese seem to recognise the nature of the problem and are now planning to expend significantly more funds on developing domestic social safety nets - precisely the kind of structural measure that will raise government spending in China, encourage Chinese consumers to save somewhat less than they do in the absence of those social safety nets, and thereby potentially help correct the global imbalance precipitated by the purchasing of US bonds in order to undervalue the Renminbi. China's rapid and powerful response to the global crisis is a potential harbinger of change. Its four-trillion RMB stimulus programme included a massive expansion on infrastructure spending and significant domestic credit growth. This is the general direction it needs to take, although these measures were clearly designed to cope with the immediate effects of the downturn rather than directly correct the imbalanced monetary relationship with the United States. One downside of this approach is that it appears to be triggering a property bubble in Eastern China (Dadush). Ultimately though, the Chinese will have to allow the RMB to appreciate to a level where its exports are not grossly undervalued - a condition which has not only distorted trade with Europe and the United States, but has also compelled Japan, South Korea, Brazil and South Africa to manipulate their own currencies in response (Kennedy).

12. An American contribution to correcting this imbalance would involve reducing chronic budget deficits, through some combination of spending reductions, particularly in the largest budget items, revenue raising measures and tax reform. The projected fiscal gap as a share of the US economy in 2011 will be 9.8% or close to $1.5 trillion. Already the deficits of $1.4 trillion in 2009 and $1.3 trillion in 2010, when measured as a share of GDP, represented 10% and 8.9 % of the nation's output, respectively, and were the largest since 1945 (Congressional Budget Office, CBO).

13. The future path of this deficit is very difficult to predict given the politics of Washington and uncertain global economic prospects. The CBO nonetheless projects that US growth rates will remain substantially below potential for a number of years. These numbers prompted Fed Chairman Ben Bernanke to say that "the long-term fiscal challenges confronting the nation are especially daunting because they are mostly the product of underlying trends, not short-term or temporary factors… Sustained high rates of government borrowing would both drain funds away from private investment and increase our debt to foreigners, with adverse long-run effects on US output, incomes and standards of living" (Harding 4/2/11).

14. The US Congress and the President have engaged in rancorous high stakes budget negotiations under the spectre of a potential default were the borrowing limit not raised. Although the immediate problem has been solved, finding a combination of spending cuts and revenue increases to bring down the deficit has so far eluded negotiators, who represent profoundly different constituencies with profoundly different economic perspectives. The deep political divide in the United States and the ever more apparent institutional weaknesses militating against decisive budgetary policy-making are undermining investor confidence and generating global economic uncertainties with real economic consequences.

15. The United States is hardly alone in its fiscal woes. Indeed, a number of industrialised countries have undergone a sharp deterioration in macro-economic fundamentals over the past three years and now need to engage in short, medium and long-term fiscal consolidation programmes that will invariably involve reforming pension, tax and healthcare systems as well as reducing defence outlays (Dalton). This is proving politically, strategically and socially unsettling.

16. This crisis has also exposed deep problems in the European monetary order, some of which are rooted in profound fiscal problems at the national level, the absence of a common European fiscal policy and sharp divergences in productivity. Moving out of the crisis will require a number of countries to put their fiscal houses in order. As a result, these countries will be subject to deflationary adjustment for several years (Dadush) and this will be a drag on overall European growth and growth. The Greek, Irish, Portuguese and now burgeoning Italian and Spanish debt crises have also precipitated a fundamental rethinking of the euro rules laid out in Maastricht. Although the Maastricht criteria had theoretically restricted deficit and debt levels of euro members to 3% and 60% of GDP respectively, these limits were routinely ignored in many countries. This represented a general invitation to fiscal irresponsibility with grave financial and monetary consequences.

17. A second problem was that euro membership accorded certain states credit terms that their underlying fundamentals suggested they should not enjoy. It is quite normal for capital to move from high savings to high investment countries. The problem in Europe is that this money has not necessarily underwritten productive investment but rather precipitated asset bubbles, for example, in the real estate sectors of Ireland and Spain while underwriting unsustainable levels of consumption and deficit spending. The euro area had thus begun to mirror global savings-borrowing imbalances, with the export dynamo Germany acting as the net saver, and several Mediterranean countries over borrowing. The problem is that the euro system seemed inadequate to the task of compelling its members to take appropriate corrective measures before crisis conditions set in. This narrative was unfolding, moreover, precisely when the global crisis was generating higher budget deficits due to falling growth, declining tax spending, increased automatic stabiliser spending, and stimulus packages designed to bolster domestic demand in the midst of crisis. As a result of this perfect financial storm, Europe now must manage a sovereign debt crisis that threatens to undermine monetary credibility and global growth.

18. The situation in Spain and Italy is of far greater potential impact than that of Greece, Ireland and Portugal. In early August, Italy's borrowing rates rose to 6% on a debt that is 120% of GNP, the second-highest level in Europe, after Greece. Economists estimate that it will have to refinance nearly $500 billion in 2012, one of the highest amounts in the euro zone and the equivalent of 20% of Italy's G.D.P. Moreover, it must manage this fiscal challenge at a moment when its growth in recent years has been sclerotic. Italy, however, does have substantial cash reserves, remains an important exporter (Danadio). Still, even the prospect of default in these two countries has helped send global equities into a tailspin and triggered yet another round of emergency meetings in Brussels about how to put a lid on a potentially catastrophic euro-area crisis.

19. The politics of fiscal consolidation will invariably prove extremely difficult to manage. Although the European Union has its part to play in resolving the problems, individual countries will have to make and implement the toughest decisions which will likely inflict pain, at least in the short term. It is not at all clear if governments will be willing to do so or if their publics will support the kinds of budget cuts and other changes that will be needed to put national budgets on a sustainable basis. Of course, the pain will be much more acute if consolidation is not carried out and this may be the greatest risk our countries confront.

20. The EU is working to address these problems, although there is a keen debate about the proper course of action to take, driven, in part by a divergence rather than a convergence in

economic conditions within the euro area. As a result, different countries will consider different policy mixes as optimal, suggesting to some that this particular monetary union may not meet the criteria for what the economist, Robert Mundell, famously described as an optimum currency area. Although a strong euro and low inflation may be in the interests of core euro zone countries, these same conditions could prove a hindrance to the recovery of several Mediterranean countries, which have a history of using devaluation and expansionary monetary policy to counter the effects of recession. The absence of a common European fiscal policy has clearly exacerbated the euro problem.

21. European leaders have recently agreed a package that will include new rules on budget discipline, a strengthening of Europe's temporary bailout mechanism for indebted euro members, certain details on a permanent rescue fund and pledges to improve euro zone competitiveness (Walker et al.). European leaders have replaced a temporary emergency rescue fund with a permanent one. At the insistence of Germany, contributions into the fund will be made more gradually than anticipated at the programme's inception in 2013 (Faiola). This package was put together just as the Portuguese government resigned over Parliament's refusal to adopt its fiscal consolidation plan which cut state pension, health-care and infrastructure spending. Market scepticism about the capacity of the governments of Portugal, Greece and most recently Italy and Spain to finance their debt burden and concerns about the sovereign debt holdings of a number of European financial institutions have rendered Europe's fragile economic recovery even more precarious. Serious concerns are now being raised about the resilience of the European Monetary Union, at least in its current form.

22. Monetary imbalances are thus pushing the international community to reconsider the multinational rules of the game and general governance questions. Since the collapse of the Bretton Woods system, there has been a relative absence of international monetary governance, and the world has been operating under a kind of non-system of flexible exchange rates and ever larger and uncontrolled flows of international capital. The creation of the euro bloc was essentially one response to this challenge, but even this was insufficient to shelter its members from the uncertainties of a non-system. The challenge now is to create a framework for correcting global imbalances in a way that is symmetric (i.e. simultaneously inducing change and reform in both deficit and surplus countries), while ensuring that general growth is not undermined.

23. According to the OECD, pro-competition reform in product markets could unleash opportunities for investment in advanced surplus countries while greater social protection and financial deepening reforms could discourage precautionary savings in emerging market economies like China. Meanwhile entitlement and tax reforms will be needed to trigger greater savings in chronic deficit countries like the United States. Tax reforms that reward investment and savings and restructure labour markets and educational systems could also be part of this broader effort. But global reforms will not be possible if Europe and the United States do not get their respective houses in order. The problem is that there are structural and political barriers which are undermining the best intentions of reformers.

IV. GROWTH FRIENDLY FISCAL CONSOLIDATION

24. There are two desirable ways to move out of high levels of government debt. In the first instance, economies can simply grow out of the problem. This can unleash a boom in tax revenues, and, all things being equal, lower government outlays as higher incomes reduce government spending on income supports like unemployment benefits. This is obviously the best means to slash debt levels as growth not only eases fiscal burdens; it also generates jobs and prosperity. That said, mature economies are far less likely to achieve sustained rapid growth than are emerging economies as the former have already undergone important efficiency gains from structural and policy rationalisation. Emerging economies are still going through this phase of

development and naturally grow more rapidly as a result. Demographic trends in developed countries will also work against sustained rapid growth as ageing societies can count on having a diminishing and less productive labour pool available to them in the future. This is one of the reasons why today's fiscal problems in a range of Western economies could pale in comparison to future ones if structural deficiencies associated with societal ageing are not adequately addressed. In any case, mature economies simply have a natural rate of growth that is less than that of emerging economies which are more likely to find room for significant productivity gains.

25. Nevertheless, Europe does have a range of yet to be exploited structural opportunities that could help raise its natural growth rate in the future. The EU has undergone significant monetary and commercial integration; yet, that process is hardly complete. The existence of a range of formal, and more importantly, informal barriers to integration mean that Europe stands to gain by completing a genuinely unified market (including a more mobile work force, common standards, an integrated defence market, etc.) that would introduce a range of productivity and efficiency gains. Of course, labour mobility is far more difficult to achieve in a multi-national-multi-linguistic Europe than it is in the United States. Europe could also reap benefits by introducing new efficiencies to the innovation and knowledge fields. Its research sector is not as productive as it could be if it were genuinely integrated across borders. Europe is not exploiting new knowledge in a very efficient manner and still lacks the kind of scale and venture capital structures enjoyed by the United States. Many economists also believe that university reform in Europe will be essential to galvanizing innovation on the continent. Similarly, it is often suggested that US educational reform below the university level will be essential to raising its own growth trajectory over time. Doing so in an era of fiscal retrenchment will not be easy.

26. A second means of reducing debt, of course, is fiscal consolidation. Here the goal is to move from primary deficits to primary government surpluses which might be generated through major spending cuts and/or revenue generating measures. The problem with fiscal consolidation, however, is that, at least in the short term, such measures can impede growth. In the longer run, however, supporters of fiscal retrenchment argue, these measures can have munificent effects because they lower debt load, ease borrowing pressures and, all things being equal, drive down long-term interest rates while encouraging private investment. In any case, the fiscal stance of different countries will be conditioned by their current and expected level of government indebtedness, their outlook for growth, where they are along the business cycle trajectory, and international pressures to adopt particular policy positions.

27. One critical challenge of fiscal consolidation coming out of recession is timing. For neo-Keynesian economists like Paul Krugman, it is very important that fiscal consolidation not be launched too early as the combination of tax hikes and spending cuts could well choke off a still tenuous recovery and throw a national economy back into recession. As growth accelerates, however, there will be more leeway for spending reductions and tax hikes (Wolf). Ideally, governments should generate more savings in periods of growth which will, in turn, create reserves to finance future downturns. Failure to consolidate budgets even after recovery is well underway, however, can endow deficits and debt with a more structural character, making consolidation a particularly compelling long-run challenge. This has been a particular problem in the United States where economic growth has triggered pro-cyclical tax cuts that have undermined the country's long term fiscal position. The US government has therefore not generated the savings it needs to weather economic downturns, and this is precisely why its fiscal position has grown so precarious over the course of the recent financial and economic crisis.

28. The matter of when to retrench has become a central debate both in the United Kingdom and the United States. Indeed, the United Kingdom has become a kind of test case as it was one of the first large economies to launch significant tax increase and spending cuts to get its budget under control. So far, roughly £9 billion in tightening has occurred, and the economy has slowed further than expected (Macdonald). The British economy shrunk 6.4% in the recession and has

rebounded 2.5% - which is still 3.9% below peak GDP and significantly behind the pace of recovery in the United States, Germany and France (Macdonald; Aldrick).

29. Getting the timing right is all the more difficult because fiscal consolidation is rife with political implications and can rapidly take on an ideological rather than a technocratic character. Ideological battles about taxes, and disputes about which social groups ought to bear the brunt of spending reductions and/or tax hikes, are intensely partisan matters. Political reality itself undermines the notion that the fiscal spigot can be turned on and off at precisely the right moment. The notion of all seeing, technocratic governments making perfectly timed and calibrated decisions exists on paper, but not in reality. For this reason, monetarist and supply-side-oriented policymakers argue that in a fallen world states should not engage in discretionary fiscal policymaking at all and should simply focus on getting the fundamentals right. What emerges in crisis, however, is that theory goes out the window as policymakers seek pragmatic solutions to serious and immediate problems.

V. FISCAL CONSOLIDATION - THE EMPLOYMENT DILEMMA

30. Unemployment has posed perhaps the most daunting policy dilemma arising out of the global crisis. It is by its very nature politically sensitive. Job losses are always unwelcome in democratically accountable systems, and political leaders pay a high price when unemployment soars. High rates of joblessness were certainly a factor in the 2010 US mid-term elections, and this has featuring in the politics of a number of European countries as well. Governments across the OECD have sought to minimise job losses even in the poor economic climate of the past three years and, in many respects, the various stimulus packages and employment measures that governments introduced were, at least partly, designed for that purpose. But invariably deep recessions rooted in banking crises produce significant and extended job losses. The unemployment rate in the OECD area in 2010 averaged 8.6% (OECD Labour Force Statistics). By December 2010 there were 46 million unemployed people in the OECD area, one million less than December 2009 but still 15.1 million higher than before the onset of the crisis. Germany and Chile are the only OECD countries reporting a lower unemployment rate today than in 2007 (Guerrea), while the Netherlands has the lowest unemployment rate in the EU. Although key economies are beginning to recover, job creation seems to be lagging behind.

31. In serious recessions, some job losses become structural or permanent and sustained high levels of unemployment can, in turn, inflict long-term damage on labour markets. When workers are compelled to leave the job market for several years due to the absence of employment opportunities, the likelihood of their return to gainful employment diminishes the longer they remain without work. Skills are lost, despair sets in and the work world moves on, leaving behind a segment of the population that has not been able to adjust.

32. Overall unemployment rates in the OECD today average between 8-9%. The rate for young people is twice that. In the United States youth unemployment stands at 25%, in France it is at 20% and in Spain at nearly 50% (Guerrea). The longer this endures, the more likely an important share of potential young workers will be permanently lost to the job market, and instead of contributing to national economic life, they will constitute a drag upon it. This is particularly worrisome as even educated young people for whom significant social investments have been made are losing skills and hope. Long-term unemployment is thus not only a manifestation of economic crisis; it is also a source of future economic, societal and political difficulties as well, and this is why governments have reacted with alacrity to the problem. The policy approaches have been as varied as have been the results.

33. Stimulus packages have been a first line of defence against potentially soaring unemployment. Empirical evidence does suggest that jobs were saved as a result of increased

government spending in the face of the recession. Without that spending, more workers would have likely moved to the unemployed rolls and the long-term damage to the job market would have been significantly greater. The problem today is that fiscal budgets and debt levels in a number of countries have soared. As economies recover, OECD countries are compelled to enter a period of fiscal consolidation to correct the damage from yawning budget deficits and accumulated debt. Stimulus spending responses to unemployment are thus rapidly winding down. More targeted responses will now be needed as countries wait for a return to growth.

34. German and US responses to the unemployment crisis reveal that very different policy approaches can be adopted in the face of job loss. Political, economic, historical and cultural factors shape labour markets. There is clearly a higher priority accorded to job protection in Germany, whereas the US political and economic culture accepts very flexible job markets where labour shedding and labour hiring is relatively easier than in much of Europe. In the recent crisis, German policymakers sought to maintain employment levels, not by engaging in massive deficit spending but rather by encouraging companies to reduce work hours. This helped many German workers continue in their jobs, although they were not taking home as much pay as before. In the recent crisis, the US government relied on deficit spending to slow the pace of inevitable job loss. US unemployment in May 2011 stood at 9.1% while the unemployment rates were 6.0% in Germany, 4.2% in the Netherlands, 9.5% in France, 20.9% in Spain, 9.9% for the euro area and 9.3% for the European Union as a whole.

35. There is another view, however, suggesting that it is precisely because American firms were able to react with great flexibility to the financial shock that the US economy was initially emerging more quickly from the recession than Europe, although the price has been higher unemployment. The response of US firms to the crisis has yielded increased labour productivity in the United States of 3.5% compared to a 2.5% decline in Europe in 2009. Another reason may be that the United States is less dependent on this recession's hardest hit sectors - manufacturing, construction and bank lending - than were countries like Spain and Ireland, for example.

VI. FISCAL CONSOLIDATION - IMPLICATIONS FOR DEVELOPMENT ASSISTANCE AND DIPLOMACY

36. In 2000, a United Nations conference set out the eight Millennium Development Goals, which aimed to eradicate extreme poverty in the world and to make critical progress on a range of human welfare indicators by 2015. Budget pressures and recession have slowed progress on a number of fronts, while aid budgets are now in the crosshairs of budget cutters. Total Official Development Assistance (ODA) by the 23 countries of the OECD's DAC (Development Assistance Committee) rose by 0.7% in 2009 in real terms, (by 6.8% if debt relief is excluded), to US$119.6 billion. The amount is equal to 0.31% of DAC countries' combined GNI (Gross National Income). The UN ODA (Official Development Assistance) target for wealthier countries is 0.7% of GNI which is exceeded by Sweden, Norway, Luxembourg, Denmark and the Netherlands.

37. The world's largest aid giver in absolute terms is the United States (which disbursed US$33,9 billion in economic aid as well as US$11 billion in military aid in 2009), France, Germany, the United Kingdom and Japan, as well as organisations like the EU and UN are substantial givers as well. At the Gleneagles G8 Summit in 2005, the G7 countries committed to do their part to increase global aid by US$50 billion to US$130 billion by 2010, half of which was meant to go to Africa (Gleneagles Communiqué). The level today stands at only US$120 billion. France, Germany, and Italy have not fulfilled their 2005 assistance growth commitments. Italy, for example, cut aid by more than 30% in 2009 and is actually spending less on aid than it did five years ago. The UK spends 0.52% of GNI in ODA, France 0.46%, Germany 0.35%, Canada 0.3%, the US 0.2%, Japan 0.18%, and Italy 0.16%.

38. Virtually all Allied governments continue to characterise foreign development assistance as a critical component of national foreign and security policy. The British Conservative-Liberal Democrat coalition government, for example, is increasing its aid budget, even though government spending is being cut across the board. Aid budgets are under more serious pressure in the United States and elsewhere. Foreign aid is difficult to defend politically as its most apparent beneficiaries do not vote. A recent Gallup Poll indicated that foreign aid was by far the most popular candidate for cuts among the American public with 59% supporting foreign assistance reductions (Dombey). There is even a push in some political circles to eliminate entirely the US Agency for International Development (USAID), but this is not likely to go very far (Rogers). That said, aid level cuts seem very likely in the United States.

39. Funding for US diplomacy will also be reduced, although the Obama Administration had been pushing for a budget increase. The scope of the State Department's mission in countries critical to national security – particularly Iraq, Afghanistan, Pakistan and Yemen has expanded significantly in recent years. The State Department has hired hundreds of new Foreign Service officers and aims to increase funding for the Foreign Service by 25% over 2008 levels by 2014. However, it is unlikely that requested funding levels will survive a budget-cutting Congress. The administration had originally requested $51.2 billion for the State Department and USAID for 2012, but a House appropriations bill would cut levels to $39.6 billion, an 18% decrease from 2011 levels (Rogin). Secretary Clinton has warned that cuts of such magnitude "will be devastating to our national security, will render us unable to respond to unanticipated disasters, and will damage our leadership around the world."

40. European diplomacy may face similar fiscal challenges. The EU's new European External Action Service created under the Lisbon Treaty is still under development, but its budget could rise to €3 billion when it becomes fully operational (BBC 7/12/10). The co-ordination of foreign policy at the European level does have the potential to reduce costs for countries that cannot afford to maintain non-essential embassies around the world, but it will have costs that governments may be reluctant to underwrite. Finally, other so-called soft power instruments could face serious cuts in Allied countries on both sides of the Atlantic. Britain's government-funded BBC World Service, for example, has shut down numerous foreign language broadcasting programmes eliminated several Balkan language, Portuguese for Africa and English for the Caribbean, broadcasts as well as Russian, Turkish, Ukrainian, and Mandarin Chinese radio shows while imposing limits on radio distribution in Hindi, Indonesian and Swahili (BBC 26/01/11). This could be a harbinger of a broader reduction of soft power projection among NATO member countries.

VII. FISCAL CONSOLIDATION - THE DEFENCE AND SECURITY POLICY DIMENSION

41. Democratic societies must constantly assess defence and security spending in light of available resources and competing demands on those resources. The global economic crisis has exacerbated structural deficits and debt levels in a number of countries by lowering both tax revenues generated through economic activity and by increasing outlays through automatic stabilizers and more ad-hoc efforts to stimulate demand. These temporary measures, however, are only part of the story as there are more permanent or structural phenomena that are driving up long-term debt in a number of countries. Mandatory or entitlement spending as a share of GDP, for example, is slated to rise in most NATO countries. Rapidly ageing societies will face the greatest burdens as ever higher percentages of their populations become pensioners entitled to government financed health and income support.

42. Fiscal problems have become the core challenge to American political leaders. The CBO recently projected that if recent spending patterns continue, public debt could increase to 300% of GDP over the next 40 years, with a sharp acceleration beginning in 2020 due largely to rising health care and other entitlement costs coupled with societal ageing. The CBO furthermore

predicted that by FY 2018 the government would spend more money paying off debt interest than it would on defence (Cordesman). These trends could put enormous downward pressure on discretionary budget items including defence spending. The political situation in Washington, however, subsequently shifted, and fiscal consolidation has clearly emerged as a central priority, although how to achieve this has become the subject of an intense ideological and political struggle. Thus while there now seems to be a greater willingness to address huge budgetary shortfalls, the toughest decisions are still being put off for later. Cutting spending and/or raising taxes is politically challenging, particularly in a country where members of the House of Representatives are on a two year election cycle and where the level of unemployment is now hovering around 9%. Citing the brinksmanship of the debt ceiling settlement and expressing a lack of confidence in the political and institutional setting for economic policy making, Standard & Poors recently downgraded the debt rating of the United States from Triple A to AA+, a move that will likely drive up interest rates on the US debt and which will tarnish the reputation of the dollar (Appelbaum and Dash).

43. Projections in the United States suggest that more dramatic cuts in primary spending and/or greater tax increases will be required the longer deficit reduction is put off. The CBO has indicated that reductions in primary spending or increases in revenues needed to close the 25-year fiscal gap would have to be in the order of 4.8% of GDP if begun in 2011 but 12.3% if begun in 2025 (Cordesman). The future of US defence spending will therefore hinge on how that country responds to this very serious challenge and the speed at which it does so. After years of generous defence appropriations, the mood in Washington now suggests that the Department of Defense (DoD) will not be exempted from the budget axe. One defence specialist recently noted that “in 2000, we were responsible for one third of the global economy and one third of (global) defence spending. Now we have a quarter of global GDP and 46% of defence spending” (McGregor). On the face of it, this does not seem like a sustainable position.

44. There are concerns that the US force structure remains overly wedded to Cold War realities, has become bloated and inefficient and is now strained by current operations in Afghanistan, Iraq and elsewhere. Former US Defense Secretary Robert Gates made a series of recommendations to President Barack Obama on ways to address this and had been speaking about the problem for a number of months prior to his retirement. Thus even traditional defenders of large defence budgets now recognise the need for spending restraints (McGregor and Lemer).

45. Other savings are being made by revisiting DoD cost management procedures. The Pentagon’s acquisition chief, Ashton Carter, has introduced a “should-cost” analysis of all programmes to counter the tendency for programme managers and contractors to exaggerate costs - a practice which becomes a self-fulfilling prophecy (Bennet). Some have suggested that as part of a force rationalisation programme, the United States ought to reduce its footprint in Europe, but the Libya operation illustrates how important Europe remains in American strategic calculations. "I think that European platform permits us to reassure Allies, to deter, to conduct military operations as we're doing today in Afghanistan and in Libya, and to do this training, and building and partnership capacity – those are vital functions" according to NATO SACEUR (Supreme Allied Commander Europe), Admiral James Stavridis. But he has also pointed to the possibility for US force reductions in Europe as part of a broader rationalisation of US forces (Vandiver).

46. At this writing, the US Congress has just ratified a debt limit agreement that could eventually result in cuts of hundreds of billions of dollars from the military budget over the next decade, although there are are few details in the debt ceiling arrangement. Cuts in the 2012 budget will be relatively modest, but afterwards military spending reductions could amount to as much $550 billion over the next decade. This is $150 billion more than President Obama had originally suggested. A new bipartisan Congressional Committee will be charged with finding an additional $1.5 trillion in cuts by November or trigger automatic across the board spending reductions of

$1.2 trillion starting in 2013. Roughly 50% of those cuts would come from military spending. In other words, the recent budget deal will likely put the military budget on the table. Under the terms of the debt ceiling agreement, security spending would be capped at $684 billion in 2012 compared with this year's budget of $689 billion. This includes the budget for the Pentagon, the State Department, the Department of Homeland Security and elements of Veteran's Affairs and Intelligence spending. The debt ceiling agreement, however, does not factor in any reductions that might come about from a drawdown of US forces in Iraq and Afghanistan (Buhmiller).

47. US Secretary of Defense Leon Panetta has recently warned that any defense budget cuts exceeding $400 billion over the next decade could risk "hollowing out" the military while limiting its capacity to cope with rising powers like China. He called on the US Congress to raise tax revenues and cut entitlement expenditures like Medicare and Social Security, which constitute two thirds of total government outlays, before slashing defense budgets beyond the recently agreed levels. Mr Panetta said that the roughly half a trillion in additional cuts in Defense Department spending that would go into effect if Congress fails to enact a separate savings package by the end of the year would be "unacceptable." Any further defense cuts would "damage national security" (Cloud).

48. The United States remains by far the world's largest defence spender, and in 2008 accounted for 41.5% of global military expenditure. China accounted for 5.8%, France 4.5%, the UK 4.5% and Russia 4% (SIPRI). Trend lines, however, tell a somewhat different story. China and Russia, for example, have launched significant defence spending increases in recent years as a result of strong economic growth. Among NATO countries the trend is clearly moving in the opposite direction. Diminishing defence spending in the West and rising defence outlays in Russia, China and India will eventually alter the global balance of power. If Western recovery is slow, and deficits and debt levels rise, political pressures will mount to slash defence budgets further, undercutting available funds for defence research and development, procurement, and personnel. Defence cuts would eventually undermine Allied capacity to maintain its security commitments and certain countries would be compelled to lower their outstanding security ambitions. According to NATO Secretary General Anders Fogh Rasmussen, NATO risks becoming increasingly divided between security providers and consumers as some countries start slashing defence outlays to balance budgets.

49. Containing costs and increasing efficiency will be essential to ensuring that even reduced defence spending purchases reasonable capabilities at reasonable costs. There is ample room for improvement here because defence spending is riddled with inefficiencies. Thinking in a smarter and more multilateral fashion will be essential to overcoming the serious tension between fiscal and strategic realities.

50. French and British efforts to achieve greater synergies are hopefully a harbinger of things to come. The economic crisis has helped re-energise an important bilateral relationship between NATO Europe's two greatest military powers, which together account for nearly half of the EU 27's military spending. Among other things, the UK-France Defence and Security Co-operation Treaty calls for the creation of an integrated strike group incorporating assets owned by both countries, shared deployment of aircraft carriers with war planes stationed on each other's carriers, refuelled by each other's planes and with these carriers protected by one or the other's brigades. Joint deployment of a bi-national rapid reaction force, deeper nuclear co-operation, and closer defence industrial, procurement and research co-operation are also included in the agreement (Gomis).

51. The global economic downturn has unleashed serious fiscal pressures in both countries. This clearly encouraged the governments of David Cameron and Nicolas Sarkozy to identify new ways to employ bilateral co-operation in order to foster mutual defence savings in ways that might minimise the loss of military capabilities. The capabilities problem is no longer an abstraction. David Cameron has announced his government's intention to cut Britain's £36.9 billion defence

budget by 8% in real terms over the next four years - although this may well have to be reconsidered. His government has terminated several large spending programmes and significantly reduced others. For example, the Nimrod Spy plane fleet, which was engaged in operations in Libya, will be shelved in the hope of garnering savings of roughly £2 billion over the next decade. A final decision about replacing Britain's Trident submarine fleet, which is the platform for all of the country's nuclear deterrent forces, will only be made in 2016.

52. Meanwhile, the French defence budget has been rising at pace with inflation. Cost savings envisioned in the 2008 White Paper on Defence and Security will be generated by reducing the military ranks by 54,000 troops and by auctioning military owned real estate and radio frequencies. The revenues generated from these initiatives have been slated to help underwrite technological upgrades. The Triennial defence budget for 2011-2013, unveiled in September 2010, fixed French defence spending at €91.6 billion for this three year period instead of the €95.3 billion initially envisioned - a reduction of €3.7 billion.

53. With both countries now embracing spending reductions, bilateral co-operation has become an attractive means to preserve capabilities. Previous co-operative efforts like the 1998 Saint Malo Agreement were limited, partly because fiscal conditions were less dire than they are today and because France was then not part of NATO's integrated military command structure. This placed certain limits on the potential depth of bilateral collaboration. France has now rejoined that command structure, and with both countries facing fiscal pressures in the midst of serious operational engagements in Libya, Afghanistan and elsewhere, it makes a great deal of sense to look for bilateral solutions to several key defence challenges. The new co-operative schemes go well beyond those of Saint Malo and even touch upon the highly sensitive nuclear realm. They are important not only in themselves, but also insofar as they chart a way for improved resource pooling and mission specialisation among all Allied members.

54. NATO picked up on this theme at the Lisbon Summit where fiscal and economic difficulties loomed large. The final declaration noted that "(…) in light of these difficult economic times, we must exercise the utmost financial responsibility over defence spending. We are determined to pursue reform and defence transformation and continue to make our forces more deployable, sustainable, interoperable and thus more usable. We will ensure that the Alliance is effective and efficient" (Lisbon Summit Declaration). These are hardly new promises. Dozens of Alliance statements over the decades have called on members to strive for greater efficiency in defence spending, while real change has been far more difficult to enact because of the persistent prerogatives of nation states and the triumph of national politics over collective efficiency.

55. Indeed, there remain myriad barriers to greater European and trans-Atlantic defence industrial co-operation and the kind of mission integration that might induce real savings. Indeed, the most daunting barriers typically involve core national sovereignty concerns. Defence industrial co-operation as well as capabilities and mission specialisation are premised on the insight that countries will willingly forgo certain industrial or military capacities in order to specialise in those areas in which they exercise a certain comparative advantage. These states will specialise, only if they are fully confident that their allies will develop complementary industrial or military capabilities and willingly make these available when called upon. They also need to be reassured that the economic benefits outweigh the costs and this requires taking a long-term rather than static perspective. That is often a very large conceptual leap for countries to take, and most have deep reservations about doing so despite the potential economic benefits. This is precisely why the defence industrial sector has been exempted both from the rules of the European Common Market and from the trading rules of the WTO.

56. The current fiscal climate, however, could encourage more NATO countries to seek multilateral solutions in order to meet capability requirements and defence obligations. This hardly reflects a reversal now need of traditional conceptions of national sovereignty. Rather, it is an

expression of a situation in which states are financially so hard pressed to meet their defence obligations that they have little choice but to think in an innovative and multilateral fashion. The new Anglo-French agreement can be seen in this light. But there are other initiatives that seem to be working in the same manner. The nascent NORDEFCO (Nordic Defence Co-operation), for example, aims to deepen co-operation in Europe's Northern region. The founders, Denmark, Finland, Iceland, Norway and Sweden, invited Estonia, Latvia and Lithuania to join the effort in January 2011.

57. In Europe there is enormous potential for defence productivity gains. Put together, the militaries of NATO's 26 European members are larger than that of the United States in terms of personnel, but lag far behind in defence spending, investment and, most notably, capabilities. Europe's defence market is highly fragmented but six countries play leading roles: Alliance members the United Kingdom, France, Germany, Italy and Spain and NATO partner Sweden. In order to maintain capabilities while cutting defence budgets, Europe will have to engage in cross-border force restructuring, integrate its defence markets and, if politically feasible, even establish deeper defence market integration with the US. There are, however, daunting barriers to all three of these possibilities.

58. The European defence market and European military forces themselves are riddled with unnecessary redundancies, primarily because governments insist on developing broad ranges of military industrial and operational capabilities rather than specialising in those areas where they might hold comparative advantages. While a degree of force specialisation and deeper co-operation has been achieved, defence remains the ultimate pillar of national sovereignty. There is no indication that large or even many small countries are prepared to forgo national forces and a national defence industrial base for a transnational one, which they might feel less able to control.

59. Insufficient co-operation between NATO and the EU produces another set of inefficiencies that are particularly frustrating insofar as most EU members are also in NATO. Deeper co-operation between these two important institutions is effectively blocked due to highly specific political disputes involving only a small number of countries. The problem now is that budgetary matters alone are making these kinds of disputes a luxury that most countries no longer want to underwrite. Pressure for solutions is thus mounting. More efficient co-ordination and the reduction of costly redundancies between NATO and the European Defence Agency are now essential. This too was highlighted at the Lisbon Summit.

60. Article 296 of the European Community Treaty denies the European Union any formal oversight over defence markets. In practical terms, this has allowed EU member governments to protect defence industrial firms on purely national security grounds. The EU, however, recently adopted Directive 2009/81/EC which removes some important barriers to integrating defence procurement markets in Europe. Member states must transpose the Directive into law by August 2011. This should make it somewhat easier for defence firms shut out from bidding or discriminated against in the bidding process to challenge governments that invoke Article 296 after they have engaged in overt discrimination in favour of national firms. The new rules will not end the practice but will provide some recourse for firms that feel that politics have triumphed over sound procurement policy.

61. Even before the economic and budget crises struck, many Alliance members were not meeting NATO's 2% of GDP defence spending target. GDP growth outpaced defence spending growth from 1990 to 2010 in all member States except Estonia, Latvia and Lithuania, with Poland and the United States keeping closer to pace than others. Greek and Turkish defence spending levels have fallen off in real terms over the past decade after relations between the two erstwhile rivals improved. Greece spends more on its defence for its economic size than any other European country and significantly more per capita than Turkey; yet more than half of its budget is dedicated to personnel outlays and is less focused on developing real capabilities. Similar

spending patterns are apparent in a number of other Allied countries. Within NATO, only Canada, the Czech Republic, Estonia, France, Luxembourg, Norway, the United States and the United Kingdom spent less than half of their defence budgets on personnel in 2009. Ideally defence budgets should apportion one third of spending on personnel, one third on procurement and one third on research and development, housing, and other such outlays. As NATO governments seek to rectify grave budgetary and debt problems, they must look very hard at their defence budgets to determine if they are really getting the best deal for their taxpayers. The goal should be to acquire the most effective and strategically relevant capabilities at the lowest price. NATO governments and parliaments will need to think multi-nationally in order to achieve this over the coming decades.

62. It is critical that governments make realistic assessment of how forces might be used and to structure those forces accordingly. Eliminating force structures that are irrelevant can help governments achieve important budgetary savings in the longer term, although defenders of the status quo tend to point to the short-term costs of doing so. Still, change is accelerating. Germany, for example, has recently ended conscription, and its forces are to be cut from 250,000 to 185,000. The goal is to make this new force significantly more deployable and ready than the old conscription force, which was still largely structured for Cold War scenarios. At the same time, however, Germany plans on making defence spending cuts of €8.3 billion by 2014. (In NATO, only Denmark, Estonia, Greece, Norway and Turkey retain conscription). With the UK also making significant defence cuts, some American officials worry that it will be even more difficult to share some of their considerable security burden with their closest and most important partners.

63. A number of these issues were laid out in the final speech Robert Gates made as US Secretary of Defense in Brussels on 10 June 2011, a talk in which frank expression replaced diplomatic niceties. In that talk, the then Secretary of Defense thanked the European allies for their dedicated support in Afghanistan. But he also noted that "crucial support assets such as helicopters, transport aircraft, maintenance, intelligence, surveillance and reconnaissance and much more" were inadequate to the task at hand. He suggested that this gap was leading to a two tiered alliance between those allies "willing and able to pay the price and bear the burdens of alliance commitments and those who enjoy the benefits of NATO membership…but who don't want to share the risks and the costs". Mr Gates pointed out that "despite the demands of the mission in Afghanistan, total European defence spending declined by nearly 15% in the decade following 9/11." He warned of the risk of "collective irrelevance" (Gates).

64. In that presentation, Secretary Gates also noted that diminishing budgetary commitments to military force in Europe have sharply undercut capabilities despite years of private complaint from his predecessors to their European colleagues. He noted that just five of the 28 allies today exceed the agreed minimum of NATO defence spending benchmarks of 2% of GDP - the United States, the UK, France, Greece and Albania. He recognized, however, that in the current economic environment, spending increases would be difficult to enact. One way to avoid strategic irrelevance lay in finding new ways to boost combat capabilities: in procurement, training, in logistics and in sustainment. NATO's "Smart Defence Initiative", however, represents a step in the right direction but will not solve the problem completely. Indeed, "the blunt reality is that there will be dwindling appetite and patience in the US to expand increasingly precious funds on behalf of nations that are unwilling to devote the necessary resources or make the necessary changes to be serious and capable partners in their own defense", the Secretary said, adding that "if current trends in the decline of European defence capabilities are not halted and reversed", many US policymakers "may not consider the return on America's investment in NATO worth the cost" (Gates).

65. With the US share of NATO defence spending rising to 75%, and with the United States in the midst of a fiscal crisis of its own, the politics of allied defence spending could well become a serious issue as the former Secretary of Defense recently warned. He noted that many new

members of the US Congress are not old enough to have had the formative experience of a previous generation of American leaders who had placed Europe at very centre of their strategic calculations for compelling historic and strategic reasons. The new Congress, he warned, will be less inclined to conform to long term strategic habit and will rather act on immediate security imperatives. If US taxpayers fully understood the huge discrepancy in allied defense spending, Gates concluded, they might add momentum to such a movement.

66. If anything, Secretary Gates was being diplomatic. Europe's defence posture has grown woefully weak, and there has not been a serious effort or even a sustained political discussion about how to remedy the problem. It is time for Europe to get serious about this issue. In some respects, the fiscal crisis we confront could be an opportunity as we can no longer afford to continue along the same path and our resources are limited. Far deeper co-operation and far more intelligent use of scarce defence resources are needed not only to counteract the security effects of the fiscal and economic crisis, but also to begin to deal with precipitously eroded military capabilities and the diplomatic and security implications of these shortcomings. It is worth recalling that when NATO's founding treaty was signed on 9 April 1949 in Washington's Constitution Hall, the band played George Gershwin's *I've Got Plenty of Nothing*. The European members of this Alliance are now compelled to demonstrate that this was not a prophetic performance but this will require a very concerted effort at a time when much more focus is being paid to economic matters. The fact is, however, that there is much an economic as a strategic imperative to undertake these measures.

67. At a time when NATO's European members are undertaking significant defence spending cuts, the international security environment has remained unforgiving. The old discussions of a post-Cold War peace dividend are now a memory. Allied militaries are being deployed at unprecedented rates, and this has very consequential financial implications related to maintenance, operating cycles, equipment replacement and manpower costs. US and European forces are now engaged in upholding the UN Resolution 1973 to maintain a no-fly zone over Libya and provide protection to civilians in that country. European naval forces in the Mediterranean are deployed in the counter-terrorism operation Active Endeavour and in the anti-Piracy Open Shield mission, in addition to the vital roles NATO forces are playing in Afghanistan and Kosovo. The uprisings in North Africa and the Middle East could pose additional security challenges to Europe including a potentially serious and destabilising refugee crisis with important implications both for Europe's Southern flank and energy security. In short, while tight budgets demand far greater efficiency in defence spending, procurement and research, any reduction in vital capabilities could prove extremely dangerous. Efficiencies need be found, and this should include scrapping superfluous capabilities and wasted manpower, both of which now ought to be seen as luxuries.

VIII. CONCLUSION

68. Debt and massive budget deficits are among the worst legacies of the instability that has plagued the global economy over the past four years. Yet, in many cases the roots of these fiscal problems pre-exist the crisis and, in several important cases, were factors that helped trigger it. All Allied countries must now begin to shape fiscal consolidation strategies that promise to be as politically painful as they are economically necessary. This will require cross-aisle political co-operation if it is to succeed, but in many countries, national budgets are the very stuff of partisanship. The stakes are clearly rising as high debt levels threaten to crowd out private investment, which is critical to long-term growth. The very mettle of our political systems are going to be challenged as these problems are sorted out, in part, by meting out varying degrees of pain.

69. As a starting point, the best way to encourage some degree of broad political co-operation is to ensure that this pain is shared in an equitable manner. Sacred cows will have to be sacrificed so that reasonable levels of critical public investments in education, infrastructure, research, social

safety nets and defence can continue to ensure long-term growth and stability. For countries with explosive fiscal deficits and high levels of public debt, tax reforms and, in some cases, tax hikes will invariably have to be part of the solution. They must be structured in such a way as to enhance rather than undermine long-term competitiveness.

70. Failure to make these corrections would have grave consequences. Soaring debt would reduce resources needed both to keep economies competitive and to defend national and collective security interests. Inflation would creep upward and trigger interest rate hikes; both could undermine investment and significantly worsen economic conditions. Future economic crises would be more likely and the international monetary system would be thrown into even greater chaos. This would lower the potential for economic growth to act as a catalyst for deficit and debt reduction. The longer adjustment is put off, moreover, the harsher the choices are likely to become (Rubin). Markets need to be convinced that fiscal sustainability will remain a central priority for Western governments. If they are not, instability and ultimately economic and strategic decline will become the new paradigm. That must not be allowed to happen.

71. Fiscal realities will invariably play a more prominent role in shaping how the Alliance is structured. The recession, debt and budget shortfalls in member countries are inspiring new levels of trans-national co-operation but also leading to radical defence spending cuts that could undermine critical capabilities as well as national and collective security. Relentless fiscal pressures on a number of governments are likely to persist, and it is simply not realistic to expect increases in defence spending in the near and middle term. This makes it incumbent upon all NATO governments to deepen the level of collaboration in order to drive down costs without sacrificing critical capabilities. NATO must play a role in fostering this kind of co-ordination with the aim of helping each of the Allied members and the Alliance as a whole to achieve capability development in the most cost-effective manner possible. As the recently signed Franco-British co-operation treaty suggest, creating efficiencies by reducing redundancies can also be achieved by smaller groups of states. Such efforts should also be encouraged.

72. There are many policy changes that if undertaken would help the Alliance weather the fiscal crisis and emerge from it militarily stronger and more integrated. Among the steps that might be considered are pooling funds to pay for needed capabilities, common development and procurement programs, common munitions stocks, and using personnel longer rather than enacting early retirement programmes. Creating procurement consortia could help garner savings, and such arrangements could allow countries to drive better bargains with defence firms. Defence planners and political leaders also need to consider substitution principles. For example, in some circumstances reserves might replace regulars, police might replace soldiers, attack helicopters might replace tanks and service contractors could replace military personnel for a range of support services provided to troops and military bases (Hartley). Defence market protectionism must be abandoned. It has all the costs of normal protection and the result is to leave our societies less secure. Open defence markets among NATO members could give the Alliance a genuine competitive advantage in every sense of the word. Europe also needs to consider embarking on a greater level of military integration which would allow a higher degree of mission specialization so that its members are not paying for redundant forces which are ultimately a drag on national budgets and ill-equipped for actual deployment.

73. The United States will invariably have to recalibrate its international posture as it copes with very burdensome fiscal challenges and ever sharper political divisions that some financial analysts now view as seriously debilitating. The US defence budget is unlikely to be spared, and its diplomatic corps, foreign aid and other important dimensions of its foreign policy tool kit are also likely to suffer cuts. This does not mean that the United States will simply retreat from its position as a NATO and indeed a global leader. The United States will continue to see Europe, East Asia and the Middle East as critical priority areas for its own national security and economic interests. But it too will have to make tougher decisions about what potential deployments conform to vital

national interest and justify significant resource outlays. Less essential missions are thus more likely to be foregone for the sake of generating essential savings. This has been one element of Congressional criticism of the Libyan campaign. The United States will continue to look to others to take up the slack and here a more efficiently structured European defence community will be essential.

74. In this rethinking, highly expensive and difficult nation building exercises may no longer make the grade. Missions in Iraq and Afghanistan have cost the United States and its allies billions of dollars (and counting) with results that have been modest to say the least. American taxpayers, who are now going to be asked to make enormous sacrifices at home - reduction of long-held medical, unemployment and pension benefits, public sector lay-offs, the termination of collective bargaining rights, less funding for schools, and higher taxes - are not going to willingly endorse new nation-building exercises in far-away countries unless very compelling cases can be made (Mandelbaum). President Obama said as much in a December 2009 speech announcing the deployment of an additional 30,000 troops to Afghanistan: "As President, I refuse to set goals that go beyond our responsibility, our means, or our interests… I'm mindful of the words of President Eisenhower, who – in discussing our national security – said 'Each proposal must be weighed in light of a broader consideration: the need to maintain balance in and among national programmes'… We can't simply afford to ignore the price of these wars" (Obama).

75. The ongoing Libya operation provides an immediate illustration of the tension between national security obligations and fiscal realities. The United States government has asked its allies to take the lead because of its compelling commitments elsewhere. But the operation also demonstrates how stretched European defence budgets are. The head of the British Royal Air force, Air Chief Marshal Sir Stephen Dalton has warned that his service will need "genuine increases" in its budget over the coming years, if it is to continue running the range of operations ministers demand while preserving core capabilities. The RAF currently has an active presence in Afghanistan, the Falklands and over Libyan airspace. In its 2010 Strategic Defence and Security Review, the government, which has called for an 8% reduction in the MOD budget, laid out proposals to cut 17,000 jobs from the armed forces, 7,000 from the Army and 5,000 from the Navy and the RAF. It was expected that the Tornado fleet might be eradicated; yet, it has played a key role in the Libyan campaign. The Nimrod R1 has also been granted a reprieve as long as it is supporting the Libyan mission (Hopkins). US plans to rely more on its Allies for certain missions may well run up against these kinds of budget realities in Europe. In the future, Europe will have to be better prepared to carry out these kinds of missions and more European countries need to position themselves to contribute in a meaningful way. Failure to embark on these changes will quickly undermine alliance solidarity and put our collective security interests at risk.

76. Force restructuring will thus be very much part of the response to the fiscal burden. Military technologies could be rendered far less valuable as a result of technology proliferation elsewhere – from China's development of anti-access/area-denial capabilities which threaten US naval dominance in East Asia, to the accumulation of high-tech weaponry such as guided rockets in the arms of irregular forces like Hezbollah (Krepinevich). The increasing sophistication of cyber weapons promises to transform the international security environment. Making investments to maintain a strategic edge in this rapidly evolving environment will necessitate redirecting funding away from more traditional defence programmes in order to meet emerging and compelling potential threats. We must not defend old military programmes for reasons of nostalgia or for short term concerns like employment. Staying on the cutting edge of technology requires member states to embrace the kind of dynamism that has been greeted with scepticism and fear in the past.

77. Ultimately, all Allied parliaments must ensure that every dollar, euro or pound appropriated for defence spending is underwriting critical capabilities rather than serving some other purpose like subsidising a particular firm or keeping local employment levels up. Those may be noble goals

when governments are flush with cash, but in a time of fiscal stress, they represent ends best pursued by other means. The world is no less dangerous than before the crisis and may well be more so. It is vital that our societies be prepared to defend themselves from potential threats but they will have to be able to do so in far more cost effective ways than in the past.

78. For this reason, the Secretary General of NATO, Anders Rasmussen, has advanced the idea of building a smarter defence, "ensuring greater security, for less money, by working together with more flexibility." As part of this approach, he has urged nations to pool and share capabilities, to set relevant priorities, and to better co-ordinate the efforts of allied defence establishments. He has not only called for deeper collaboration but working through slimmed down and more efficient defence establishments. Secretary General Rasmussen sees NATO as playing a catalytic and support role in this process. His proposal makes a great deal of sense, particularly in the current budgetary climate and far more effort is needed to move defence establishments in this direction.

79. Far greater co-operation between NATO and the EU in defence matters is also critical. Progress here has been blocked diplomatically, but this is no longer tenable and it is certainly not fiscally justifiable, particularly for countries that are members of both institutions. A renewed diplomatic effort is needed to overcome the barriers to this co-operation and the effort needs to be more serious and concerted than in the past. Capabilities are being sacrificed to accommodate certain national positions which are, at least collectively, untenable. This inexcusable state of affairs must now be addressed because the status quo is not only highly inefficient; it also puts our societies at greater risk.

80. Finally, many of these matters have been discussed for years if not decades. But political inertia which, in part, has arisen out of decades of prosperity, has meant that tough savings and efficiency measures have simply been put off. The very serious economic and political crisis that our societies confront today, however, makes it imperative for Allied governments to take action. This will not be easy. Old paradigms die hard. Embracing new ones requires leadership and this is precisely what our societies and our Alliance now need. On these matters, national parliamentarians are going to have to lead from the front.

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