

THE BROOKINGS INSTITUTION

CONTINENTAL DRIFT: EUROPE'S SHAKY POSITION IN THE WORLD

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PARTICIPANTS:

Welcome and Introduction:

FIONA HILL
Senior Fellow and Director, Center on the United States and Europe
The Brookings Institution

FIRST SESSION: POST-CRISIS OR LOST DECADE? EUROPE'S ECONOMIC
FUTURE AFTER THE EURO CRISIS:

Moderator:

THOMAS WRIGHT
Fellow, The Brookings Institution

Panelists:

DAVID RENNIE
Washington Bureau Chief
The Economist

SIMON TIFFORD
Deputy Director
Center for European Reform

RANDALL HENNING
Professor, School of International Service
American University

SECOND SESSION: POST-NATIONAL OR PRE-POPULIST? THE ROLE OF THE
EUROPEAN UNION IN THE WORLD:

Moderator:

ANAND MENON
Professor of European Politics
King's College London

Panelists:

ANDREW MORAVCSIK
Director, European Union Program
Princeton University

JULIANNE SMITH
Director, Strategy and Statecraft Program
Center for New American Security

CHARLES KUPCHAN
Whitney Shepardson Senior Fellow
Council on Foreign Relations

WOLFGANG ISCHINGER
Distinguished Fellow, Woodrow Wilson International Center for Scholars
Chairman, Munich Security Conference

KEYNOTE ADDRESS: THE CRISIS IN UKRAINE AND THE TRANSATLANTIC
PARTNERSHIP:

Moderator:

FIONA HILL
Senior Fellow and Director, Center on the United States and Europe
The Brookings Institution

Speaker:

ANTONY BLINKEN
Deputy National Security Advisor and Assistant
to the President of the United States

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PROCEEDINGS

MS. HILL: Ladies and gentlemen, I'd like to get our proceedings started.
I'm Fiona Hill, the Director of the Center on the United States and Europe and I'd really
like to welcome you here to our annual conference for the Center. We're meeting today

ANDERSON COURT REPORTING
706 Duke Street, Suite 100
Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

obviously against a pretty historic backdrop. We've got President Obama's trip to Europe, he's been to Warsaw to mark the 25th anniversary of Poland's free election, he's been to Brussels for the G7 meeting, and now he's in Normandy for the 70th anniversary of the commemorations of D-Day which is taking place right now as we gather here today. So it's a historic time in Europe. It's also by coincidence, or perhaps not entirely by coincidence, the 10th anniversary of the creation of our Center on the United States and Europe here at Brookings, and we'd like to thank a few people for getting us as far these 10 years, not an easy situation for anything related to Europe, and certainly not for think tanks; it's actually always quite difficult to sustain activity. And this event today is made possible by the financial support of the European Union delegation here in Washington, D.C. He's not with us today because so many other things are happening in Europe but I wanted to begin with a thank you first to the Ambassador of the EU, Ambassador João Vale De Almeida, who was the first post-Lisbon Treaty ambassador here for the European Union, and he's shown really great leadership and has been a great friend to Brookings in the time that he's been here. He's returning to Brussels after four years here in D.C. As we know a lot of things have been happening in Europe with the European parliamentary elections and I'm sure we'll be seeing more of Ambassador Almeida in different capacities.

Our other partners for the conference are Kings College in London and we're very appreciative to Anand Menon who you're going to be seeing a lot more of today, and also our very own Jeremy Shapiro who is missing somewhere in the audience -- oh, there he is at the back -- for putting the event together. I also want to thank some other colleagues from the Heinrich Boll Foundation here, the German Foundation for their ongoing support of our activities in Europe, and also many people here in the audience who represent the embassies of our European partners countries who always join us for

these events and are here again today to show their support.

Now one of the reasons that CUSE, the Center on United States and Europe, was launched 10 years ago was that our Vice President of Brookings Foreign Policy at the time, Jim Steinberg, who many of you know from his many different capacities including as Deputy Secretary of State and Deputy National Security Advisor, he really felt 10 years ago that the issues we were facing in transatlantic relations were not just significant but extremely challenging, because 2004—if we think back a decade ago—was a very contentious time in the transatlantic relationship. A number of differences had emerged between the United States and Europe after the September 11th terrorist attacks and the United States' launch of the war on terrorism, which of course is still going on behind the scenes. And there was a little bit of skepticism at the time about the future of the alliance and how much Washington was going to be able to count on its European allies in this post 9/11 world, post-cold war world. Then of course U.S. made the decision to invade Iraq in 2003 and that led to even more rifts in the alliance. But Jim, along with the Founding Director of the Center, Phil Gordon, thought it was very important to remember how much the shared history counted in transatlantic affairs and to remember that we'd also found ways over the years to recognize and build upon our common interests. And so they launched the Center to underscore the principle that had made all the differences. The Transatlantic Partnership was an extraordinary relationship with a richness and depth unparalleled anywhere else in the world. And I think this conviction remains true today as we're going to be talking about. And although we have this title about Europe's shaky position in the world I think what I've just said tends to underscore that we're always in a shaky position, so hopefully we'll be able to do this for another 10 years. And hopefully, of course, find that there are, you know, ways of moving things forward, but as we meet against the events that took place in Normandy

70 years ago I think we can certainly say without a shadow of a doubt that this is still going to be a very important relationship as far as for the next several decades and that we need to remember as we're thinking about Normandy and the events of 10 years ago when we set up the Center that there's an awful lot of things that we have to proud about together, and also be very grateful for.

We'll also have later on the podium today Andy Moravcsik who was a speaker at our very first conference and has been one of the most consistent voices on the importance of the relationship, as indeed have all of our other participants. There's also one very -- then actually he's just come in at the back here so, Andy, perfect timing, which is everything of course.

We're also especially to be able to dedicate this conference today to the memory of our colleague Clara Marina O'Donnell. Many of you here in the audience are friends of Clara's and longstanding colleagues and you know that she was taken from us at too young an age in January of this year. And we at Brookings really miss Clara very much, professionally and personally. Clara was a much loved and respected colleague. She was a great inspiration for our work on Europe and she was also the inspiration for this specific event. She suggested it back in November of last year when she was first really, you know, going into the end of the time that she shared with us. And she urged us to put something together on what she said was going to be a momentous year for Europe of 2014, and she was of course right. Of course we couldn't all have anticipated some of the things that were going to happen, like of course the crisis in Ukraine, the annexation of Crimea, and the things that we're going to talk about when we have Tony Blinken with us at the end of the sessions today. But in any case Clara was always very present about this and, you know, we're here today as a result of some of the ideas that she had back at the end of last year.

Brookings shared Clara with the Center for European Reform in London where she covered European and Foreign Defense Policy. She also graduated from European studies from Kings College in London. And we have of course Anand here today. And she took her Master's Degree in International Relations at Cambridge. We have Simon Tilford here from the Center from European Reform to represent her work there. And we have our colleagues at Cambridge who are with us in spirit because they couldn't join us today. But we're especially proud to have Clara's parents here in the front of the audience, Peter and Carmen. They're showing here in celebration of Clara's work and also reflecting Clara's great passion for Europe. And I just want to also announce that together the three -- the four entities actually, the Center for European Reform, Brookings, and the Center in U.S. and Europe, Kings College, and the Department of Politics International Studies at Cambridge, are going to establish a fellowship in honor of Clara to sponsor a similar young scholar of Europe to spend six months at the Center for European Reform in London and also a week here at Brookings with us to promote their work on European Foreign Security Defense Policy. So we're very much looking forward to welcoming the first fellow here and we hope that many of you will be able to help us in support of this fellowship, especially all the friends of Clara that we see here in the audience.

Now we'd like to think that this conference will reflect Clara's habit of asking very tough questions about Europe, hence the title which probably wasn't particularly popular for any our colleagues from the delegation who saw this but nonetheless this reflects the passion that Clara and the rest of us share for getting at the answers, posing the tough questions as I said, but ultimately reflecting the great deep faith and confidence that we have in Europe and our desire that it be a better place and that the transatlantic relationship should continue.

So now I'd like to turn over the floor to the people who are going to make that happen today, ask the tough questions, give us some answers. And I'd like to thank everyone again for joining us today and I'd like to hand over to my colleague, Tom Wright, from Brookings who's going to chair our first panel with many of our distinguished participants on the economy and Europe's future. So, Tom, thank you. And thank you again everybody for joining us. (Applause)

(Interruption)

MR. WRIGHT: Thank you. My name is Tom Wright; I'm a Fellow here with the project on International Order and Strategy at Brookings. And I'm particularly delighted to be able to chair the first panel. I would like to thank Fiona and Jeremy Shapiro for asking me to do it and it's a particular privilege to do it at a conference in honor of Clara who I knew for the past two years here and who was a really wonderful colleague and she is sorely missed. And I know several people here knew her and on the panel and I think she would be very interested in the topic today, not just because of the events in Ukraine but also because she had such a strong passion for European Union foreign policy and for Europe's role in the world.

We're very fortunate to have three excellent panelists for the topic of really what's going on inside Europe. The second panel looks at Europe's role in the world. And we're trying to look at not just Europe's economy but really everything that goes on inside the box. Is Europe about to get out of the financial crisis and the existential phase has passed and is about to return to robust growth and really take on a greater role in the world and complete the project of monetary innovation by adding sort of fiscal federalism and all of the things that economists and others over the last decade said they need to do in order to be as stable and competitive, or are we at the beginning of a Japan style lost decade where the worst of the crisis is over but it's going to be very

hard for Europe to get the political support to do what is necessary to really fix the fundamental flaws of monetary integration? And after the parliamentary elections of last week what does that mean for the future of European federalism? Are we seeing a populist backlash whereby the politicians -- and Juncker's famous phrase -- may know what they need to do but don't know what to do -- don't know how to get reelected once they do it, and that maybe they won't be able to get the reforms through and what are we looking at in terms of the commission president and some of the key positions?

So what I'd like to do is to turn to each of the panelists to offer us their initial thoughts on this and then we'll have a conversation and then open it up for a conversation with you all for about half an hour. So, Simon, if I could start with you, could you begin by talking about the Europe sort of economic prospects. Are we really out the worst of the crisis? And where do we go from here in terms of, you know, ensuring that there isn't a new crisis and that we see some sort of growth and getting out of deflationary sort of spiral and that Europe can, you know, begin to sort of punt its weight economically in the world again? Sorry, I should add as well -- I apologize for not introducing properly Simon, but Simon is the Deputy Director of the Center for European Reform and specializes in the Eurozone and European fiscal policy.

MR. TILFORD: Thanks, Tom, and good morning, everyone. And thank you very much to both Brookings and to King for inviting me here to speak today. I think it's a lovely gesture to dedicate this conference to Clara, and all of us here are very, very grateful to Brookings, Kings, and to Cambridge for the help you've given us in setting up the Clara O'Donnell Fellowship which we hope will run for many years.

Turning to the subject. I used to argue about this quite a lot with Clara. She didn't disagree with my analysis but I think for Clara it was close almost to heresy for a colleague to argue that the Euro, which is a huge symbol of Europe and integration,

could actually have become a threat to the EU and a threat to European integration, so we would have lengthy discussions about this. I'm going to start off by outlining why I think the economy and the Eurozone economy in particular is still in such poor shape, why this situation poses a threat to the EU as a whole, and why the choice really does now come down to more or less Europe. Now despite the talk of economic recovery that one hears a lot of in Europe and despite claims by Eurozone and policy makers that the crisis is over the Eurozone and by extension the EU remains in a very serious mess. It's worth remembering that the Eurozone economy is still three percentage points smaller than it was at the beginning of 2008. Now even the U.S. which is supposed to be pretty moribund at the moment is six percentage points bigger. And if one breaks down the Eurozone into its constituent parts we see some truly, truly terrible numbers. The Spanish economy is still seven percent smaller, the Irish one over eight, the Italian over nine, the Greek one over twenty percent smaller than it was six years ago. Now Eurozone unemployment has come down a touch, largely because of people withdrawing from the labor market and emigrating, but it's still 12 percent and much, much higher than that in places like Spain. Youth unemployment -- and I think this is the number that really shocks people on this side of the Atlantic, is at about a quarter across the Eurozone, over 40 percent in Italy, over 50 percent in Spain. So we're seeing some truly shocking numbers still. Now unfortunately the myth persists in Europe that these problems are the result of countries mismanaging their public finances. This was the case in Greece, but aside from Greece it wasn't the case. The central problem we saw in Europe was huge capital flows from the core of the Eurozone places like Germany to places like Spain in what are termed the periphery of the Eurozone. Now this was interbank lending. That combined with the absence of so-called adjustment mechanisms in the Eurozone is the hub of the crisis, not mismanagement of public finances. Basically interest rates in the

run up to the crisis were far too low for the likes of Spain, Ireland, other countries, and too high for Germany's then moribund economy. Inflows of all of this money into Spain led to booms in those economies, pushed up their wages and their costs. When the financial crisis hit, the capital inflows stopped overnight resulting in bank crises in those countries; basically the capital stopped, the economies bombed, that hit public finances, the weakness of public finances hit the banks because the banks were sitting on all of the government bonds and then that depressed economic conditions hitting public finances again and rebounding on the banks, the so-called sovereign bank doom loop that everyone talks about in Europe. Now the failure to predict this is forgivable; no one spotted this, this link between governments and banks and what it could do. But the weakness of adjustment mechanisms within the Eurozone was predicted. This is a very large and very diverse currency. It comprises some very, very different economies. So an economic shock will hit some of them very differently to others. But Euro members cannot devalue their currencies as everyone knows and they don't have what economists call, "a lender of last resort". They essentially borrow in a foreign currency. There is no bank that will step in and buy their debt in the way you see here in the U.S. or the U.K. or elsewhere.

So without a currency and without a fully fleshed central bank, something else has to be flexible. Now this means that markets for goods and services, capital labor have to be highly integrated so resources move to where they can be used most productively. Now within the Eurozone there is a market, an integrated market for goods, so for cars and goods, clothing, everything, but there isn't much integration when it comes to services which are comprised mostly of economic activity. Capital is very slow to be allocated or to be used in the most productive fashion, so its very slow productive capital factories or whatever, are very slow to move from one part of the Eurozone to

another. And crucially labor mobility is very low. We have seen a lot of people emigrating from Spain and Ireland, Portugal in recent years, but a lot of those people, a majority of those people have gone to countries outside of the Eurozone. So the Irish it's been to Britain and here, Australia and Canada, the Spanish have gone to Latin America and Britain and America. Very few have gone to other members of the Eurozone.

The second factor is that the European Central Bank has hampered adjustment by allowing inflation to collapse in the Eurozone. The inflation rate in the Eurozone is now 0.5 percent which makes it very, very hard for countries such as Spain and Italy to engineer declines in their real exchange rates while getting on top of their debt burdens. I'm going to say why, why this is -- why low inflation is such a risk. The European Central Bank has also acted in a nakedly political manner for example by backing fiscal austerity in a slump which ignores economic theory and history, and for exaggerating the likely impact on economies of structural reforms.

Three, the Eurozone lacks any mechanism to transfer resources between constituent members. So with no federal budget to smooth asymmetric shocks, fiscal austerity has become the weapon of choice to address the crisis. The problem with this is that fiscal austerity is so called, "procyclical". What it does it exacerbates rather than ameliorates recessions; it makes everything worse. Now adjustment based on austerity and internal devaluation, which is what Europeans now call deflation, is dangerous. First, low inflation let alone deflation makes it very hard to reduce real wages. Take Spain, they need to reduce their real wages relative to Germany, but if inflation is very low that's very hard to do because nominal wages do not fall. It's almost impossible to cut nominal wages. To bring about cuts in real wages you need a bit of inflation. Two, inflation increases the real value of debt, both public and private. Raises with interest rates and this -- and then can lead consumers and business to delay

purchases if they expect prices to fall further. And third, fiscal multipliers -- and this basically means the impact of cuts in public spending -- are very large when interest rates are close to zero. So spending with actions with governments tend to have a very big negative impact on demand. Now what is needed against that kind of backdrop? Well, in the short term looser monetary policy and an accommodative fiscal policy. So asset purchases basically quantitative easing, a big, big program of quantitative easing and I would argue a higher inflation target, at least temporarily.

MR. WRIGHT: What bar would you put that at, the inflation target?

MR. TILFORD: Temporarily four percent. Now this would help prevent countries sliding into insolvency and facilitate the needed exchange rate, real exchange rate adjustment. More investment, more government investment by countries that have the fiscal scope to do so would also help underpin demand. That's the short term; in the longer term it's hard to see how this can work without a proper banking union rather than the truncated one that's been agreed, but a proper one that includes a large and Eurozone fiscal backstop, so making the banks, removing responsibility from banks from the national level to the federal level, putting the backstop at the federal level and a common deposit insurance system for the bank depositors across the Eurozone. Another thing would a safe Eurozone asset for banks to hold, some kind of Eurozone bond. This would help break the doom loop between the banks and the government by making it easier for governments to restructure sovereign debt. The problem is they can't do that at the moment because their banks are sitting on so much of that debt, and by restructuring sovereign debt they threaten to implode their banks. So you need this kind of safe Eurozone asset. And I would argue an element of fiscal union beyond what is implied in a fully-fledged banking union. Now a planned Eurozone unemployment insurance system could form the embryo of such a fiscal union. And finally a more

democratically accountable central bank for the broader mandates, something akin to the mandate of the U.S. Fed, responsible for price stability but also for growth and employment.

The problem with everything I've just said is that that requires more not less Europe. But as time goes on it's becoming harder to make the case for more Europe. Anyone following the European political scene can appreciate that. Europe increasingly is now defined by the constraints that it places on governments rather than the opportunities it provides them with to improve the lives of their electorates. And the longer this continues the greater the likelihood that we see a serious anti-European backlash, not just against the euro but against the EU more broadly. So I think there are two solutions, one is a jump forward to a more federal political Europe within the Eurozone with politics resuming at the Federal level, or I would turn to a European Union without a single currency and let individual countries manage their economies as they see fit. The problem is that the latter option will be hugely destabilizing, it would require capital controls, default in several countries, measures to deal with the ensuing financial crisis, and an agreement about how to deal with legacy debt and contracts, hugely complex stuff. It would be a very big crisis. But if a more federal Europe is impossible it will be better to get on with this before the politics turn seriously nasty. Thank you.

MR. WRIGHT: Thank you. It's fascinating. Simon, you said the, you know, you outlined what I think is a good sort of solution for Europe's problems in a number of areas, everything from monetary policy to fiscal policy to some of the politics, and you said that one of the reasons that that can't happen is because there's not enough support for more Europe, but another reason maybe it can't happen is because Germany in particular but also the ECB and many of the leading thinkers in Europe want more Europe but they actually disagree with those steps. You know, so they disagree

about a Euro bond and they disagree about quantitative easing. And there's been this pretty significant philosophical gap in economic policy that's opened up between Germany on the one hand the United States and some other countries on the other hand. So I think it's a tough question to think through because even if there is support for European integration and even if there are people in key positions who want to be forward leaning there is this deep philosophical, you know, disagreement about whether or not you can do these things.

And so I'd like to turn to Randy Henning who is a Professor of International Economic Governance at American University and really try to put this question to you, that if we are where we are in economic terms, there are these solutions out there that many people believe would have sort of a big bang effect of really being game changers and kick starting growth, but they're exceptionally unlikely because of German opposition and also because of rising sort of populism and the difficulty in getting it through in terms of treaty change. So what does that mean for the next sort of decade in European economics? I mean if we can't do what Simon sort of outlined and there's unlikely to be a collapse of the currency union for all of the reasons that, you know, people are afraid of what the alternative will be, what is the middle sort of muddling through option? How bad is it, is it not quite as bad as we think, and what can they do within the constraints that they have?

MR. HENNING: Well, thank you, Tom. I'm pleased to be a part of this panel and happy to celebrate the life and work of Clara O'Donnell in this way with you.

Let me approach the questions you've posed to me with three bullet points, right. And I'm going to preface this by saying that on this 70th anniversary of the allied landing in Normandy, the United States is still tied to the fate of Europe, albeit thankfully in a different way. And this country I think has an abiding interest in the

success of European integration. And I've been an early and consistent support of European monetary integration in particular and I want to see it succeed. I say this at the outset because we're going to talk about the problems associated kind of with Europe and the barriers to success and how these -- but we do this in the spirit that it's in our mutual interest across the Atlantic to overcome them. So I have three main points. Now the first is the jumping off point, Jeremy Shapiro in talking ahead of this conference suggested that I make this comparison to Japan and the decade of stagnation there. So I'll begin with that. Europe is not Japan but its stagnation displays some worrying similarities. And the second point I'll make is that the European Central Bank shows a path that differs from the Federal Reserve in monetary policy, ultimately owing to its institutional contacts characterized by political fragmentation. And the third point will be that Europe will need to do more than it has yet agreed if it is to stabilize the Euro Area permanently. In the long run it will need to find a way back to the no bail out clause of the Maastricht Treaty. And I'll use the American example to explain how and why that should be.

So with respect to the comparison to Japan there are important differences between Europe and Japan to be sure, but the parallels are ominous and Europe wants to avoid them. So in Japan, you know, we saw the bursting of an asset price bubble, imposed losses on the banking system. Regulators exercise forbearance, monetary policy was behind the curve, deflation was allowed to settle in which created further losses for the bank and perpetuating a downward spiral. Italy has already suffered a lost decade in terms of growth. Low inflation makes its debt deeply problematic, and Italy has at best only one and a half of the famous three arrows that Japanese Prime Minister Abe has used, fiscal policy, monetary policy, and structure reform. Structural reform being the one arrow that it has at its disposal for the future and

it's essential that structural reform in Italy progress to yield kind of increases in growth over the long term. Now Ben Bernanke warned Japan about this downward spiral I just talked about early in the process and his advice was not heeded. The European Central Bank also shows a path that was different than the Federal Reserve and yesterday's announcement in Frankfurt doesn't fundamentally change that picture. But the institutional context is the reason for that different choice and that's the subject of the second point. The interaction between monetary and fiscal authorities and was famously modeled by Sargent and Wallace three decades ago is a contest between fiscal dominance and monetary dominance, right. And under fiscal dominance the government sets the policy, the fiscal policy, independent of monetary policy and the central bank adjusts. So deficits, debt, and inflation are high, maybe very high under the fiscal dominance scenario whereas they're lower under monetary dominance. Now in the Euro crisis this game took the form of chicken. Creditor governments could create a finance facility and bail out the debtor or the ECB could buy sovereign bonds. The two actions were close substitutes at least over the short to medium term and each side was better off if the other made its concession first so each had an incentive to wait. So when we see this pattern repeat itself repeatedly between the spring of 2010 and the summer of 2012, the upshot is that the ECB delayed taking aggressive measures much longer than the Fed and the Bank of England did. So the ECB won this contest, right. Monetary dominance prevails, inflation is extraordinarily low, and the European Central Bank is an overachiever, right, in this sense. But perhaps too much of an overachiever given that it's undershooting its monetary price stability mandate and deflation is a palpable threat. But ECB behavior it's important to understand was a function of this strategic interaction with governments and the political fragmentation of the Euro Area.

So this takes me to the point about fiscal policy. The Euro Area has

chosen to apply fiscal discipline in a centralized fashion. And I think this path is fundamentally unworkable. The Euro Area needs to find discipline in a decentralized way to be politically sustainable in the long run. So to think about this consider how different the U.S. rules are from the fiscal rules of the Euro Area. The fiscal compact in Europe has been introduced into national law, but the process was initiated by the center, by the community institutions and in some cases under duress. In the United States got rules limiting debt accumulation were adopted autonomously by the states and this has implications for domestic political ownership of discipline. And second, community institutions play a leading role in enforcing the rules whereas the U.S. Federal government has no such rule. Congress cannot legislate fiscal rules for the states. So the U.S. model of fiscal rectitude for the states rests on multiple layers of rules kind of at the state level combined -- and this is really important -- with a no-bail out norm in the United States. By contrary Euro and member states have been bailed out. So the next generation of proposals in Europe for dealing with fiscally dysfunctional states is likely to embrace more intrusion into domestic politics and policies. The rescue fund -- like the size of the rescue fund and intrusive fiscal rules can go hand in hand.

MR. WRIGHT: Can you just -- when say, "intrusive fiscal rules" you mean, you know, going into a country and basically, you know, trying to, you know, determine their tax policy or spending or structural form, and that's pretty serious interference.

MR. HENNING: Yes.

MR. WRIGHT: We're not -- it's not sort of a technical --

MR. HENNING: Exactly.

MR. WRIGHT: -- sort of stand back, you know, you need to sort of fill out this performance sheet at the end. It's really -- you know, people -- you know, troika

types in capital cities, you know, writing the budgets of these countries. Is that correct?

MR. HENNING: Yes, absolutely. So it's not just the size of the fiscal deficit that's coming under scrutiny from Brussels, the commission in particular, but it's also the elements of the budget that achieve those deficit targets as well as of course the debt kind of targets as well. So a good example of this is -- of this next generation of proposals that I see on the horizon was Jean Claude Trichet's proposal which is now a couple of years old in which he advocates federal governance by exception, right. And in the -- which would apply in the case where the recommendations of the commission and council are for corrective action of the deficit are not implemented by the member state. And so in that case Trichet proposed that the European institution should be able to propose a VAT increase for a specific country, or they should be able to impose an internal devaluation, right. And so the important thing to recognize, okay, in the comparative context is this represents a degree of intrusion, okay, in complexity that could never possibly work in the United States, okay. And in the United States I'd argue we'd have a more favorable environment for this kind of thing than we do in Europe, all right. So there's no support for it in U.S. history, there are not good examples in other federal institutions and I think it's no more likely to succeed in the Euro Area.

So there are two or three logical implications that come from this that I'd like to fill out and then I'd rest my case. This approach that Europe has taken kind of risks a repeat of the epic showdown between the Union on the one hand and the member states on the other that we saw 10 years ago. And we already see this conflict looming again between the commission on the one hand and Italy on the other, followed soon by France and then possibly Spain, right. And my alternative to this strategy I would call, "get back to Maastricht", by which I mean Article 125 of the Maastricht Treaty which contains the no bail out clause. The U.S. experience kind of teaches that strengthening

of the Federal institutions protects the union from contagion when the center denies requests for a bail out from member states or say from Greece, right. A robust kind of fiscal role for the center established credibility for the no bail out norm here by erecting defenses on the part of the Union from blackmail on the part of fiscally irresponsible sub Federal units. If California, right, were ever to come to the Federal government to ask for a bail out, right, this would be out of the question. Fortunately, California is actually running a surplus now, but two years ago it didn't look so good in California. Such a request for a bailout would be out of the question because California is a wealthy state partly, but also because the union -- the rest of us have protected ourselves from contagion arising from a California default through a couple of different mechanisms. And because of this protection the other states in the union are less vulnerable than say Germany and Austria are to a default on the part of their periphery. So the implication is that Europe should put a more robust fiscal union in place in order to restore the protection that many, especially Germans, thought that they had in the no bail out clause in the Treaty. This is paradoxical, right. A stronger fiscal union contributes to decentralized fiscal discipline, but that's kind of why this is interesting. From this perspective the European stability mechanism is an anomaly among federal systems, right. Other federations bail out their states from time to time but I'm not sure there are any that maintain a very large standing fund for this purpose, right. And the ESM is supposed to be permanent. So arguably kind of rules are needed more for the center to protect against the temptation to indulge requests for bail outs more than they are needed for the states, right.

And so this is the last point and I'll end on this, if the Euro Area kind of succeeds in moving to a deeper fiscal union, right, the institutional solution should be first to convert the ESM from a sovereign support facility to a banking Union fiscal back stop,

right, separating the sovereign from the banks which Simon emphasized, and second to reestablish the no bail out clause. And I think this, right, is the formula kind of for solving the problem with maintaining defenses for the Union against blackmail from the periphery without creating fiscal moral hazard for the states. So let me leave it at that and we'll come back to some of these other points in discussion.

MR. WRIGHT: Great, that's terrific; thanks. I'd like to move onto the political aspect now because obviously with economics, it's highly political. You know, we have had what, five or six years -- five years of this crisis now, very low growth throughout Europe, very, very low inflation heading toward deflation at the end of sort of the existential phase of the crisis, but real concern I think that there's no sort of plan for robust growth or to deal with some of these issues. And that sort of brings us I think to last week's, you know, elections that we saw rise in populous movements and throughout Europe, not up to a majority or anywhere close to that, I mean it's still very much a minority but it was a strong sort of signal. And so I'd like to turn to David Rennie, and David is the Washington Bureau Chief for *The Economist*, but prior to that you were the Brussels Bureau Chief for *The Economist*, so you've seen it on both sides. What is your sort of assessment, you know, of the elections? And if you could also speak a bit about this drama we're seeing unfolding about the commission president. I mean how significant is that in terms of Europe's future and does it really matter or is it sort of the Brussels personality game where we're all sort of focused on this, you know, battle between the commission and the government as far as actually, you know, the real substance goes somewhat neglected?

MR. RENNIE: Well, you know, I think what's happening at the moment is very serious and my bias as a political reporter -- a foreign correspondent/political reporter, is that it's always been about the politics. You know, the economics -- the flaws

in the economic systems are the results of political disagreements.

Before I get to kind of what happened last week, I mean just responding quickly to some of the things on the panel here. I remember when I was writing the Charlemagne column and running the bureau-- in Brussels. You know, people you see have this line about the problem with the Euro is that it was created back to front. We created this monetary union without a sort of fiscal union or a sort of Federal political structure behind it as if it had been a sort of oversight, as if they just had forgotten to create a political union. The reason that they created this thing back to front was because they profoundly disagreed about what the political union might look like. And let's not forget -- I mean to my mind the European Union and to some extent the Euro, the single currency, they can be understood as a kind of ethnic tussle between two visions of how to run an economy, and you can call one kind of competition and one solidarity. And I think that, you know, we need to understand why, you know, why does the Euro have all of the incompatible countries that Simon talked about? You know, why did Greece get into the Euro, why did Spain get into the Euro? That wasn't the original idea. If you talk to the sort of the Benelux countries and the Germans that was never their intention, that was never their intention. How did it happen? Well, in part it happened because France and Germany at that time representing if you like competition versus solidarity. This is one of my favorite stories about the creation of the Euro because it's so emblematic of what happened. There was a summit in Italy just after President Jacques Chirac got elected as President of France. And he had run an election platform attacking the four, the strong franc. And he had this very sort of French vision that you devalue a currency and let inflation run to try and boost growth. And he came to a summit in Italy, and this was the time when it looked as though countries like Italy were not going to be in monetary union, and France was quite anxious about having

a more southern European Union in monetary union. One, because they didn't want to be locked into a kind of German, sort of deutschmark basically, they didn't want to be kind of bolted onto the deutschmark. That was not a happy vision for France. But Chirac started attacking the Italian Prime Minister. He said since time and memorial every springtime there's a place called the Plateau de Millevaches in the Alps between France and Italy and the French Alpine farmers raise these beautiful calves, these lovely veal calves, and then they are driven over high passes into Italy where they are fattened to turn them into Italian veal calves for the Italian veal market. But because the Italian Lira devalued twice against the French Franc in the last year and a half the French veal calves cost too much. So for the first time in living history, and Chirac was very emotional about calves, you know, this was kind of thing got him going -- for the first time in history, monsieur, the calves of the Plateau de Millevaches had not crossed the high pass into Italy because they cost too much. And thus Italy had to join the currency union because for France the fear was the competitive devaluations in the south would make it impossible for the richer countries in the north to sell goods. And that was the pitch, you know, made to the Germans. You want to sell a BMW again in Spain you better make sure they go into your currency union. And so that kind of political thinking that did not really contemplate the sort of the elements that Simon talked about in terms of compatible currencies, that was the kind of thing that was being done. At the same time, Simon is absolutely right, people didn't predict what was going to happen and my own newspaper -- magazine if you want -- we supported the creation of the Euro because we thought precisely because these countries could no longer devalue they would have no alternative but to undertake the painful structural reforms and labor market reforms that were sort of crying out to be done. And we missed the problem of these huge capital inflows that made the structure reforms impossible.

Now how does this connect to the present day? I think one of the biggest misunderstandings that you see among the kind of small handful -- probably most of whom are in this room -- of people in America who really care about what happened in Europe last week, there's a tremendous misunderstanding. There's a very, very bad column in *The Washington Post* last week that said this is all about silly Germany not understanding how bad austerity is and, you know, wicked, wicked Germany forgetting the lessons of the second World War has been imposing this wicked austerity on Europe and now Europe has quite understandably kind of rebelled. And behind that is a kind of lazy kind of apolitical Keynesianism that essentially what's going on is the withdrawal of, you know, demand from the European economy because of this silly German austerity and if we can just correct that by restoring the demand then everything will be right. I think that's (a) never accuse the Germans of forgetting the Second World War. If that's your argument, you're, you know, you're wrong; (b) the people saying they're against austerity in Europe, the parties that have been doing so well in some of these countries, you know, Syriza, Podemos in Spain, this new kind of essentially sort of Latin American leftist party that's, you know, done quite well in Spain. When they talk about austerity what they really mean is reforms, what they really mean is keep the money coming. I mean look at Syriza's election platform, it's raise the minimum wage, enlarge the welfare state, nationalize major companies. You know, that's not a rejection of austerity in terms of, you know, fiscal discipline coming through some sort of monetary mechanism. That is these indisputably painful economic circumstances in the south of Europe leading to a sort of wholesale rejection of globalization, of openness, of structure reforms. And so, you know, people who sort of lazily assume that this can be fixed with kind of tweaks to the monetary rules, I think they're missing the whole point, that this is a very serious moment to kind of contestation. I mean look at my own country, UKIP. Now the UKIP

vote winning the European elections is mostly a process vote, you know. They will not do as well in the national elections next year. But let's understand what's happened, the reason that Europe -- the European debates is coming so dangerous in my own country is my own Europe now basically means immigration. I mean that's a kind of crude version but, you know, it's gone beyond the kind of complaints about, you know, excessive rule making, it's about immigration now. And I think that American audiences - - and I know there's a lot of Europeans in this audience and Americans who know Europe well, but I was on Capitol Hill on Monday, there was a kind of Congressional meeting about the elections and I sort of said to -- there was a bunch of Congressional staffers and people and I said, listen, you need to understand Europe has done some incredibly bold and liberal things over the last few years in terms of responding to globalization with sort of openness and embrace of competition. Imagine how it would work if you said to the U.S. Congress under the new NAFTA rules there's going to be free movement of labor, any Mexican who wishes to move to America to find a job can do so tomorrow and the American government will have no legal ability whatsoever to control the numbers of Mexicans or Canadians who wish to move to America. You can just tinker with things like welfare rules. Or the NAFTA Court of Justice would have the ability to tell Congress not to give state aid to a factory in Detroit to keep it open because it was against NAFTA competition rules. And then a Mexican and Canadian Judge could order Congress not to give state aid to an American company. I mean you could never in a million years get away with that. So we need to understand that Europe has done some incredibly radically things in terms of open borders, open movement liberalization. A response towards globalization that tried to offer sort of solidarity through fiscal transfers but also a sort of an extraordinary embrace of competition. Things that *The Economist*, my employers, we wholeheartedly supported. But I think we need to understand if we

wholeheartedly support this stuff we need to understand how much danger it's in now, how these election results are a bellow of rage, a bellow of kind of contestation from voters in Europe. Do they directly matter in terms of will these specific members of the European parliament start taking specific votes in unison that start doing bad things? I don't think that's where the danger lies. The danger is fundamentally indirect.

So, you know, there was someone on the panel on Monday who said, oh, you know, 70 percent of the vote when to the mainstream parties and they'll have a sort of grand coalition of the center left and the center right, it will all work fine. Well, at a sort of purely kind of mechanical level that's right. And one of the sort of terrifying things about the mood in Brussels is people are proposing Jean-Claude Juncker, the former Finance Minister and Prime Minister of Luxembourg to be the president of the European Commission because, you know, he was chosen by, you know, the state actors and the European parliament wills it. Understand what that means for a second. They're essentially saying we hear this cry of kind of populist rage from the peoples of Europe and our solution is to offer you more of the same, our solution is to offer you the past, our solution is to offer you an old guy who stands for smoke filled rooms, opacity, who boasts about how important it is not to tell the truth to European voters, and who believes in stitching up deals behind the scenes. And that's their response in Brussels right now to what his happening and that's kind of terrifying if that's their response.

Just a final point to respond to some of your -- I mean Simon makes this sort of economically perfect argument that the logical next thing to do is to either have more federalism with the Eurozone or to end the single currency. The problem is I think neither of those things is going to happen.

MR. TILFORD: I give you that.

MR. RENNIE: So we're into -- so we're into something else. You talked

about sort of fiscal discipline rules and I think you understood -- I mean you also sort of indicated that you suspect that these fiscal discipline rules are going to be very hard to pull off if they meant, you know, intrusively going into a country with a troika and sort of extend these still further. Just a final kind of through based on my time in Brussels, it always seems to me that people misunderstood why Germany -- and there are plenty of very distinguished Germans in this room, Ambassador Ischinger for example; I'd love to hear from them -- but it always seemed to me that people misunderstood why Germany was so insistent on a no bail out clause and so insistent on fiscal discipline as though it was somehow sort of just an economic preference. Again it seems to me to be even more than a political preference, it seemed to be -- to me the problems in the Eurozone when the crisis first broke out it was worse than a clash of economic policies, it was worse even than a clash of political positions. It was in essence a clash of social contracts. The fundamental democratic social contracts that bind elected governments to their electorates. The Germans have a social contract since the Second World War entirely informed by -- I mean, you know, very much informed by the prewar hyperinflation -- the vital importance of monetary stability. That social contract, you know, work hard, don't ask for excessive pay raises, maintain, you know, sort of labor market flexibility, you know, have sort of a corporatist labor market settlement with limited sort of inflation, don't spend too much, be thrifty, be sort of prudent, and in exchange the government will guarantee you lower inflation and a stable currency, a rock solid currency. That was the kind of fundamental social contract, prudence and thrift and stability. And you then bolted that onto countries whose fundamental social contract was something different. In Greece -- I mean people talk about, you know, wicked austerity in Greece. I know Greece is a special case because it's by far the worst behaved. Take the example of ERT, the national broadcaster. Once they closed that down as part of the

austerity package, ERT had 10 percent market share of the TV audiences in Greece. It had an annual budget of 300 million Euros a year for a country of 10 million people. There were over 100 employees of ERT earning more than a million Euros a year. All of them were political employees. Every new government came in and plugged in some people into the sort of directors cabinet who could never be sacked. So closing that down is that austerity? And keeping that going is that a kind of Keynesian stimulus? I mean that's the problem is that you're asking in a country, you know, in a monetary union which doesn't have a political union you are asking German voters to carry on funding things like that. That's what they see in the newspapers. You're saying to them you've agreed to extend your retirement age to 67 but you're going to have to fund Greeks who want to retire at 55. That's politically impossible; it's a clash of social contracts. That is politically impossible. And the problem with the election results last week was the bellow of pain from southern Europe which is entirely understandable. They have these appalling economic numbers, appalling, you know, appalling youth unemployment. We should be sort of, you know, very alive to the human agony of that. But the problem was that those votes were saying keep the money flowing, Germany; stop the world, we want to get off. We want to have, you know, a higher minimum wage, a European-wide minimum wage. The politics just is not there to ask countries like Germany to improve much, much larger fiscal transfers.

Now in the fiscal discipline point it always seemed to me that the fiscal discipline was actually a German response to the democratic deficit. The single most painful thing about a political union with this monetary union is what happens if German, Dutch, Finnish voters send money south and then there are no structure reforms and then there is still endemic corruption and the -- you know, essentially the south takes the money and says thanks for the money, suckers, we're just not going to do anything that

you wanted, we're going to break all of our promises. That is politically totally unsustainable. And because German voters have no say on the government that is elected in Greece or in Spain or in Portugal it seems to me always that the fiscal discipline rules, clumsy though they were, were essentially an attempt to kind of fix that democratic deficit, to make it impossible to turn around and say so long suckers, thanks for the money. And so I think we need to be much, much more sensitive to the incredibly tough politics that I think explain why the economics is so broken and be very worried about last week's election results because they are sort of a -- they're a smoke signal of this class of social contracts as bad and as deep as ever.

MR. WRIGHT: Thank you. I particularly liked the (applause) -- I particularly liked the image of NAFTA immigration. I'm just wondering what FOX News would do with that if we had a NAFTA Court of Justice overruling the --

MR. RENNIE: The Mexican Commission explaining it, yeah.

MR. WRIGHT: -- Congress. It would be quite interesting. I think one of the -- you talked about the periphery and I think it's important to be sort of clear on Germany's sort of narrative of success because there is an -- it's sort of missing on the panel, but there is a view -- and we make hear it in the questions and answer parts in terms of how this works. And it's largely based on structure reform that, you know, the structure reform that's occurring doesn't have pay offs now because it's sort of a slow burning thing but it will have pay offs later and that that will cause a return to growth and competitiveness in the periphery and you don't need this great leap forward on monetary policy or with quantitative easing or on the fiscal side. But one of the problems that has arisen is almost because of Dragy's actions we've seen the, you know, the cost of sovereign debt come down quite a lot. I think yesterday Irish sovereign debt basically passed U.S. Treasury bills in terms of how cheap and they were certain types of Treasury

bills. So all of the periphery's costs have been coming down over the last 12 months or so where they're all pretty sort of manageable. And that has taken off the pressure for structure reforms. So, you know, Germany's sort of theory of the case was that the problems in the bar markets would lead to pressures where governments had no choices except to reform, and because that pressure is now off it's harder for him to do so because of this political opposition. Because as you, David, I think rightly pointed out, a lot of the political sort of populism is actually against -- it's not -- you know, they're against austerity but they're mainly against some of these very tough reforms and cuts that are taking place, you know, in their countries.

And so I guess my question to all of you is if we see this sort of rising populism and opposition to sort of the status quo of the last few years and if we see that governments find it very hard to initiate structure reform, what is the case as to how this will work? I mean not going back to the well, they really need to do this or that but is there any sort of scenario in which sort of the Germany or the ECB's position will prove us wrong and in three or four years' time, you know, the situation is a lot rosier if they just stay the course? Or is there just no way this is actually going to work? Simon, do you want to?

MR. TILFORD: I think it's worth bearing in mind how difficult it is to push through structure reforms against a backdrop of slump. Politically that is very, very difficult which is why typically when any country faces the need to push through onto structural reforms it does so against the backdrop of some kind of stimulus. So for example if Greece had been or Portugal had been under an IMF program, yes they would have actually imposed fiscal discipline but it would have been accompanied by very large currency devaluation to boost exports and provide some offsetting stimulus to what was happening to domestic demand. The problem we have in the Eurozone was that there

was nothing to offset the austerity which means that it leaves these countries trying to two contradictory things. One is to try and rebuild that trade competitiveness within the Eurozone which they've lost some of because their inflation rates have been higher, while at the same time ensuring that their debt burdens don't rise relative to GDP. Now that is an impossible thing to ask them to do. The result of that has been a huge increase in debt relative to GDP since the onset of the crisis. We hear a lot about -- particularly from this sort of -- the right on this issue that basically look at their debt patterns, why can't -- they're still not serious about reducing their debt, they're still not serious about austerity. The Greeks have cut more than any developed economy has since the '30s. They have made huge, simply massive cuts in public spending, far greater than anyone thought possible. But the net result of that is that their economy is 25 percent smaller than it was because if you cut spending -- the government cuts spending by anything like that amount when private sector demand is also contracting what you're going to engineer is a slump. So the economy shrinks dramatically and the burden of debt relative to GDP rises dramatically. And that's what's happened. Now we saw write off of Greek debts, essentially a write off three years ago. We're now back above where they were prior to that debt write off. That's not because they haven't been cutting spending. They're now running pretty close to a primary budget surface before the payment of interest on outstanding debt, but it's because the economy continues to contract dramatically.

So I think in a place like Greece it isn't just a question of people wanting to hold onto their benefits, this is a poorly governed country, there's no doubt about that. It should not have been in the Eurozone. And there are all kinds of vested interests in Greece that need addressing. The question is how to go about doing that and whether you can pull that off politically in an economy that has been pushed into this kind of slump.

Structural reforms, these are not a panacea for all problems. Structural reforms -- if accompanied by a recovery and investment will in the medium to long term deliver some benefits. But there isn't a particularly strong correlation between economic growth and say very flexible labor markets. For example everyone is touting Germany as an example here. Germany does not have a flexible labor market. Germany has by U.S. or British standards a very highly regulated labor market. There's no correlation there. And it's not just the south that needs to push through structural reforms. According to the OECD for example, Spanish markets for goods and services are far more competitive and contested than Germany one. This is a problem of structurally very weak demand. We cannot all do what Germany does which is run a huge surplus savings and a massive trade sale. That means it's dependent on foreign demand to close the gap between what it produces and what it consumes.

MR. WRIGHT: But that is the plan though.

MR. TILFORD: Yes, that is -- but that's my point though. But we can't all do that. So if you're going to find a sustainable solution to what happens in Europe yes there needs to be adjustment with structural reforms in the south, but there also needs to be change in structure reforms in countries in Europe that are running huge, unsustainably high surplus savings.

MR. HENNING: So let me -- can I add on?

MR. WRIGHT: All right. Can you just -- yeah, can you also just address this sort of German surplus issue which is really quite extraordinary and just is there really any prospect of, you know, internal rebalancing where some of the surplus would be used for investment? Because when people talk about, you know, a rebalance or, you know, a change in sort of the stimulus what they're really talking about is that that should occur in Germany, not that it would occur in the periphery. So what is the -- is there sort

of a prospect of that on the horizon?

MR. HENNING: So it's essential, right, that we have rebalancing within the Eurozone, right. So now we have the situation where -- and to answer Simon's question, right, there has to be something to offset austerity in the periphery and this would be German growth, it would be increase in wages, it would be some kind of German deflation, right, because we can't expect, you know, relative improvements in competitiveness on the part of the periphery without the periphery undergoing deflation. If German inflation is a half a percent or one percent, we need to get that up into the higher ranges. One of the underreported events over the last couple of months is that the commission actually cites Germany for an excessive surplus under the Macroeconomic Imbalances Procedure. Kind of where this goes and kind of how this develops is unclear. It's not as if -- it doesn't appear as if this is going to be a strong discipline on German policy to produce a stimulus of some sort. But this is essential, right -- and in fact this is in fact where the rest of the world comes in -- it's essential, it's important from the standpoint of U.S. interests that the Eurozone as a whole doesn't become just a large Germany in terms of the macroeconomic imbalances and running continuous large current account surpluses, right. The way to -- you know, one of the ways to think about this problem in very specific terms is to think about the situation of Italy again, right. So in Italy we like to see structural reform of course but this needs to come in the context of growth, right, in order to be effective. Italy's solution for this that Renzi and Pier Carlo Padoan would like to see room in the fiscal rules for greater investment in infrastructure for example as a way to provide this. And indeed Italy needs this. Now this is a structural policy for Italy that could compliment reforms in the -- liberalizing reforms in the service sector and the labor markets. But of course this would require a change in the rules and that's part of the Italian agenda for its president and the

council of ministers in the second half of this year. I think this is important; it's important that that goes forward.

MR. WRIGHT: Thank you. David, before go to the audience I'd just like to raise a big question that I'm sure will come up in the Q&A but it's the role of the U.K. in, you know, we've sort of got Cameron, you know, really do a -- lead the charge against Juncker's commission, you know, president, but, you know, there are sort of huge issues on the agenda for the U.K. in Europe over the next sort of four years. It poses very difficult challenges for Chancellor Merkel because how does she make the concessions necessary so Cameron feels like he has enough of a victory to be able to keep the U.K. in, you know, while also deepening integration within the Eurozone and doing the things that are needed to fix sort of the incomplete monetary union? So what is your assessment of not so much of, you know, UKIP and if the referendum won't happen but on the diplomacy between Cameron and Merkel and how that plays into Europe's future? You know, is it possible for the Chancellor to pull off this balancing act and keep Cameron happy while also deepening integration or is there sort of a tradeoff there?

MR. RENNIE: I think the problem is that there is a lot of mechanisms that have sort of set in motion for short term political reasons of sort of the expediency that will have very unpredictable effects. And so I mean you have this odd situation that Chancellor Merkel does not want Britain to leave and she is willing to do, you know, quite a lot to keep Britain in, although there's certainly those who always say not at any price. The leaders of the three main political parties in Britain, all of them are committed to the idea that Britain should stay in the European Union. And, you know, more or less in opinion polls just about a majority of the Brits want to stay in. So, you know, on the one hand it all looks fine. The problem is that a lot of mechanisms have been sort of set in motion, in particular this idea of a referendum on Europe, should the conservatives win,

you know, win the next general election next year. And I think the problem with that is -- and I remember when I was in Berlin by chance when David Cameron was elected Prime Minister and there was a group of European correspondents and were invited to see Chancellor Merkel for this kind of very, very off the record sort of meeting that they do every year for European correspondents, and someone in Berlin -- because I can't say because it was (inaudible) but the basic German position from the Kunstler Ampt was pretty clear, it was Germany does not want to be left alone in a kind of tight Eurozone Union with just the Club Med countries. Germany would much rather have Britain and Sweden and Denmark and the other sort of more reform-minded countries there as a kind of balance, not because Germany's on Britain's side or on France's side but my impression of Germany's European policy is very often Germany likes to have the deciding vote. It suits Germany quite well to have kind of balancing powers and Germany gets the deciding vote. So she was definitely open to the idea of doing a lot to keep Britain in. The problem is expectations on the British side and the British analysis. I mean the fundamental problem with Britain's membership in the European Union is the British never loved the European Union, they never felt proud or happy about being members of the European Union, it was a cost benefit analysis that begun when we joined in a kind of state of gloom and misery in the 1970s because the Continent looked so much more economically dynamic than Britain. Britain was at the end of a very inept sort of corporatist experiment which had reached the end of the road. You know, our version of state planning turned out to be, you know, even crappier than most versions of state planning and we'd kind of reached -- you know, I mean just remember the cars that Britain was producing in the 1970s and that's all you need to know. So we joined in a kind of fit of sort of, you know, well they seem to know better than we do and so we have no -- and it was kind of a cost benefit analysis. What has fundamentally changed the

short version is once the British public looked at Europe and thought well that looks like an economic basket case, if you never loved it and now it looks like an economic basket case what's left? And the single sort of biggest driver -- you know, conservatives used to hold their noses and go well, we like the single market but we don't like any of the other stuff. And the really dangerous dynamic in the last few years in British politics was the number of conservative MPs. You know, a big chunk of that party can now say well, you know, is a single market really worth that much? I mean, you know, shouldn't we just be the sort of Cutty Sark, you know, this kind of nimble little sort of mercantilist kind of globalized Anglo-Saxon power nation zooming around the world's oceans trading with the emerging power. You know, at the moment we're sort of tethered by rotting ropes to this kind of rotting Venetian hulk of the European economy and if only we had the courage to, you know, cut the ropes and zoom forward we could be this kind of super global trading power. The problem with that analysis is of course we are actually an island 23 miles off the coast of France rather than the Cutty Sark. So that is a problem. The other problem with the analysis is that Germany which obeys all the same supposedly crushing European rules that we do actually has a much more dynamic economy than we do. So clearly there are other facts in play.

But the problem that David Cameron faces, I mean is Britain going to leave the European Union? You know, on the one hand the grown up kind of sober answer is no, I don't think so. But the thing that kind of slightly worries me is when you map out how we stay in, so here's how it works, I mean if --- there sort of seems that the conservatives win, you know, either outright which seems very unlikely or, you know, as the larger party in the coalition which is, you know, a possibility, a strong possibility, here's how it seems to work to me, for us to stay in -- so this us staying in past the 2018, here's the British general election, here are the intervening steps where there are forks in

the road and they all have to go right, so David Cameron goes to Europe and says I would like to have a renegotiation in which I'm going to hold you hostage and try and extract things you don't want, and the others have to go okay, we'll let you do that. It might happen, you know, it might happen. There might be other reasons why there's treaty change needed or something, but they might just go, you know what, we don't particularly fancy that negotiation. So he then has to secure these negotiations, he then has to secure concessions that actually mean very much from Europe. Now he'll get some stuff. He then has to come home and say to the conservative party these concessions are what you wanted. Well, they want not stuff, they basically want sort of cut price membership of the single market with nothing else, they want an a la carte membership is what they want. So he has to get the concessions -- has to have a negotiation, get the concessions, convince his own party that these concessions mean a thing, then so that they will campaign for a yes vote in the referendum, and then the British public have to be disciplined enough to vote on what's on the ballot paper. Because remember this isn't an in-out referendum, the referendum is do you approve of the deal that the Prime Minister has just secured in Europe. Now the history of referendums is that voters very often don't vote on what's on the ballot paper. They vote on what they feel about the economy or what they think about the government today or other stuff, or in the British case at the moment Europe is fundamentally about immigration. And if we think we're going to sort of tear up the immigration rules that ain't going to happen. So all of those things have to go right for us to stay in. So I'm in this kind of strange position that my kind of gut instinct is, you know, most of the big kind of powerful forces in British policy and economics want us to stay in, you know, the big business community and the three main party leaders. So I don't think we're going to walk out but I think we could kind of trip and fall out and that does kind of worry me.

MR. WRIGHT: Very interesting. If you were a betting man then you would?

MR. RENNIE: The only bet I have ever done in European politics made me huge amounts of money which was when they were choosing the first council president under the new system and there's an Irish internet betting site -- I probably shouldn't even admit this. So it was at the council summit where they were discussing who was going to get it and everyone was still talking about Tony Blair and that was obviously nonsense. And there was this Irish betting site called Paddypower.com and they do political betting. And so I just idly looked and they were offering odds on the European council president and Tony Blair was still odds on favorite which was just nonsense. And it was one of those rare circumstances where you know more than the bookmaker about what's going on because, you know, I was working in Brussels. And Herman Van Rompuy was 33 to 1. And I thought, you know what, they need a small country, they need a center right guy, they need a Christian democrat, the need -- you know, I think I'll stick some money on Herman Van Rompuy. So unfortunately the website wouldn't let me put on more than like 50 Euros I think. But I did put on 50 Euros and then the odds immediately changed, so their algorithm kind of saw me. I shouldn't admit that, should I, because that was deeply corrupt. But it didn't affect my reporting of the Herman Van Rompuy -- but it made me a serious amount of money.

MR. WRIGHT: So we'll watch very carefully the odds on Powerpaddy.com --

MR. RENNIE: No, I can't do it again.

MR. WRIGHT: -- for your --

MR. RENNIE: Can't do it again.

MR. WRIGHT: -- for little known sort of leaders. I'm sure both of you

want to come in on this Britain question but we might go to the audience because we've got about 23 minutes left and we've got lots of questions. So let's start up and near the front is the microphone and Andy Moravcsik over here on this side.

MR. MORAVCSIK: Andy Moravcsik from Princeton. Two quick questions, one to David. You portrayed the elections as a referendum on European issues, but the conventional wisdom on European elections is the second order elections because European voters don't care about the issues that the European parliament deals with. You could make an argument for them caring about the Euro but the European parliament doesn't deal with the Euro. So why should we care about what the voters said in these elections really and why should we expect policy makers in the parliament really to adjust to it given that there's no real electoral connection between voters and European issues?

To Randy, so you've tried to sort of make, you know, the Euro dilemma not look quite so bad by saying if they were just more American they could get out of this dilemma. But doesn't that depend on them really being more American in two ways? The first is they would have to accept American standards of social welfare provision and deprivation in the face of economic problems, not European ones. So that assuming we don't create a social welfare system to the European level that's fully adequate they would have to be willing to accept a greater level of deprivation if there were really a no bail out clause because economic circumstances would get more difficult as they adjusted. And secondly the way America really adjusts to these kind of macroeconomic difference is by factor mobility which was brought up before, right? When Michigan goes through a decade of low per capita -- negative per capita income growth, negative aggregate income growth, and negative population growth for an entire decade other American's say move to Arizona, right. That's the American system of adjustment. We

can't say that to Italians, we can't say that to Spaniards. So would that really work in Europe?

MR. WRIGHT: We'll take a few together and then we'll come back to our panelists. So just the gentleman right in front there. Yeah.

MR. ROUSSEAU: Thank you. Jean Rousseau with French Treasury. Just a quick point on what a great panel. I agree with a lot of what has been said between Simon. Quick (inaudible) of equal points about David's story which was a great story. We'd be the last one to deny that Jacques Chirac never forgot that he was first administer so take the farmers interest deep in his mind and heart. Plateau de Millevaches actually is in Massif Central, it's 600 miles away from Italy. So the calves travel not by passes but in trucks which they cannot do in the U.K. because of little old ladies throw themselves under the wheels of the trucks to save the innocent comfort of the veals. And sadly, more sadly, Plateau de Millevaches does not mean famine cause but thousand springs. But the question that was raised at the time I think was an important one, which is how can you have a single market if countries engage in competitive devaluations which was the situation at the time? And there were two main reasons to go to the Euro. One was a political one, counterbalance reunification of Germany, and the other one was completion of the single market at that time which is also a major issue and still at the heart of the project of this.

MR. WRIGHT: Yes, we'll take one more but go in the middle here, the lady in the middle. Yeah.

MS. HOXELL: Thank you. Valerie Hoxell from the EU delegation. Just two remarks and a question. The EU hasn't started with Maastricht and with the run up to the Euro, it started much longer ago and I always have the impression when faced with a panel such as this one that everybody starts with the Euro and the Euro crisis and this is

not true. Many more aspects of policy areas have been put in common and together since the buildup of the Euro. We started in the aftermath of the Second World War with putting together coal and steel and then we agreed on a certain putting together of policy areas at EU level. Second, fiscal rules. I've heard interesting ideas coming from Randy on this with decentralization. This is merely an idea that isn't in an interesting -- in pursuing fiscal integration. But that said member states have set these rules themselves and it's not as if Brussels was setting rules outside in a vacuum. Member states agreed to these fiscal rules. So the parallel with the U.S. has its limits because members or the equivalent of U.S. states actually agreed to those rules in the beginning.

My question is a little bit in line with David's remark about Simon's intervention, why are number one and number two solutions not feasible probably? I'd like to hear one constructive proposal from Simon that has a chance of success, of succeeding politically in Europe. Thank you very much.

MR. WRIGHT: And we just -- one more just right -- I think the gentleman right behind had a question, then we'll come back then. No, no, sorry, this gentleman. Yes. The person who had the microphone is the right person.

MR. KLEIN: Hi, Sean Klein, I used to be the Bureau Chief of the BBC in Brussels. I was in Berlin last week just before the elections listening to the Alternative for Deutschland which made some interesting gains and a new party in Germany. They were suggesting a kind of two speed Eurozone. I'm just interested to know what the panel thinks of that. So they were saying it would be a mercy action, an act of mercy to let Greece go and let Greece leave the Euro and others like it. Would that be the halfway house solution?

MR. WRIGHT: Thank you. We have a lot of questions still to come as well so if you could all just pick and choose in terms of the ones that were directed to you

and try to be brief so we can go back and get another round. But, Simon, why don't we start with you.

MR. TILFORD: I think it's important to remember on this no bail out issue that this isn't about making life harder for the countries struggling most with the public debts, this is about correcting a situation in which unsustainable levels of debt are being maintained rather than whittled down. What has happened in the Eurozone in recent years is that countries haven't been bailed out, they've been lent lots of money to pay back their creditors and their creditors have been banks in the countries who've been lending the money. What this is effectively is a way of perpetuating unsustainable levels of debt in particular countries and requiring those countries to pursue unsustainable levels of austerity. Over a lengthy period of time the austerity leads to further falls in economic output which further increases the amount of debt relative to GDP. So this isn't about bailing countries out, this is about a no bail out clause combined with some kind of automatic stabilizer in terms of some mechanism, perhaps for a banking union of transferring money. Is it probably I'd argue the best way forward, but it's not about making life even harder for particular governments in the south.

MR. WRIGHT: The one constructive idea.

MR. TILFORD: Yeah. I'll come -- I'll look into -- I'll come onto that. There's a competitive devaluation. Devaluations in the run up to the Euro were typically undertaken by countries that had had higher levels of inflation. Now if you can make all of these member states too similar in their structure that their inflation rates are very similar then the risk of getting rid of national currencies can be addressed. If you can't, then you've just removed a crucial, indispensable tool of macroeconomic adjustment. Also it's worth acknowledging that real depreciation is as much a problem as nominal depreciation. So within a currency and if one country pursues wage restraint over a 10

year period of time and cuts its real exchange rate relative to its trading partners this imposes far greater costs on them than Italy ever did in the run up to the Euro because devaluations of the Lira and the Pound basically just took them back down to where they had to be prior to the pickup in their inflation rates. And you can rack real exchange rates back to 1980 and Italy and Britain were not the problem.

In terms of something positive, I think I've said what I think needs to happen. You need -- there needs to be in short order some significant monetary stimulus, there needs to be an acknowledgment that there has to be some demand creation from some source. So in terms of the sustainable politically practicable that has to be a big investment program, perhaps under the auspices of the EIB. It needs I think a broader -- the problem is if we could just get to the point where people acknowledge that this isn't just about countries breaking the rules then most of this I think would fall into place. But in terms of what could be done it's an investment program by the EIB, it is a pretty radical change on the part of the European Central Banks, a big program of monetary stimulus. I think those two things are possible. We're going to get more action by ECB. The question mark is whether they can do enough. Because the problem with quantitative easing is that it's only effective if investors believe that the central banking question will go the instance. The problem with the ECB is that the investors might doubt its ability to go the distance. But anyway, leaving that aside, ECB action and a big, big investment program.

MR. WRIGHT: Thank you. Randy?

MR. HENNING: Well, let me respond to the questions from Andy and from kind of Valerie with respect to this proposal for decentralized federalism, decentralized fiscal discipline that I have. Let me stress that this is in fact a long run version and nothing that we're going to be able to implement tomorrow. But I'm going to

argue that it's likely to have more political traction over the long run than this strategy that we've had so far of committing large resources through an ESM which is challenged within the German political context, and then at the same time tougher rules to go along with them. And the -- it does require that there is a larger fiscal center in Europe. It doesn't have to be the same size as the U.S. Federal government. Four or five percent of GDP could do it. Nonetheless I acknowledge that requires more stronger commitment to central, you know, to kind of mutualization of fiscal policy than we have now. It's important, you know, it requires also a large fiscal backstop to the banking union. And here this is more important than the transfers that take place through the social safety net in the Federal system in the United States. I mean we've looked at the economic studies, a lot of economic studies kind of done on the importance of these transfers and -- but the transfers that take place in the midst of a banking crisis got through the fiscal backstop and for the banking union and bank recapitalization are huge compared to these transfers that they placed through the social safety net. So quantitatively speaking this is far more important for maintaining the cohesion of the monetary union and through crises kind of like this. So for that reason I think we can accomplish what we need to do with a modest fiscal center in Europe.

On Valerie's point that kind of we have kind of member states agreeing to these rules in the form of the fiscal compact and the stability and growth pact and I acknowledge that we've done this through the council, through kind of accession to these treaty changes, some of which would have been voted on through referendum within member states. But we're now testing the domestic political ownership of these rules and I think we have to admit that in some cases, particularly in the southern periphery, there's been agreement to these rules under duress, all right. And so this case of Italy is very interesting. Italy signed up to the debt rule in the fiscal compact and now its adherence is

being tested. And while legally because the rest of Europe might be on solid ground and arguing that Italy had agreed to it so it should follow through, I'm not sure we really want them to do this economically speaking, and in fact I think we don't. I think we want to create some mechanism by which they can make the investments kind of that they need in infrastructure and for this adjustment. And I think inevitably this accommodation is going to happen. One of the big political questions in terms of fiscal rule enforcement will be how that happens. And I have great sympathy for the position that the commission finds itself in because I think the commission is torn between -- frankly torn between the literal application of these rules on the one hand and economic reasoning on the other.

Now there's an additional problem in the administration of these rules that's worth pointing out and that is that the rules under the fiscal compact apply to a budget deficit which is defined in structural terms that is cyclically adjusted terms. This requires someone to make the calculation of what the appropriate adjustment is, right. This is not an observed variable, this is a calculated variable and it's a -- and it is a group of economists that are going to be making this judgment as to what the structural deficit for any country in the Euro Area is. Is it conceivable that serious consequences could hinge on the accuracy of this calculation when in fact economists differ widely about how that calculation should be done? The Bundensbahn actually did an interesting article a month ago on the range of calculations for these kinds of adjustments that are done on the part of the IMF and the OECD, and the range is fairly large. So it's not conceivable to me that a large fine or serious consequences would be delivered on the basis of a technical argument like this. It's going to be more political and resolved in a political way. And so that's why I think we need to -- the upshot is I think this is an argument for a much more decentralized system of fiscal enforcement which has to come with this no bail out clause.

MR. WRIGHT: Thank you. David?

MR. RENNIE: So Professor Moravcsik's argument about, you know, what political message is or is not being sent. I mean I remind that I covered the French, Dutch, Spanish, you know, whatever referendums on the constitution and I remember when the Irish voted no, when the French voted no, when the Dutch voted no. All kinds of very clever, sincere people in Brussels said well none of them have read the constitution so why should we listen to what they really think about it. It was nonsense to put it to a vote; they're not capable of reading these things. So it didn't really mean that the constitution wasn't the right solution. And so they came around and repackaged it and turned it into a new sort of form of salami and called in the Lisbon Treaty and rammed it through. And that was kind of fine, but at some point if you insist there are no messages being sent of any sort at the kind of largest possible level, if you insist the Dutch weren't saying, you know what, we'd like to put our foot on the brake in terms of European integration or, you know what, we are now uneasy about immigration and globalization and, you know, all manner of liberal things and Europe has become a proxy for those, or if you ignore the fact that in France Europe is kind of an avatar for, you know, free market economics in a kind of European context, you can keep ignoring all those things as long as you like and make a perfectly sort of, you know, technically accurate argument that people aren't arguing about what's the on the ballot paper. And it is true that in this most recent European elections, you know, a lot of it was not about the work programs of the large parties in the European parliament. That's fine. I mean I'm the first to admit European parliament has no real mandate from voters for what it says it has a mandate for. I think it's a useless organization but I don't think that's probably the point you're making. But the point I'm making is at some point you hit the wall, and what is the wall? Is the wall the national front winning the European elections in France? Or is

that just, you know, that doesn't matter? Is the wall UKIP winning the European elections in the U.K.? Because it won't have a direct effect; it won't be that national front MEPs will control important votes in the next 12 months in the European parliament, but it will have an indirect effect every time there's a kind of fork in the road where national governments, all the big parties in the European parliament, all the European commission, there will be endless forks in the road. Should we do the unpopular rigorous thing, should we do the populous easy thing? Shall we do the open thing, should we do the closed thing? So, Marine Le Pen, one of her first demands was just to scrap the TTIP negotiations. Now is it in her power to scrap the TTIP negotiations? No, because she's only the woman who runs the party that won the French election in the European parliamentary elections. But I bet you it makes it harder for France to agree to stuff during the TTIP negotiations. I bet it doesn't help. I bet it's really unhelpful, but that's her position. I bet it's really unhelpful when Europe decides, you know, America says to Europe okay, Putin's done this, we need to do some serious tough sanctions now because the western world needs to align itself against Russia. Does it matter that so many of these far right parties basically are more sympathetic to Russia than they are to America? In direct terms their votes will not affect things but I bet it matters in terms of whether Europe goes along with those tough sanctions or doesn't. You know, when Britain -- if Britain comes through and says here are the concessions we would like does - - you know, will UKIP write the list of concessions? No, but plenty of conservative members of parliament who already don't like their Prime Minister and think he's too centrist, they think that if they had a much tougher, more anti-European, more anti-immigration line their seats will be safer next year at the general election. So that will dramatically impact David Cameron's room for maneuver. It will dramatically harden the list of things that Britain has to ask for when concessions are asked for if we get to that

point. It will make Britain much less realistic about what is possible by way of concessions. And the other parties in the mix will make it harder for national governments to let Britain have what it wants. So it makes it that much more likely, not dramatically more, not decisively in a binary way, it just makes it much harder for Britain to stay in. So on all these kind of marginal calls, you know, that's how politics works. Politics is kind of like the weather, you know. There's a freezing gale out there and that makes today's people who take decisions put on an overcoat and a scarf and hunker down. And it's at that level that it makes a difference. And, you know, you could ignore it, you can tell me -- you can give me lots of clever reasons to ignore it but at some point, you know, it's going to catch up with you, you're going to hit the wall. And we may not have hit the wall right, right now but, you know, you can't just keep ignoring this stuff and say it doesn't mean anything.

MR. WRIGHT: Thank you. Jeremy, are we running -- are we finishing up now with a break for 15 minutes or are we running until 10:45?

MR. SHAPIRO: No, unfortunately (inaudible).

MR. WRIGHT: Okay. Unfortunately we don't have time for more questions but there'll be plenty of time to address those questions I think in the next session which is on the Role of the European Union in the World. I'd like to thank our panelists. (Applause) We'll reconvene here in about 10 to 15 minutes. I'd like to ask the panelists for the next panel to meet just over here so you can sort of discuss the next panel in advance. And with that we're adjourned. Thank you very much.

(Recess)

MR. MENON: Welcome back to this second session, in which we're going to look more directly at the role of Europe in international politics. We'll look at that role in general, and also more specifically at Transatlantic relations. Transatlantic

relations was a subject I discussed with Clara, quite frequently, back in London. And we had, on several occasions, expressed the hope that we could set up something with Brookings. I think this was even before she came to Brookings, in the way of a sort of regular events on Transatlantic relations. So, I do hope that this can be the first of many occasions where we can work together. And thank you to Fiona, and particularly for Jeremy, for letting me free ride on his hard work in putting this event in place.

We've got four fantastic speakers for this session. So, I'll do you all a favor, and not waste any more of your time. We're going to go in order, starting with Andy Moravcsik on the far right, geographically. (Laughter). I hope we have plenty of time for discussion. Andy.

MR. MORAVCSIK: Great, well thank you very much for having me. So, I want to dispel a little of the gloom, by starting with optimism. So it will be sweet and sour here. Every American administration starts by turning to Asia, somewhere in Asia, and ends up by turning back to Europe. And this administration has done the same, and there's a very fundamental reason why this is true, and that's because observers always underestimate Europe's power and influence in the world. And I think we should reflect on that for a moment, to put all this in perspective.

So Europe, judging by practical results, and what it's achieved over the last couple of decades, is the other super power in the world besides the United States. It is ambitious. It is successful. It is extraordinarily powerful. Europe sometimes works together formally. Sometimes works as coalitions of the willing. Sometimes works individually, as individual countries. But it really, across the entire spectrum of ways of influencing the world, military, economic, ideational, Europe is the only counterpart to the United States, and in all these respects, has much more influence in the world than China, that gets much more press.

It's the world's second largest military power. It has had on the average, over the last two decades, 75,000 combat troops in action throughout the world, compared to China, somewhere between zero and 2,000. And in various operations like Libya, it's led those operations. Most problems in the world don't have military solutions. Europe is the preeminent trade and investment power in the world, larger and more influential than China or the United States. It has the world's second largest reserve currency. It might be in trouble, but that only goes to show us how important it is because we see what might happen if it goes south. It's the world's largest supplier of foreign aid. It's the most dynamic, expanding regional power. So the single most cost effective instrument, that any country or political body has had in the world to promote peace, security, and economic well-being in the world over the last couple of decades, has been European enlargement. And European enlargement continues into the Western Balkans. It even has influence in places where there is very little hope in the short term of a country joining the European Union like Ukraine, to which I will return at the end.

It's the world's major supporter of international law and institutions, not just in the region, but throughout the world, everything from the ICC to the UN organization, and everything else and trade.

And it is the world's most important source of soft power ideas. If you poll people across the world, or you look at what they write into their constitutions, most of those ideas come from Europe, not from the United States, China, or elsewhere. It educates students. It does dozens of other things of that kind.

And throughout all this, it has a firm alliance with the United States, which is an enormous asset. Something that permits it to work in cooperation with the other great super power in the world, and again, something that can't be said of China or

India or any of these rising powers.

You will remember -- I remember in this room, just a decade ago, Bob Kagan up here, telling us how Europe and the United States were from two different planets, and destined to drift apart. That hasn't come to pass at all.

Moreover, Europe, the EU as a whole, is, I believe, and to a greater extent than the conversation we just had up here, might lead you to believe, completely stable. Because pulling out of Europe would be suicidal for any country. The Euro, we can talk about how stable it is, but Britain's not going to go anywhere, anytime soon.

And even today, the EU is more popular and more trusted by publics in European countries than national governments are. And that is even true for the British. If you poll British today and ask them, which institution do you trust more, the European Commission, or the British Parliament, they will tell you the European Commission.

So this is an institution that has a tremendous amount going for it. It has one major problem that started in 2008, with the economic crisis. Because in 2008, I lived for a year in China. All the Chinese wanted to know about was Europe, because Europe had managed to convince people, and I think rightly, that it was a real force in the world. Since then, Europe's achievements and global influence have been called into question by the failure of one policy, and that policy is the one we just recently discussed, the Euro.

So, as Simon, I think, pointed out correctly in the initial panel, it's a kind of tragedy of Europe, that its success has brought about questions, because the Euro has become a threat to European integration itself.

There are three possibilities. One possibility is that Europe moves forward toward a federal solution. That will be extremely costly, politically and economically. The second is that it slips back, fragmenting into different Euro zones, or

into single currencies. That will be also traumatic, difficult, and costly. The third, and probably most likely, is that it stagnates in a kind of Japanese solution of low growth and muddling through, and that too, will be economically and politically difficult.

Any of these options, mean that Europe's economic and political capital, will be lessened over the coming years and decade. So, I would concede David's point, that there are some public opinion and political constraints to what Europe can do internationally. But I don't think they're as great as people think. For example, Europe has continued to enlarge, now to 28, and continues the process of enlargement, despite the fact that that process has never had strong public opinion support in Europe. And in many countries that public opinion support is single digit, and has been for decades. But nonetheless, European leaders continue with it, and have done so successfully.

The more important problem is, that in order to pursue effective foreign policy, one needs economic resources and political wherewithal or room to move, and that is difficult. And the difficulty here is that there are issues in the world for which Europe, because of its great power, is essential.

And you see this very clearly in a case like Ukraine. We're only in the situation in Ukraine, because of the extraordinary attractive power of Europe. That is how we should remember the crisis started. Ukraine is closer to the western camp today, than it was six months or a year ago. And Putin is in worse shape than he was six months or a year ago today, or trying to get back to where he was, precisely because the attractive power of Europe, managed to change the government in Ukraine, and changed the status quo.

But to the current situation in Ukraine, there is, as Ambassador Ischinger will state in more detail, no military solution. The solutions in Ukraine are going to be economic and political. The western tools we have are only marginally military. NATO's

nice, but NATO can't really do very much in the region, except reassure Poland. For influencing Ukraine, what's needed is action on trade, action on energy, action on foreign assistance, action on immigration, action on education, and other assistance. Those kind of policies are going to have to come primarily from Europe. It is Europe that dominates economic relations, social relations political relations, and cultural relations, in that part of the world. Europe is the entity that matters.

So that what we see, is that in the end, it is the civilian power of Europe, more often than not, and the return to Europe that emerges when we look beneath the surface of issues in world politics, like the Ukraine.

Now Europe may not do as well as we hope, as a result of the recent crisis, but it still possesses large power resources to influence the Ukraine situation, and that is what we should look for in the future. Thanks.

MR. MENON: Thanks, Andy. I'm always tempted to say, we should stop there and go for champagne now. (Laughter). I suppose we should plow on. Charlie.

MR. KUPCHAN: Thank you, like Andy, I'm delighted to be here and to share the panel with the distinguished colleagues. And also because this is a conference that is being held in memory of Clara. I didn't know her extremely well. I had many interesting conversations with her about her passion, which is European defense and European integration. And she's one of the most decent people I knew in Washington. So, I think I speak for all of us here, and in London, who worked with her, that she is sorely missed.

I don't take fundamental issue with Andy, in the sense that I share his view that Europe punches above its weight in a civilian respect. And the best testament to that over the last six to eight months, is what happened in Ukraine. Where you had a popular revolution take place, because when Ukrainians were offered a choice between a

future, that was with Russia, or a future that was with the European Union, they took to the streets, and said resoundingly, we want Europe. And that suggests its attractive power, despite its internal difficulties, is extremely strong.

That having been said, I'm a little bit more worried about the political trials that Europe faces as a consequence of the Eurozone crisis and the recent Parliamentary elections. So let me begin by saying a few things about those elections and the surge in the right.

A couple quick comments on Ukraine, and then I'll end with a thought on the implications for the United States and the Transatlantic relationship.

I don't think that the Parliamentary elections that took place a week-and-a-half ago, represent a political earthquake, or a fundamental turning point in the trajectory of the European Union for the following reasons. One is that most of the folks that will be sitting, in what one could call the populist quadrant, are not scary folks. Right, there are scary folks -- Jobbick, Golden Dawn, Neo-Fascists, Neo-Nazis, Anti-Semites. They are growing in number, but they are still at the very fringe of European political life. Most of those people, who will be sitting in the European Parliament, represent people who are anti-immigrant, who are skeptical about the European Union, but they are within the confines of what you would call a respectable political spectrum.

The second point is, they represent a very broad set of views. And I think it will be difficult to see the parties come together and form groups in the European Parliament, which they need to do, if they are going to have the voice that they would like to have.

And the third point is that the European Union and its member states, is a parliamentary system. And if you step back from the vote that took place ten days ago, and you say, well, what's the broader picture here, it is that European center right and

European center left parties, both of which remain staunchly pro EU, have number one, tacked to the center, since the end of the Cold War. And number two, been in power. Now the bad news is that they have steadily lost market share, with a couple exceptions. And that means that even though they've tacked to the center, and there isn't much difference between social Democrats and Christian Democrats, they have ceded the left flank and the right flank to these growing populist parties. That doesn't mean that those populist parties are in power. They are not, but it does mean two things. One, they are having a greater and greater effect on those Centrist parties, because those Centrist parties feel a need to co-op them and expropriate or appropriate some of their language and policies.

And secondly, and more worryingly, they could win a national election. In the UK, in France, in Denmark, populist parties actually got the largest share of the vote. That means that in a French election, you could have a candidate named Le Pen, become the next president. I don't think it's going to happen. If it did happen, even though I agree with Andy that getting out of the Euro or getting out of the European Union is a very tall order, it would fundamentally change the equation. And I'm less confident than Andy that the UK is there to stay. In fact, I would say that if Cameron wins, there is a better than even chance that the UK will leave the Union. But that's obviously a speculative venture, and at least the polling numbers right now, don't put Cameron in a very good position.

So, bottom line is, it's worrisome, what happened. The European Union has been shaken by this event. It will make Europe harder to move forward, which is worrisome from the perspective of what happens if another major economic financial crisis emerges. The Germans, in particular, aren't ready for full-scale banking and fiscal union. I'm not convinced that the EU is out of the woods, when it comes to the financial

crisis. This particular Europe is not well prepared to deal with that crisis, if it re-emerges.

Let me end with a quick comment on Ukraine, and then implications. I would say on Ukraine Transatlantic perspective, the glass is more half-full than it is half-empty. The United States and its European partners, generally stayed on the same page, which is no small task in a Europe of 28 members, that reside in a very different geographic and geopolitical space.

That having been said, a couple things worry me. One is the debate in Germany, where I think you have a government that is actually very close to the Obama administration, and a public that is actually very far from the Obama administration. And it leaves Merkel in an exposed political position. I'll leave it to Wolfgang to say a few things about this, but having been in Germany twice in the last four weeks, there are weird things going on there -- about Germans being closer to Russians, about Germany not wanting to move in a direction of taking on more responsibility. The debate on Ukraine there, is all over the place, in a way that I don't think I've seen, certainly since the end of the Cold War.

And secondly, I'm a little bit uncomfortable with how readily the G-7 partners opened up to Putin over the last 48 hours. I would have been more comfortable had Hollande met with Putin one-on-one and given him a stern talking to, but to have him have these one-on-ones with most of the European partners, I think sends the message that it's too -- my view is it's too soon to kind of bring him back into the fold. What he has done in Crimea; what he continues to do in Eastern Ukraine, is over a red line, over a fundamental red line, and I don't think we should mince words, when it comes to that question.

Finally, implications -- what does all this mean for the Transatlantic relationship, the security partnership, not much. Why? Because, I think, number one,

the Ukraine crisis has led to a recommitment to the United States, to Europe. We saw in the last 48 hours, a one billion dollar commitment from the president to beef up defenses in central Europe.

And number two, I don't think there is much elasticity in this relationship. In fact, I think 20 plus years after the end of the Cold War, the resilience of the Transatlantic partnership is, to me, stunning. Europeans and Americans keep coming back to each other, come hell or high water. And that's in part because of common values and common interests, and it's in part because there isn't much in the rest of the world that offers anything close to the Transatlantic partnership. Whether it's Indonesia, Turkey, Brazil, India, China, you name the emerging power. And you say, are these countries stepping up and providing public goods? The answer is definitively, no. They're not anywhere close to playing that kind of role in international affairs. And it's because of that, that I think, even if Europe weakens, even if they stay a civilian power and don't move in a more decisive direction on amassing military capability, which I think right now is probably not going to happen, we're going to complain. We're going to talk about smart defense. We're going to talk about two percent spending GDP on defense. But the overall relationship is, in my mind, in very solid shape.

MR. MENON: Andy, can I just come back to you very quickly on one thing, which is, I got the impression that you don't think the shifts in politics within Europe are affecting its world role at all. It just struck me, that in one area at least, they are, which is how we deal with the countries to our south in Europe, where we've adopted a very security driven anti-immigration driven stance, which seems to be wholly at odds with your portrayal of Europe as still sort of an island of liberal values. I mean, until quite recently, our main partner in dealing with immigration was Colonel Gaddafi, who we basically paid to set up camps to keep him away from our shores. Surely in that way, at

least, you see a kind of, slightly less, sort of salutary shift in how Europe's dealing with the world.

MR. MORAVCSIK: I think that's true. I mean, I do think that Europe has been more moved to -- there's no doubt, that Europe has moved to a more closed immigration policy, particularly with respect to southern countries. That's true. Whether it's moved to a more closed immigration policy all around, or not, is a separate issue. And I think we need to look at all the political pressures and all the obligations that Europe has, but there's no doubt that what you say is true.

MR. MENON: Julie.

MS. SMITH: Well, thank you. Thank you for the invitation to be up here on the stage with so many friends and colleagues. And I'm thrilled that I could be part of a tribute to Clara. I met her a couple of years ago, when I was working at the Department of Defense on European defense -- her favorite subject. And she came in, I think it was in late '09, to interview me, and about ten minutes in, I was interviewing her. And the conversation flipped rather rapidly, and I realized that she should be sitting in my chair and working at the Pentagon on European defense, because she was incredibly knowledgeable. But, of course, as we all remember, it wasn't just that she had just incredible depth of knowledge and expertise, but she was just such an enjoyable person to be around. No ego, no hidden agenda, and you could sit for hours. And I think it was supposed to be a half-hour meeting. I think it went 90 minutes. And again, I was peppering her with questions. After that, I always made sure that I had time for Clara, and would come and hear her speak, whenever she was here at Brookings or around town. So, she is dearly missed, and we're thrilled to pay tribute to her today.

On the question of the EU, the election results that we saw a couple of days ago, and foreign policy at large, I certainly would echo what Charlie said, in terms of

the election results probably not having a drastic impact on the foreign policy agenda, inside circles, across Brussels. I think, you know, the emergence of slightly greater representation of some of these populous parties, will muddy the debates and create complications in a couple of very obvious areas. Obviously, Russia would be at the top of that list, to the degree that the EU will continue to have conversations about altering energy policy, TTIP trade policies, and certainly enlargement, to the extent that the EU is interested in continuing to have a debate about that. One can imagine how this cast of characters that are arriving on the scene would, you know, alter those debates. But I think it's a mistake to make drastic assumptions about how this will fundamentally force the EU to alter course on any of the issues I just mentioned, or any of the other issues that it's juggling, from Ukraine to Iran to Russia, or Asia, and a whole list of other foreign policy concerns.

But I have been worried about EU foreign policy. I'm not as optimistic as some. I think, I worry, not just about the European Union and Europe's approach to foreign policy. I really have deep concerns right now about how America, the United States and Europe are handling, kind of their common foreign policy agenda. And I think what we're seeing is that, both sides of the Atlantic find themselves in this post, post 9/11 world. They've certainly been able to sketch out and have interesting conversations over the last decade about what they have learned, and how they've worked well together. What they didn't like about the post 9/11 world, about the global war on terror, about the Bush years. But they're having trouble defining the new agenda, their new foreign policy framework, the new strategy, for everything that's coming at them in the world. And I'm going to be issuing a report next week. We actually dubbed this, the era of compounding complexity, and it doesn't roll off the tongue, but I think this is an environment that is so incredibly complex, that I think Europe and the United States are just really struggling to

cope with the number of challenges that are coming at them. And just to cite a few -- we have not just the emerging rising powers, but we have all of the arrival of the variety of non-state actors, individuals, corporations, that are now playing a huge role in crafting national security agendas. How we use statecraft; how we use the tools of national security. And playing roles in ways that we never imagined. And I think trying to find a way to fold those groups into the foreign policy debates, and give them a seat at the table, has been a huge challenge for us. But I also think we're coping with this diffusion of power. I'm not going to stand up here and get into the decline debate. Is America in decline or not? Is Europe in decline or not? I think that's, you know, those binary debates are not particularly useful. But I think we do have to have a conversation between Europe and the United States, to think about, you know, our share of world power has certainly diminished, as all of these other actors have arrived on the global stage. And I think we're, again, trying to wrap our heads around that. And when you pair that with the proliferation of game-changing technologies, with very mixed public opinion right now, on both sides of the Atlantic, about what we should be doing in the world. How we should be leading the world. What types of tools we need in our tool kit. And then you look at this alphabet soup of international institutions that collectively -- Europe and the United States-- have spent 60, 70 years, creating and building, but they all feel quite rusty and creaky and unable to deal with a lot of the challenges that we're facing from cyber to maritime security to drones, and it goes on and on and on. I think you'll find that this is an environment that has just been particularly hard for both sides of the Atlantic to come together to craft common policies. I mean, we've succeeded in Ukraine, more or less as Charlie noted, in standing shoulder-to-shoulder, but we've had trouble having broader strategic debates about what Ukraine and Russia's action in Ukraine mean for us as partners going forward. What it ultimately means for the EU/US relationship. What it

means for the NATO alliance. What it means about our assumptions about great power politics. And I think we're missing the boat a little bit, if I could just tie it specifically to Ukraine, on the strategy side of things.

I mean, while we've succeeded in coping with this crisis, I think where we failed was, before the crisis, where the United States in many ways, felt like it could easily outsource Ukraine to its friends in Europe, and then suddenly we were rubbing our eyes in disbelief, saying, what just happened here. We failed to have a conversation early on, to say, gee, this doesn't look like it might play out so well. What would happen if Yanukovich ran for the hills, or what would happen if Russia overplayed its hand? And we weren't having those types of strategic debates and conversations.

And even now, in the middle, as we figure out what to do with Poroshenko, and how to provide support to Kiev, and all the rest, I'm not so sure we're thinking strategically about where we go with our relationship with the Russians. We're thinking very much in the short-term of, what's our next move in the next week to two weeks.

But the strategic gap, I think, is what troubles me, and worries me about - together our ability as partners to deal with a lot of the global challenges that are coming at us. And I would just say in closing, I think we have to think more creatively about -- in our Transatlantic dialogues, folding other players into the dialogue, thinking about the tools of statecraft. What do we have in our toolbox today? What's missing? Where do we have to make investments? And most importantly, how do we take an affirmative, but also an affordable foreign-policy agenda to our very skeptical public right now, and explain to them the importance of global engagement, how we plan to pursue it. How we can use limited resources, and apply them in a very strategic way. So, we've got a lot ahead of us, but those are some of the things that I worry about more in the long-term

perspective for this relationship.

MR. MENON: Thank you. Could I just come back to something that you said very early on? I wonder if we're not being a little bit complacent about TTIP? Because as David said this morning, the results of the election, put enormous pressure on national governments.

MS. SMITH: Sure.

MR. MENON: You know, I would try to exercise at least a symbolic veto at some point on TTIP, just because of the state of electoral play in France. And in the European Parliament, it is far from clear, there is now a majority that will vote for this. And if you're the European Union, and you can't do trade, what else do you do? Do you not feel that there's more -- I get the impression from all three of you, that you're fairly relaxed about the prospects.

MS. SMITH: Personally, I'm not relaxed about TTIP.

MR. MENON: All right, good.

MS. SMITH: I mean I was nervous about it before the Parliamentary election. And I think we have cause, as you noted, to be concerned about how this might continue to overshadow the debate. But I've been worried for quite some time, because I think neither the folks here in Washington, nor our counterparts over in Brussels, really have mapped out a plan of how we're going to get to a win on this. And what I fear is, that we've lost considerable time right now to those that are mounting the campaign against TTIP. They are must more organized. They're definitely working on their outreach, their PR, their narrative, their messaging. We are not. In some ways, we've turned the lights off here in Washington. Because of the congressional piece, we want to wait until we can get past the mid-terms. But by doing that, I think we've given some of the anti-TTIP permission to move forward with their agenda.

MR. MENON: Thank you. Ambassador Ischinger.

MR. ISCHINGER: Thank you. It's a pleasure, real pleasure, to be here. I remember that I walked into this building the first time, when I was -- I think I was a Third Secretary or something like this, at the German Embassy at the end of '79. And I wasn't sure that anybody was going to actually see me here, but in any case, it's wonderful to be back.

Let me start by saying that I'm delighted that Andy started us off on a positive note. It is important to note, that contrary to predictions by major and credible personalities, certainly most of them on this side of the Atlantic, the Eurozone has not collapsed over the last couple of -- it's still there. Problems, we heard this morning, that are not resolved, but we are working our way through them.

One point too -- you know, the 100,000 or so EU flags on Maidan Square, in Ukraine, some months ago, were a powerful reminder for those of us who have become skeptical of our ability to make of the European Union, what we think the European Union should be. And how do you explain this exuberant joy of young Ukrainians, looking at Europe, and the result of these elections a week ago?

Well, why can't we have a tea party? I mean, you're suffering through this. So why can't we have some of that ourselves? I think it's normal. It was practically abnormal in my own country, for example, that there was not a single party in the Bundestag, that said, no, to this basic consensus, that we have had now, over a number of decades.

So actually, I don't want to minimize the challenges that this new configuration will create in the European Parliament and in national elections and national Parliaments -- far from it. But I think it's actually a healthy development. It will force us -- us, I mean the mainstream governments, mainstream parties, to work harder on the

arguments, with which we need, or they need, to convince publics that have -- as was said in the first panel, that have come to identify the EU, not only with overregulation -- I think that was a proper point made in the first debate this morning, but with this bad idea of immigration, this bad idea of immigration.

How should we think about the European Parliamentary elections? I'd like to introduce one aspect, which has not yet been highlighted enough, I think. I call this -- I mean these right-wing parties that are now entering the European Parliament, I call this -- you have to give them a name. I call it the Putin Alliance. Isn't it interesting that President Putin is getting applause, not only as everybody would expect, from the far-left in Germany, the post-Communist party -- they travel to Moscow, as they've done all the time, and say thank you for being seen in the Kremlin, but Marine Le Pen, and others, have decided to look at Vladimir Putin as their hero, because he is such a wonderful defender of nationalism, of the nation state.

In other words, what we have here, is an interesting challenge by, as I see it, by President Putin, and those who support him or admire him in Western Europe, to the very fundamental idea of Europe. Namely, overcoming the nation state -- creating something new, something better, after centuries of strife and conflict.

So I think this is important, but not because we're going to lose our ability to govern, but because there is a rather fundamental challenge here, going on between Putin and Western Europe.

On Germany -- I mean Charlie is correct. He's a good observer of things that are going on in the German public debate. Fortunately, the German government has an 80 percent majority in the Bundestag, so Chancellor Merkel, while she has to take note of these debates, she can rely on a very strong pro-EU, pro-NATO coalition in the Bundestag. But it's true; the public has a different view. And I think the view of the public

in Germany, is informed, I'm sorry to say, by an overwhelming sentiment in Germany, that the Americans have stopped listening to us. They're only listening in.

It's the Chancellor Merkel cell phone thing. It's the Snowden revelations. It's the total loss of trust in what used to be the American, you know, trusted senior partner. And, you know, this -- I don't want to dwell too much on this, but the relationship between Germany and the United States is different, of course, from the relationship between, say the UK, or France and the United States. We've always had this kind of daughter/father or daughter/mother relationship between Germany and the United States. We were growing up, and we were being chaperoned and protected, as a nation, and as the EU, by the United States. So that creates very special sensitivities.

This is a big problem, and it also affects this loss of trust. It also affects the ability in Germany, and some other EU countries, to come up with a positive response to the TTIP challenge. Because it is now popular in certain circles in Europe, to argue, oh, this is yet another ploy by large international companies, mostly based in the United States, to gain additional advantages, et cetera, et cetera. And we, the simple citizen, the citizen, we're going to not be as well protected, regarding modified corn and chlorinated chicken, and all these rather ridiculous items, that are being quoted as harmful to the health of Europeans, et cetera, et cetera. So this is not an easy thing to overcome.

Let me -- I don't want to speak for too long. Let me just make a couple of points on Russia, and on European foreign policy. I, for one, believe that we Europeans should have spoken out more clearly, when the question was raised some months ago, should we or should we not cancel the G-8 meeting. My own view is, it was wrong to cancel the G-8 meeting. We should have had the G-8 meeting, but we should have told President Putin, there is only going to be one item on the agenda, that's Crimea. And we

will talk to you, as long as you are prepared to listen to us about Crimea, and why you did the wrong thing.

What we are now seeing, is because we are not having a G-8 meeting, now we have this spreading out of these bilateral meetings. And I think I agree, this makes me uncomfortable too. I don't know what President Hollande is saying to President Putin, bilaterally. I believe I know what Chancellor Merkel is saying to Putin. But I think it would be better to have him sit across the table, and be given one response or more or less the same response in one meeting. As a professional diplomat, I've always thought, and I've always defended the idea, that entertaining a dialogue, whether it's multi-lateral or bilateral, is never, in and of itself, a sign a weakness. The result of your negotiation can be a sign of weakness, if you're a bad negotiator -- if you give in too much. But having the discussion, in and of itself, cannot be a mistake.

Let me remind you that, even at the height of the Cold War, American presidents, including President Reagan, had numerous discussions with Soviet leaders, and that was not seen as a sign of weakness either. So, I think I have a question here -- on how we deal with Russia in the Ukrainian crisis. I think there is also a nuance that I just want to highlight with one sentence. I think we in the EU, and certainly my own government in Berlin, we believe that our priority objective ought to be, to do whatever it takes to stabilize Ukraine, right? Sometimes I get the impression, that some people here in Washington, believe that the priority number one, ought to be to maximize punishment for Russia. And when I was in Ukraine, I got the impression, that in some ways, my Ukrainian friends thought they were getting the message from Washington, to be even more anti-Russian than they themselves felt necessary. So, I think this is also an issue about which our governments need to have a continued discussion. How anti-Russian do we want Ukraine to be? Ukraine will always live next to a big neighbor called Russia.

And at some point, they'll have to figure out a way to live together again. Even if it's hard, given the annexation of Crimea, et cetera.

The last point -- European foreign policy. We are doing a terribly bad job, and here I'm really critical about our own performance, both national and EU wise. We, in my own country, have not had a single important national security document for the last eight years. I think the last one was in 2006. The world has changed significantly since then. In other words, neither our public, nor our soldiers, nor the members of the Bundestag, know exactly for what purpose we have our forces, and why you should or should not use military force in whatever circumstances, et cetera.

Even worse, the European Union, which under the leadership of Javier Solana, who I'm glad to say, has a relationship with Brookings, developed a first-strategy document, way back in 2003, more than ten years ago. The European Union has not been able to come up with a new version of this. I understand the hesitation of some of my friends, who are national security advisors, et cetera, in various European capitals. Their argument is, let's not do it, because if we do it, we will only get the smallest common denominator. And the smallest common denominator will look so terribly poor and weak, that it's better not to have the document, than a bad document.

Well, I think the exact opposite. I think, even if we come up with an insufficiently, impressive document, we can improve on that in the next round. But we've got to start at some point, and tell the citizens of these 28 countries, representing 500 million, what our objectives are. What is our strategy? Are we going to conquer Africa, or are we going to play a role in the Middle East? And how do we want to deal with Russia, et cetera, et cetera. So, I think that's something that should happen, and any support that the European debate can get from this side of the Atlantic, will be much appreciated.

A final word on the conduct of European foreign policy -- I've been involved in these discussions for many, many years. And what I thought is probably invisible, when you look at this from the United States, from far away, is that among the 28 member nations of the EU, only maybe a handful are capable of developing, what I would call, operational foreign policy. Namely, you say, okay, we've got to teach China a lesson. Do we issue a declaration? That is what 20 out of 28 nations will find as the only possible action. Or are we going to do something about it? Is there actually a policy? Can we develop a policy, maybe together with the United States or other partners? In other words, there is a difference between a handful of countries, capable of having an operational foreign policy, and most of these EU member countries, that are small -- less than 10 million people each, they have only a capacity to have -- what I would call, a declaratory foreign policy. Their operational capacity affects only their relations with their direct neighbors -- think of Luxembourg. Where would Luxembourg be on the world stage, if they were not members of the EU? But their capacity to think beyond the confines of their borders, is obviously limited. I'm not criticizing Luxembourg. I'm just stating the obvious. In other words, don't be too critical of an EU that finds it so hard to come up with clear strategic direction and decision-making. Think of how hard it would be, if the governors of all the states of the United States, would constitute your national security council. And one would say, open the border with Mexico, and the other one would say, let's do exactly the opposite. It wouldn't be so easy, and that is why we need to work our way through this. I, for one, believe we should end up with majority voting and foreign policy. We're not quite there yet, but that's what we need. We need to be able to say, you know, 15 countries have agreed that we will now wage war, and then we will go. But that's a hard thing to do, and it will take many years, many months, a huge effort, to get from where we are to that point.

Maybe I shouldn't have chosen the example of war making. (Laughter).
Peacemaking is better. Thank you. (Applause).

MR. MENON: Do you think even any of the larger states have anything that you could call a strategy towards China, that goes beyond signing as many contracts as possible, and turning a blind eye to everything else?

MR. ISCHINGER: My own view is, we need to have a China strategy. Because -- speaking as a German, so many jobs in Germany now, depend on strategic stability in the Far East. It's not just because we need to work with the United States, et cetera, and listen to your strategic concerns. If there was a conflict in the Far East, let's say, between China and Japan, that would endanger the free transport sea lanes, et cetera, et cetera, the lights would go out, first and foremost at BMW and Mercedes, et cetera, et cetera, plants, which is why we have a built-in interest. Our own economic well-being, depends on strategic stability in the Far East. That is something that has not yet sufficiently been explained to the average voter. He would probably say, let's stay out of these things. Why should we worry about Chinese warships in the South China Seas? But it matters, and that's why I believe the EU should have a policy. And I believe the EU Ambassador in China, needs to be able to say, my instructions are to tell you that you are right, or to tell the Japanese, that you are wrong. We have not reached that point yet, unfortunately. So, I think there is a need to have it.

MR. MENON: Do you want to come in quickly on this?

MR. MORAVCSIK: Yeah, I'm going to say something that a professor from Princeton, with a specter of George Kennan looming over me, should never say. But, you know, do we really need a grand strategy? Because we live in a different world than we did in the Cold War. It's different for two reasons. One is that we don't have the big overriding threats that we had then, that could mobilize 20 countries, 27 countries

around the same goal. We have second order, third order security threats, and so a coalition of the willing, tends to be a couple of countries that really care about something. A few more countries that are willing to go along. A bunch of countries that don't really care, and a few countries that have some strange domestic reason for not wanting to be involved.

And then, the second thing that happens in this situation, is these things arise unpredictably. So, you can be critical of people not foreseeing that people would erupt in the streets in the Ukraine, and the problem would arise, but you could also argue it's unforeseeable. Because unlike, you know, the bilateral balance in the Cold War, this was something that just kind of came out of nowhere.

And otherwise, it's a relatively peaceful world. War is lower than it's been in centuries. Trade is more open than it's been in centuries, even in the face of the greatest depression since the Great Depression. And there are more democracies, et cetera, et cetera. So, in that circumstance, it's very difficult, and in some ways, counterproductive, to get people to argue about principle in foreign policy.

SPEAKER: You know, that is ridiculous. Right now, Putin is waging civil war in Ukraine. He wants to return to the Cold War. Why don't we oblige him?

MR. MORAVCSIK: The issue is not, whether or not we should do something about Putin. The issue is whether or not, three years ago, we should have had a global strategy designed to deal with all cases of that kind, as the basis for --

SPEAKER: What are you going to do now with Putin?

MR. MORAVCSIK: I think Ambassador Ischinger can answer that question.

MR. MENON: Before Ambassador Ischinger answers that question, we've now started the question session. (Laughter). We have to finish by about five

past, ten past, because that gives us time to get lunch before the keynote. So, I've got my priorities right. The gentleman in the middle over there.

MR. HADGER: There may be a way out of this European crisis on the Ukraine and the Crimea. My name is Henry Hadger a researcher at NARA. Basically, you take one look at the word Crimea, the word crime is in it. And, of course, they've taken this territory by force. The Mexican session is something that the United States was faced with. They took all that territory by force and paid for it later. So why not tell them to pay for the Crimea area, any area that they seize. It's a nuclear power. Trying to prevent them from doing something is very difficult. Sanctions is a way of doing things, but I don't think it's terribly effective. So why not tell them to pay for all this territory, while, you know, things are still available internationally to try to solve a crisis. Any comments?

MR. MENON: Who else? The lady -- what I might do in the first round, is take the questions over there. Because they're near the microphone, and then do this side.

MS. FLOCKHART: Thanks. My name is Trine Flockhart, from the Transatlantic Academy, at least until next week. I want to take up Ambassador Ischinger's point about the European elections being actually a healthy development. Because what worries me from what I've heard, both this morning and also, to some extent, although not as much, is that we can have these elections and then carry on as usual. I don't think we can, because that is not how democracy works. And if we do that, then it will make a mockery of democracy.

But actually, this is the first time -- because the elections have created a swell of populist interest in the EU, this is actually the first chance ever, in the history of the EU, where there's a chance to engage at the public level on issues that have

suddenly caught the interest at a level that has never been done before. So, I suppose my question to the panel is, how do you think we can engage in a constructive dialogue with the public on those issues that are raised. Because the issues that are raised at the public level are concerns about democracy, accountability, legitimacy, et cetera, in the EU. Well, the answer to those questions are precisely what the populist mentality doesn't want. Is there a way of actually taking this as a moment, and engaging in a dialogue, where you start using the dreaded "F" word in the European debate. Thanks.

MR. MENON: All right, we've got a couple of questions on Ukraine, and one on the election. So, if we go in the same order again -- I mean, feel free to pick and choose in what you answer.

MR. MORAVCSIK: Well, quickly, on the elections, I believe the EU is plenty democratic. People in Europe could put a stop to any policy they want, simply by making it count in their national election. So, say you didn't like the Euro or the way the Euro functions, and you were Italian, Spanish, or Greek -- and I picked those three countries, because those are three countries that thought seriously about pulling out, or threatening seriously to Germany, that they would pull out, in order to increase their bargaining leverage, and were pushed back down by pressure. You could easily force a change in the system. The reason that change has not been pushed, is because there is not a Democratic majority in any of those countries to push that change at the current time. So, democracy could be part of the solution, but the problem is, there isn't a Democratic majority to change the status quo. It's perverse, but it's true.

MR. KUPCHAN: On Ukraine, I think that the idea of telling Putin that he should pay for it, would be to understate the gravity of what's happened. In that, no the loss of Crimea is not a first order security threat to us, or to Germany or to Poland or to the UK, but it is the most significant geo-political move that we have seen in Europe,

since the fall of the Berlin Wall. And what it says about Putin's potential intentions in the future, is what I think we need to worry about, and it's why I'm fully supportive of efforts to beef up NATO, to send more forces to the Baltics and to Poland, and not just do it in a symbolic way, because we don't know. In my own mind, I'm much less willing to cut Putin slack now, after Ukraine, than I was before. And moving forward, I think American policy and policy with Western Europe, has to be predicated upon the kind of worst case. Don't give him the benefit of the doubt, because of what he's demonstrated he's done.

On Trine's question, I agree with you, that it would be a mistake to say, business as usual, let's sweep this under the carpet. And that's because I think that, you know, the genie is out of the bottle. The European Union has prospered since 1949, coal/steel community, single market, single currency, by effectively flying under the radar screen. People didn't really win or lose votes because they were pro or anti. It wasn't a huge issue in national politics. It is. You go for a walk in a major EU country, and people are talking about it. It's been politicized. And therefore, I think the mainstream parties have to engage, and they have to be more courageous.

Because right now, if you step back and you read the European press, listen to European TV, the populists dominate the political narrative. Those people in power are running scared. They are not fighting back. They are not saying, okay, let's have a debate. Let's say we stop immigration. Let's kick them all out. What's that going to do to our GDP? What's that going to do to our demographic picture? Instead of having those debates, they're really ducking. And unless you get more political courage, unless you get the Merkels and Hollandes of the world, and the Renzis of the world, to fight back, the default political position, in my view, is the continued erosion of the legitimacy of the EU in the eyes of EU electorates. Yes, restoring the health of the economy will work, will help, but it's not enough.

MR. MENON: So Andy, I'm sorry to keep picking on you, but I kind of buy the argument, that before the Euro crisis, the things that the EU did, weren't things that really bothered everyone that much, and so you could muddle along with that highly imperfect Parliament to sort of legitimize decisions taken at the European level. But now you've had the Eurozone crisis. Now you've got decisions at the European level, that affect the very heart of democracy issues -- the fiscal policy, taxation, are being dealt with at the European level. Do you think we might need to move to some new way of legitimizing those decisions, or can we just keep saying, well, you've got national elections, if you need them.

MR. MORAVCSIK: You need a way of legitimating them because it is true, that for the first time, there is an issue at the European level; namely, macro-economic policy, that voters care enough about, so it has a significant effect on elections. Then the question is, whether some elections in Europe, at the national level, or at the European level, can have an impact on that policy. The answer to that question is yes. The domestic elections can have an impact on that policy. And the odd thing in Europe, is that despite the fact that policy is not working well, and despite the fact, that you would think that some people in some countries would want to reform it, you don't have a Democratic majority, even in the countries that are most effective. You can understand why the German electorate doesn't want to change the status quo, because the policy suits them pretty well. But it's harder to understand why on that, you don't have a majority in Spain, or a majority in Italy, or a majority in Greece, to change the status quo. But that is the fact, right? And if you want to change the status quo, particularly in that policy area, that is the way you're going to have to change it. If for no other reason, than monetary policy is in all advanced democracies, not a policy customarily handled by the Parliament. It's handled by an independent central bank, working in conjunction with

other political bodies. So you can't just turn it over to the European Parliament, and say, make monetary policy --

MR. MENON: It's fiscal policy.

MR. MORAVCSIK: That's not the way it works.

MR. MENON: Fiscal policy.

MR. MORAVCSIK: Well, then you would have a revolution in Europe, if you tried to turn fiscal policy over to the European Parliament. I mean, if you tried to say that 10 or 20 or 30 percent of European budgetary policy went through the European Parliament, you can easily have a situation that is Democratic, but it creates so much conflict that a policy can't survive. We've learned that in the United States, and I don't think Europe wants to repeat that experience.

MR. MENON: Julie.

MS. SMITH: To come back to Andy's point about grand strategy, you're right, we have to be clear-eyed about our ability to predict crises, and there's always an element of strategic surprise. I think Secretary Gates said, the only thing the intelligence community has succeeded in doing is consistently failing to predict what the next big event would be coming down the pipe. So, let's not assume that by sketching out some master, grand strategy, we could have either foreseen what happened in Ukraine, or anywhere else for that matter. But I think, to Wolfgang's point, the process of going through the drafting of a national security strategy or a European security strategy, or a whitepaper coming out of Berlin, I think is useful, particularly in this climate that we find ourselves, where so much is coming at us. It's useful to set priorities, to think about how we manage risk, to how we deal with strategic attention in the era of Twitter. How do you remain focused? Having been in the White House and seen how you can go six hours in the situation room, from Yemen to Iraq to Egypt -- one crisis after the next, how difficult it

is to have some sort of at least overarching general frame. It's not a perfect process, but I think there is utility in putting yourself through this. Now, all that said, with Ukraine, no perfect national security strategy or any process, would have perhaps predicted or helped us cope with what came at us. But, my point on that was, that the Transatlantic partners had really checked out in many ways, and weren't having the kinds of dialogue and exchange that they needed to, to at least cope with potential scenarios. And I think what I see happening right now, is a repeat of that. I think we were so focused on the May 25th election, as partners, Europe, the Ukrainians, and the United States, let's get through that election. Let's ensure that it takes place, that it's free and fair to the degree that we can claim it to be. And then, from there, figure out what comes next. We're now past the election, and I think we're having a hard time figuring out, and having a broader strategic dialogue about -- well, what is the long-term game plan with the Russians? Where would we be willing to engage him?

I mean, we're seeing that play out at the G-7, as you both noted. Now we have these bilateral meetings surfacing. We're not exactly sure why and what messaging is going on. To me, it shows that we've kind of lost our way, again, in terms of charting a common purpose and course vis-à-vis, Russia. And we've been focused very much on the minutia. But maybe -- Tony's going to be here shortly, so hopefully Tony Blinken will be able to sketch out for us, exactly what the strategy is, moving forward.

MR. MENON: Do you want to comment on these?

SPEAKER: Two quick points -- first on, you know, what should be or what could be lessons learned from this EU election process, with these right-wing parties coming up here and there?

MR. ISCHINGER: Well, I have one simple prescription to offer. We

need better leadership in EU. Take these two candidates who are currently battling for the next phase of running the EU commission. Neither one of them, I'm sorry to say, meets the criteria of being a new Jacques De Lau. Somebody that will actually be listened to by the entire EU electorate. So, I think the trick would be to find somebody who could really be not a nationalist leader like Vladimir Putin for his right-wing people, but an EU leader, who symbolizes the fundamental values of the European Union, and who can speak with authority. I think that's what we need, in order to hopefully get rid of this development.

Second point on Russia and Putin -- I agree that this is not only about Crimea, as bad as it is. This is a challenge to the international order, certainly to the European order as created by the Helsinki Final Act, et cetera, et cetera. President Putin has turned out to be unpredictable. That's bad in international relations. If you are dealing with somebody, where you actually have a very hard time figuring out what he might do next.

So, what should be our strategy? I think, in retrospect, I don't claim that I knew that on May 1st or May 2nd, when Chancellor Merkel met in the White House with President Obama, and they came out and said, we shall measure President Putin's behavior, in terms of how he deals with the elections in Ukraine. I think in retrospect, I would say we let Putin get off the hook a bit easily. Because he didn't have a very hard time behaving in a way that now, more or less forces us to say, okay. He actually shook hands with Poroshenko a few hours ago in France. I think what now should happen, and that's based in my own experience in Ukraine over the last several weeks -- what now should happen, is that we should tell Mr. Putin, we will measure your behavior, by your ability and your willingness to make sure that not a single truck with armed men and ammunition, et cetera, et cetera, will come across the Russian border. The Russians

say, we can't possibly control this border. It's a long border, and in the Soviet Union, there were no fences between the constituent's part of the Soviet Union. Therefore, don't ask of us, things that we can't do. Well, I believe a country, like the Russian Federation, if they want to do it, I think they can make at least some controls and arrest some of these truck drivers, and arrest some of these separatists. If they are not paid by the Kremlin, they ought to be arrested, and that would probably limit the flow of supplies, et cetera, across the border. I think that's what he now needs to do, in order to show good will. I think we need a double strategy. We need to upgrade the sanctions, if necessary. But at the same time, as always in international diplomacy, we need to at least have some door somewhere, through which he could walk. And that would be the re-entry ticket into not necessarily the G-8 tomorrow morning, but some kind of an ongoing dialogue, which is why I have been among those who have thought that maybe creating some kind of an international contact group on Ukraine with the United States, Russia, the EU, possibly Poland as a particularly interesting partner, might be one way of getting diplomacy kick started again on Ukraine. I'll stop here.

MR. MENON: Shall we take some more questions, or -- all right, I'm afraid lunch is now ready. Well, not afraid at all, actually, but it does mean that we're not going to take any more questions. So, thank you very, very much indeed to our panel. (Applause).

SPEAKER: There's a buffet lunch for you here, just to the left. So, you can go and get some food and bring it back here if you want. We'll be starting up very sharply at 12:30, with Tony Blinken, so please be back by then. Thank you.

(Recess)

MS. HILL: Ladies and gentlemen, I hope you've had a chance to enjoy some lunch. It is of course a Brookings' sandwich lunch so, you know, there are limits, I

guess, to the vast enjoyment, but nonetheless we hope you've had a good lunch. And we are extremely pleased to have Tony Blinken here, to finish off and wrap up for us today. Annual Conference

Tony, unfortunately, doesn't have an immense amount of time with us; he has to leave on the dot of 1:15, so I want to get us underway as quickly as possible. And we are extremely privileged to have him here given all the things that are obviously happening on the agenda, and obviously while the President and everyone is traveling in Europe he probably has a few things to do manning the office, and holding down the fort, as everybody likes to say.

But we really are delighted, and in particular that it's Tony who has agreed to give our keynote, because he has been a long participant in and supporter of many Brookings activities. He is a Fellow Think-Tanker, from CSIS back in the day, and he was also, along with Phil Gordon and Jim Steinberg, in some sense, present at the creation of this Center 10 years ago.

In fact, Phil Gordon, our Former Director, has now gone off to work for Tony. I think it was a -- you know, direct correlation there, clearly, you know, kind of having worked together on European front; that's been very good preparation for working on other issues. Phil Gordon went off to be Assistant Secretary of Europe, and then to work at the NSC as a Senior Director for the Middle East, so Tony is probably keeping him pretty busy.

Tony, as many of you know, came to Washington at the beginning of the Clinton Administration. He worked in the State Department on the National Security Council Staff; he has been a Chief Foreign Policy Speechwriter for President Clinton. And then he worked for Senator Biden directly at the Senate Foreign Relations Committee. He became the Deputy Assistant National Security Advisor to Vice President

Biden when he moved to the White House, and now he has moved to basically be the Principal Deputy National Security Advisor for President Obama.

So Tony has a very long record of advising people, so I think we should all pay particular attention to some things that he has to say today. And now we are asking Tony to go back to his deep transatlantic root and tell us about the effect the Ukraine crisis on transatlantic relations and, obviously, there's no one better placed to do so. So, Tony, thank you so much. Thank you. (Applause)

MS. HILL: Thank you all, very much. And Fiona, thank you so much. It's always great to be at Brookings; so many good friends and colleagues here. So many people we have stolen from here, including Phil and others. And also, an institution, and individuals, the administration and previous administrations and future administrations, rely on, on an almost daily basis, for ideas, for intellectual capital, which we don't have apparently a monopoly on.

So, it's always wonderful to be here. It's particularly good to be involved with the Center on the United States and Europe, and with King's College. And I appreciate you all hosting me very, very much.

I thought I'd try and trace where we are with Ukraine, by going back and sort of tracing how we got to where we are, and then offer some thoughts on the way forward. And of course this is a very active issue, and in fact as we gather here today, there is much going on in Europe, with the President, with his European counterparts, with President-elect Poroshenko, with President Putin, and this will be very much, as always, in the headlines.

But I want to start by going back, and if we go back to the Maidan, and to the protest that began at the end of last year, it's fair to say that while the catalyst for the protest, and the catalyst for change where President Yanukovich, basically reversing

himself on the Association Agreement with the European Union. Something that Europe expected, the United States expected, the United States expected, Russia expected, but more importantly the Ukrainian people expected.

Well, that was the catalyst. I think what we saw on the Maidan was rooted in something even deeper, and that was a profound dissatisfaction and a sense of disenfranchisement, among so many Ukrainians from all walks of life; with corruption, with kleptocrats who were stealing the country's resources, with the economic stagnation, with a lack of opportunity. And these all came together, and then we had this catalyst of the 180 on the Association Agreement, and then a vicious, vicious crackdown that followed.

And then we had Russia, and the actions that it took, and they were almost, I think, it can be said from another era. Russia used its greater size and its wealth to try to bully and intimidate a smaller neighbor. To use its influence through force, and we all know the series of events that took place; the incursion, the occupation, the annexation of Crimea, the buildup of Russian Forces along the border, the covert, and then not so covert support to armed separatists seizing building; the support for illegal referenda, the free flow of militants and material across the border, the tripling of the price of gas to Ukraine.

All of this fueled, by an almost Orwellian propaganda machine, and based on two very profound ironies. First, the ethnic Russians that President Putin claimed to be defending enjoy far greater freedoms in the Ukraine, and most of the post-Soviet space than do Russia's own citizens under President Putin.

And second, the extreme form of federalism that Russia seeks to impose on Ukraine is exactly the opposite of the increasingly centralized control that President Putin exerts in Russia. The stakes for the United States, and for the international

community at large, I think, were threefold. If you go back to the first major Foreign Policy Speech with the Obama Administration, which was actually delivered by Vice President Biden at the Munich Security Conference in February 2009, that's the speech that laid out in some detail the idea of the reset.

But the Vice President at the time also said, there are going to be clear differences between the United States and Russia going forward, and clear red lines. And maybe the most important is our profound rejection of the validity of notion of spheres of influence, that we believe profoundly, that countries and people have the right to decide their own future and with whom to associate. That principle was challenged by Russia's actions in the Ukraine.

So was the principle that, in the 21st Century, redrawing borders by force, undermining the sovereignty and territorial integrity of a democracy was unacceptable, and the precedent that that would set, not just in Europe, but beyond, was also something that needed a swift and stern reaction.

And then finally, there was something particular about the situation in Ukraine that was critically important, and that goes back to the infamous 1994 Budapest Agreement. As I think most of you in this room know very well, when the Soviet Union fell apart it left many successor states with many nuclear weapons. And Ukraine, Belarus and Kazakhstan all agreed to give up their nuclear weapons, one of the great achievements of the Clinton Administration. But in the case of Ukraine, it wasn't prepared to do that until it had a firm commitment by Russia, by the United States, by the United Kingdom, that its sovereignty and territorial integrity would be guaranteed.

And so the four countries signed the Budapest Agreement that purported to guarantee just that. The idea that this piece of paper could be, in effect, torn up by this move, by Russia into Ukraine, profoundly called into question what message this would

send to other countries around the world who might be considering giving up nuclear weapons, forswearing nuclear weapons; a terrible message to send, a terrible precedent to set.

The United States response, I think, can be looked at in two points of time. First, before Russia went into Crimea that is from the moment the Maidan protests were met with a violent reaction we worked very hard to try to deescalate the crisis, to bring the parties together. The Vice President was constantly on the phone with then President Yanukovich. The President was deeply engaged with his European partners, as well as with President Putin, and the objective was to see if we could forge a diplomatic agreement for a way forward that resolved the crisis peacefully.

But once the Russians went into Crimea, our policy shifted, and the President set three very clear directions that we followed to this day. First, we would isolate Russia for the actions it was taking in Ukraine. Second, we would support Ukraine, and build support for Ukraine in the international community, and third we would reassure our allies and partners; and let me spend a few minutes on each of those.

First, with regard to Russia; the goals were simple and straightforward. We needed to impose cost for the actions that Russia had taken. We sought to deter -- deter, excuse me, Russia from taking further irresponsible actions, and we hope to shape the decision space that President Putin and the Russian Government would operate in going forward. This involved, in the first instance, political isolation, and so you all know litany of things that happened in the immediate weeks following the incursion into Crimea; the de facto, and then the de jure suspension from the G8.

The efforts in the United Nations to isolate Russia politically, and we saw that with that with a very significant vote at the Security Council, with China, even, abstaining, and not siding with Russia. And then an incredibly lopsided vote, the U.N.

General Assembly, where Russia found itself with about another 10 countries none of whom, I think, would be partners of first choice for most people in this room.

We rejected the referenda that took place in Crimea and then in the East. We downgraded our bilateral relations, as did Europe. And even with something like the St. Petersburg Economic Conference, which has been a showcase for Russia and its economy, we persuaded many of our senior CEOs not to go.

Now, this didn't just happen, it took incredibly hard, sustained, focused work, starting with the President, to move all of our partners in the same direction. And I know are people are tempted to say, oh, so they didn't get to go to a G8 meeting, or the G7 issued a tough statement. Or there was a vote the U.N. General Assembly, it doesn't mean anything. It does. It's significant. It matters because one way that President Putin and Russia define power is by the geopolitical standing and influence that Russia is able to obtain, and undermining Russia politically in the international community, isolating it politically, diminishes that power.

But then, even more significant, were the measures we took to isolate Russia economically. We started and the President was determined to adhere to a basic principle, that we should do it with our partners, with Europe, and with other key countries, for two reasons. First, the practical impact of being able to impose sanctions with others is much greater. But second, the political impact is reinforced, and it reinforces the sense of isolation when it's not just the United States doing it.

So, I think as you all know, we engaged in the process that resulted in visa bans, asset freezes, restrictions on doing business with key figures in Russia and in Ukraine. We imposed targeted sanctions on 28 Russian officials, six members of President Putin's inner circle outside of government; 11 Ukrainian separatists, and expropriated Crimean gas companies; we did not export licenses for military technology.

And the European Union, Canada, Australia, Japan, Liechtenstein imposed similar if not identical measures. Just as significant, we developed more severe measures targeted, but at the same time potentially very effective in the financial, energy and arm sectors. The very knowledge that these measures were out there has, we believe, a deterrent effect, and indeed the fact that countries are agreed to move forward, if necessary, on them, not only deters, but it creates a climate of uncertainty that actually imposes cost without having to pull the trigger.

So, there's been discussion about the impact or lack of impact of these sanctions, and these economic measures. To me, the case is not even close, it's very, very clear. First we've heard in public, from Russia's Finance Minister, its Deputy Prime Minister in charge of the economy, even President Putin himself acknowledging the impact of sanctions.

Very recently Sberbank, which is the largest bank in Russia, and in effect a proxy for the larger economy, announced a steep decline in its first-quarter profits. And in doing so it said, in particular, recent events in Ukraine significantly impacted the dynamics of the Russian economy. Now, across a whole host of measures, we can see the dramatic impact that the economic isolation has already had on Russia. We saw it initially in the financial markets which are incredibly sensitive to isolation and to the pressure that that was exerted, and we saw them at various points in the crisis, as we exerted pressure, go to extraordinary lows.

They would bounce back if something that was perceived to be positive, or relaxation occurred. And of course, in the short term, because markets are volatile they may not be the best measure, but we could clearly see the sensitivity of the markets.

Second, we saw the ruble, which also was heading, at various points during this crisis to an all-time low. It, too, at various points has bounced back, sensitive

to events. But what's very significant, is that during this period the Central Bank of Russia had to spend \$37 billion, 8 percent of its foreign exchange reserves to defend the ruble, and the result in any event were higher borrowing costs and a decrease in the value of savings of Russians.

Maybe more significant, and even more compelling, capital flight; \$51 billion in the first quarter of the year alone which was more than all of 2013, and going forward the IMF, The World Bank, private experts now estimate that for 2014, capital flight from Russia is expected to be between 100 and \$200 billion. Foreign investors have been pulling back or staying on the fence. They look for stability, they look for countries to keep their commitments, they look for a country that's connected internationally, and in all of those areas, Russians actions had sent a message to investors that that's not the kind of environment they want to be investing in.

Russia's credit rating was cut to just above junk level, financing deals were frozen, Russian companies were not issuing bonds to raise capital. Economic contraction is already clear, we've seen it in the first quarter and through 2014, most of the experts are predicting something close to zero growth. This week alone, Lloyd's of London withdrew a multi-million -- billion-dollar trade finance deal with Rosneft, a large oil company, whose CEO, Igor Sechin, is of course sanctioned.

Now, some of this was happening before the crisis, and before the sanctions as a result of the downturn in the Russian economy, but virtually every expert, and every analyst that we have makes it very clear that everything we did, in response to what Russia did in Ukraine, accelerated and deepened this process.

So, those were the measures of what we had done to carry out the edict to isolate Russia for its action in Ukraine. But, I think what's even more important than that, when you think forward, is I am absolutely convinced that Russia's actions in

Ukraine are a strategic loser for Russia going into the future.

First, yes, you can say that Russia, "won Crimea," but in so doing it is losing and has probably lost Ukraine. Ukraine is more united in its Western orientation than it's ever been, and its sense of national identity is deeper than it's ever been.

Then there is Crimea itself. It's true that in the short term, the actions that Russia took in Crimea produced a political bounce for President Putin, but I think that's going to change in a significant way. Russia is spending about \$7 billion this just in the direct cost, budgetary and pension support for Crimea. Over the next several years, most of the experts estimate it will have to spend between 50 and \$60 billion for critical infrastructure, rail and vehicle bridges, electricity and water connections to make up from what Crimea has lost as a result of Russia's actions with Ukraine.

This puts an incredible downward pressure on defense and discretionary spending to improve the lives of the Russian people to modernize the economy. In short, the bloom will come off of the Crimean rose, as people begin to understand that this was not for free, there are real costs involved.

Second, strategically, what President Putin has done in Ukraine, more than anything else, has reenergized NATO to a point that I think we haven't seen in years. There's a renewed focus on NATO's Article 5 commitment. Ironically, the very thing that Putin has sought to prevent, which is NATO moving closer, in effect, to Russia, is exactly what is likely to happen as the allied military presence in the Eastern part of NATO territory is likely -- indeed, has already grown. And to the extent we were successful in reversing the decline in defense spending among NATO countries, this is probably going to prove to be the single-most significant catalyst.

Third, Russia, actions in Ukraine have done more than anything else could possibly have done to create the potential for real energy reform in Europe. It's the

biggest single jolt to Europeans to take real steps to decrease their dependence on Russia, than anything one could imagine. To diversify supply, to upgrade infrastructure, to develop new sources; this has the potential, ironically, to kill the goose that lays Russia's one golden for egg.

And then fourth, there are the unintended consequences, what message -- do Russia's actions in Ukraine, in the alleged defense of ethnic rights, send to non-ethnic Russians in Chechnya, in Dagestan, in Ingushetia? This could open a can of worms that will be profoundly against the interest of Moscow.

And then finally, and may be most interestingly, I mentioned a moment ago that when you think about how to define power, or how President Putin sees power, it's probably a combination of two things, Russia's geopolitical influence, and its economic strength. And indeed there was a recent survey taken in Russia where the Russian people were asked what would be their two top priorities. And it was very interesting, the results, evenly-split, international influence and create conditions for individual prosperity.

By Russia's actions in the Ukraine, both of those priorities are in profound jeopardy and indeed, so was President Putin's compact with his people to deliver that influence, to deliver that prosperity. There is a way out, integrate Russia's economy with the world, diversify it away from fossil fuels, play by the rules. And that way out remains on offer, but ultimately it's up to President Putin whether he wants to pursue it.

I have to tell you that my concern is that left with a few choices in terms of sustaining its power, there will be a strong incentive on President Putin to continue to play the nationalism card, and that means to continue to take the kinds of actions that we've seen, in order to produce a jolt of short-term support that then evaporates as

people understand the cost, which requires another jolt. That's the danger. My hope and certainly the hope of the entire administration, is that it's not the course that Russia chooses, and I'll come back to that briefly at the end.

The second big line of effort that we pursued over these months in support for Ukraine; and there was an equal effort that was put into building that international support led by the President in a very systemic way. It began with economic support. We produced a package with our European partners, and with the IMF and others, of \$27 billion over two years; tied to reform very critically, including cutting energy subsidies, improving macroeconomic management, boosting competitiveness, strengthening the banking sector, tackling corruption, increasing energy efficiency and security.

This was anchored by a \$17 billion IMF Agreement which was achieved in record time. And then there another \$4 billion from the G7 countries, from the World Bank, a \$1 billion U.S. loan guarantee to cushion the impact of reforms on low-income families. Separate and apart from that, we've been pursuing a program of transition assistance to Ukraine; U.S. technical support for economic and political reform, capacity-building in Government ministries, anti-corruption programming, et cetera.

Then most recently we've seen, of course, election support; from the United States, from Europe, of course from the OSE and others. And it's worth commenting that this election was a remarkable achievement, considering the duress under which it was conducted. I was the most free and fair election in Ukraine's history as an independent country. We would often marvel at the irony of some people complaining in Lugansk or Donetsk and in Moscow, about being disenfranchised because they were the very people creating the disenfranchisement.

Most folks in this room are probably too young to remember this, but

there was a wonderful movie when I was growing called *Blazing Saddles*, by Mel Brooks, and there is a great scene in that movie where the Sheriff, played by Cleavon Little, is surrounded in a house by the bad guys. And he comes out of the house holding himself hostage and saying, better let me go, otherwise I'll shoot myself.

That was exactly what the -- those complaining about disenfranchisement were doing. And then it's interesting to note that Russia has complained about the alleged fascists who dominate Ukraine. Well, if you look at the election results, the two far-right parties, Svoboda and the Pravy Sektor, each got less than 2 percent, so much for domination by the far right.

Besides the economic assistance, besides the assistance for elections, we've also pursued security sector assistance. \$23 million over the past three months in non-lethal assistance to help the Ukrainian security forces deal with their immediate needs, to sustain themselves in the field, to defend themselves against the armed separatists and to better monitor the border, and provided meals ready to eat, people laughed about that. Well you can laugh but then you can look at the photographs of deployed Ukrainian forces eating those meals ready-to-eat, and they could not have been sustained in the field without them.

The medical kits, body armor, helmets, night-vision goggles, communications equipment, vehicles, explosive, ordinance, disposal robots; those were all short-term measures to address what was most immediately needed in this crisis. But now with a new government, and in cooperation with Europe, we plan to engage on comprehensive security sector reform. Now, some would have us sell -- or provide Ukraine with all sorts of sophisticated weapon system starting yesterday. That's exactly the wrong thing to do. It is vitally important that we begin by assessing the shortcomings of the security sector, understand the necessary reforms, establish actual needs,

establish priorities.

Until Ukraine begins to address, with our help, with Europe's help, systemic shortcomings, insufficient resources, mismanagement, institutional incapacities, and gross corruption, assistance will not be effective. But there's a real opportunity for the new government that is determined to remedy the shortcomings of the past, and we are determined to seize it with them.

Finally, reassuring our allies and our partners; the President was determined hearing from many of our allies and partners, and listening to the deep concern that they had, faced with Russia's actions in the Ukraine, to take immediate steps to reassure them. To bolster the Article 5 commitment that lies at the heart of NATO. And what he set out to do, and what we have done is to produce a virtually continuous air, land and sea presence to the Eastern reaches of NATO.

In the immediate, we sent 12 additional F16s to Poland for training missions; 6 additional F15s to the Baltic air policing mission. We rotated ships into the Black Sea, the USS Truxtun, the Donald Cook, the Taylor, and most recently the Vella Gulf. And we deployed four company-sized paratrooper divisions to Poland and the Baltic Countries for training and exercises.

This week, as many of you have probably heard the President announced a new commitment, to reassurance and to European security with a \$1 billion fund; a fund that will allow us to preposition equipment in Europe, to expand exercises in training, to increase the number of U.S. personnel, continuously rotating through Central and Eastern Europe, and to increase assistance to Ukraine, Moldova and Georgia.

It's obviously vital that the U.S. not be engaged in this enterprise alone, and we've taken many of these steps in order to encourage our NATO partners to do the same, to take part in the continuous deployments and rotations, and we expect, over the

coming months, that we'll be able to say that all 28 members of NATO participated.

Then by the NATO Summit in September we expect to see steps to reverse the decline in defense spending that unfortunately has characterized the alliance in recent year; ironically all of this, again, catalyzed by Russia's actions.

So, where do we go from here? First, it's very important that we get a grip on and resolve the situation in Eastern Ukraine. What we've seen in recent weeks are two things. There has been, on the surface at least, a Russian de-escalation, pulling back its troops from the border, rationing down the rhetoric, making even some positive statements about the Ukrainian election.

I believe these steps were designed principally to try to take some pressure off of Russia, and possibly divide Europe from the United States, or Europeans from each other, to create some confusion. Because unfortunately this change in tactics I don't think it can yet be said, indicates a change of heart. Russia still seeks to intimidate the Ukraine and to giving Russia undue influence by sowing chaos in the East, through covert financial and logistical support to separatist fighters, and overt support that we saw recently for the illegal referendum, through increasing flows of militants and weapons across the border.

And this is, maybe, the most striking development in recent weeks, I think you've all seen it; the numerous videos and media reports of armed militants admitting that they came from Russia, including many Chechens, multiple attempts every day by convoys of vehicles to cross the border with armed men and weapons.

Recently there was the incident at the Donetsk airport, where separatists sought to take over the airport, the Ukrainian military responded, and in that battle some 30 fighters were killed, and they were Russian, with Russian passports. The separatists, unfortunately, have become increasingly violent, increasingly heavily armed and actively

targeting and killing Ukrainian security forces.

So, you can't have it both ways. You can't on the one hand purport to take steps to deescalate the crisis, but at the same time, under the surface, actually take steps to accelerate it. So, it's vitally important that we continue to keep the pressure on Russia -- excuse me -- to change course, and that's exactly what happened this week in Europe at the G7, and in the President's meetings with European counterparts.

At the G7, President Obama secured commitments from our partners to continue coordinated actions to raise the cost of Russia's unacceptable interference in Ukraine, and most importantly, to affirm their readiness, to intensify targeted sanctions, and to implement significant additional measures to impose further cost on Russia if it proves necessary.

We've also been making clear, what it is Russia needs to do and what it must stop doing in order to meaningfully deescalate the crisis and provide an opportunity to move forward diplomatically. It has to recognize the results of the election, and engage directly with the government of Ukraine.

It needs to completely withdraw its military forces from the border area, stop the flow of militants and weapons across the border, exercise influence among armed separatists to put down their arms, leave the buildings, renounce violence, resolve their differences peacefully; and of course, in terms of what I can't do, no military invasion, no bogus peacekeeping or humanitarian interventions.

Now, if Russia takes these steps it's equally important that the Ukraine respond in an appropriate manner. The President Elect Poroshenko has a plan for what he calls peace, unity and reform. It includes things like pursuing the national dialogue, a ceasefire, decentralization, amnesty for those who put down their weapons, and drawing separatists into the political process. Ukraine should pursue those steps.

It should avoid having to pursue martial law, disproportionate use of force, or full-scale counterterrorism operations, again, if Russia takes the important steps that I outlined, to meaningfully deescalate.

Ukraine is to continue to pursue political and economic reforms, especially anti-corruption because, again, let's not forget what we started with, what's really at the root of so much of the turmoil in Ukraine, is this profound sense of disenfranchisement from the country that's fueled, in large part, by the gross corruption that we've seen over the past decades. And of course, it needs to implement the IMF Reform Program that is so critical to its near-term success.

Let me conclude just with a couple of words about relations with Russia, and then we can throw it open for questions or comments. Throughout this crisis diplomatic relations with Russia have not ceased. We've remained in contact, the President has spoken to President Putin a number of times, and indeed they spoke today in Normandy. We have tried to make clear repeatedly that our objective is not to weaken Russia, it's not to contain Russia, it's to deny Russia's relationship with Ukraine.

Rather, it's to uphold a very basic principle; Ukraine's future must be decided by the people of Ukraine. Not by Russia, not by the United States, not by Europe, not by anyone other than the Ukrainians themselves.

As Fiona knows better than anyone, and can attest better than anyone, President Putin tends to see the relationship with us and with the West on the basis of two decades of pent-up grievances. Alleged broken promises regarding NATO enlargement, the ABM Treaty, missile defense, the use of force in Kosovo and Libya, he seems to believe that we want to keep Russia weak and divided. That NATO was aimed at Russia.

From our perspective none of these things, of course, are true, and none

our objectives, and ironically, the very things that President Putin claims to fear, are likely to be precipitated by the actions that Russia has taken. They risk becoming Putin-fulfilling prophecies.

The President was very clear in Brussels in March. As he put it, and I quote, "Since the end of the Cold War, successive administrations have worked with Russia to build ties of culture and commerce and an international community, not as a favor to Russia, but because it was in our national interest." And we continue to believe that it's in the world's interest, to Russia, the United States and all of Europe to work constructively together. It's hard to imagine most of the major 21st Century challenges being effectively addressed absent that kind of cooperation.

And already, we've clearly demonstrated the possibilities of cooperation through New START, through WTO accession by Russia. Through Iran sanctions and the nuclear negotiations in which Russia has been a productive participant. Through the effort to remove chemical weapons from Syria, the transit of our troops and material to and from Afghanistan; on counterterrorism cooperation after the Boston Marathon bombings, and in advance of the Sochi Olympics.

So going forward there is a way to get back to a more productive path. If Russia will deescalate tensions over Ukraine by the steps that I discussed previously, if they work to find a diplomatic way forward that respects and restores Ukraine sovereignty and territorial integrity, and resets the relationship between Russia and Ukraine, there is a basis for moving forward.

We can continue cooperation where it's in our mutual self-interest. On counterterrorism, on nuclear security, on Iran, on chemical weapons, in space, and we can work together to try to overcome old, outdated suspicions and rebuild trust. That is certainly the path that the United States would prefer to take, the question is, is that the

path that President Putin wants to take? And in the coming weeks and months, we'll find the answer. Thank you very much. (Applause)

MS. HILL: As Tony is getting mic'd up, I'd like to start with some of the questions from the floor as we have a little time. Ambassador Ischinger had raised his hand first. And then the gentleman over here, and then I'll get over to here as well.

Do you mind taking just a few questions and then I'll let you respond?

MR. BLINKEN: No. That's okay.

MS. HILL: Or comment as well, because --

MR. BLINKEN: Mm-hmm.

MR. ISCHINGER: Thank you, Tony. I feel very comfortable with what you sketched out in terms of policy approach. I have one question on how we should deal with Russia. When I was in Ukraine, as you know, for the last several weeks, I heard Ukrainian leaders say to me repeatedly, that Ukraine should not be left alone in facing Russia. That they felt too weak to handle future negotiations with Russia alone.

Obviously, the question that came up all the time, what about Geneva II? What about the repetition of this international effort? And should that happen, and if so, do you think it could turned into a process to accompany Ukraine on the way forward?

MS. HILL: Thank you. The gentleman here, yeah? And identify yourself, sir.

MR. LIEBEDEV: Yeah. My name is Ivan Liebedev, I'm with Russian Youth Agency Task. And my question is, President Obama traveled to Europe on Tuesday, and since then he took part in a number of very important events there, just to mention a few. The meeting with East European countries, the meeting with President-elect Poroshenko, and the G7 Summit in Brussels, and the bilateral meetings that took place today in particular, in Normandy. So, the question is, do you see any changes in

the overall situation around Ukraine in dealing with Russia, taking into account all these events? Or are we on the same spot as a week ago? Thank you.

MS. HILL: Thanks. Great question. I'm going to take as many questions as I can.

MR. BLINKEN: Sure.

MS. HILL: And then give you the time. Here, please, it's the Former Georgian Ambassador.

MR. KUTELIA: Batu Kutelia, McCain Institute. I have a one-billion-dollar question.

MS. HILL: Mm-hmm.

MR. KUTELIA: When the Senator Biden and yourself, and there was the 1 billion assist -- initiative, the \$1 billion assistance to Georgia it was very clear, and it was crucial for Georgia to remove the consequences of the war with Russia.

MR. BLINKEN: Mm-hmm.

MR. KUTELIA: And just recently also, President Obama announced the 1 billion Security Fund for the Europe. So, could you give us a little bit more specifics what this fund will be dedicated to? Thank you.

MS. HILL: Thank you. And Jeff Goldstein, and then we'll come down here. Thanks.

MR. GOLDSTEIN: Thank you. Jeff Goldstein, from the Open Society Foundations; I'm actually following up on the Ambassador's question. I understand that the Administration will request \$1 billion in extra appropriations from Congress for this initiative. Will the Administration also request a new appropriation for non-security assistance to Ukraine as was done for Georgia after the war with Russia?

MS. HILL: Thanks. Could you pass the microphone to the lady in front

of you? Yes, thank you.

MS. POND: Elizabeth Pond. I'm an American Correspondent in Berlin, and Author. I would like to ask you just to say a few words about how you assess cooperation in responding to Putin's actions with the Europeans in general, and with Germany in particular.

MS. HILL: Somebody else had their hand up a little earlier. Oh, yes, here. So, thank you. And then we'll come back to Tony.

MR. NAGADECH: Thank you. Alwin Nagadech from George Washington. It kind of follows up on the last question, in terms of cooperation with the Europeans; how concerned are you that you have five months until the weather gets cold, and you might see -- because you talked about a jolt but, you know, arguably we could have, you know, the crisis in early 2006 and early 2009 could have -- should have been jolted as well. So what -- are you concerned that you are seeing the Europeans (inaudible) in five months' time, and what can you do in five months? Thanks.

MS. HILL: That's great. Well, I think you've got plenty of questions to respond there in five minutes or less.

MR. BLINKEN: I'll probably do a rapid fire.

MS. HILL: Yeah. Thank you.

MR. BLINKEN: Wolfgang, first of all, it's always great to see you, and I really want to thank you for the remarkable service you performed in recent weeks, which made a big difference. And with regard to pursuing the Geneva Track, we are certainly open to that. We've heard the same thing from the Ukrainians, a desire to have as they engage with Russia, the support of the United States of the key European countries, and the European Union, and they'll certainly have that. But we have to decide and define what the best mechanism or process might be, but we are fully prepared to continue to

engage in that process, if that's the best way forward.

To the gentleman from Task, with regards to the meetings in Europe and whether there is any change in the situation. My answer is, I hope yes, but we had to judge this, not on words but on actions. And so I think there have been some positive statements that have been made, I think there was a statement that came out of Moscow today from the Government that referred to President-Elect Poroshenko, which would seem to be some sign of recognizing the President Elect as the President-to-be of Ukraine.

But the bottom line is, this depends on the actions that are taken, not the words that are spoken. So we'll test this in the weeks ahead and, again, our strongest desire and strongest interest is to, meaningfully, deescalate and to find a diplomatic resolution that we believe, profoundly, not only can sustain the interests of Ukraine, Europe and the United States, but also Russia. That's what we would to achieve.

Ambassador, with regard to the fund for European Security, there are a number of things that we would aim to support through this fund, and they are critical; the repositioning of equipment and material in Europe, support for more exercises and training missions in Europe including in Central and Eastern Europe, and then direct support to Georgia to Moldova and to Ukraine, among other things.

We also hope that this can be a catalyst again for other countries within NATO, doing more themselves as we head into the NATO Summit. And it's not that we expect everyone, miraculously, to get to 2 percent of GDP on defense spending by September, but if we can start to reverse the negative trend, that will be very, very meaningful. So hopefully this fund will help catalyze that as well.

And the with regard, Jeff, to a question of the appropriation for non-security systems, we are looking very carefully at what the needs are, what the means

that we have at our disposal are, and whether we need further assistance. I think it's significant that as a result of the leadership that we have exerted, together with our European partners, the amount of money that's being made available to the Ukraine over the next two years is very, very significant, \$27 billion in commitments from the international community, starting with the IMF.

But we'll be prepared to look at whether there are gaps that we need to fill on specific types of assistance going forward. I should emphasize though that this assistance is not going to work if it is not met by a clear dedication to reform on the part of the Ukrainian Government. We've been down this path before with previous Ukrainian governments where the international community proved itself quite generous, but the assistance did not produce lasting, meaningful results because the reform that was required was lacking.

We have a strong feeling that this is an exceptionally critical moment, but also a moment of real opportunity. Because of everything that's happened, because of the commitments that have been made, and indeed we see on the Midon, and the force that that represents a profound desire for change that is putting pressure on the entire political (inaudible) in Ukraine to deliver, but we'll see if that happens.

Elizabeth it's great to see you here today. With regard to cooperation with Europe, in general, and Germany in particular; I have to say, from our vantage point it has been exceptional. One of the things that people don't see on a day-to-day basis, because it happens behind the scenes, is the coordination, communication, cooperation between President Obama and his European counterparts.

Throughout this crisis he has been on the phone for hours on end particularly with Chancellor Merkel, with President Hollande, with Prime Minister Cameron, with Prime Minister Renzi, with the EU Leadership, with many others. And that

process of constant communication starting with the President, but then throughout the administration, throughout the departments and agencies, I think has produced exemplary cooperation.

Now, none of this is easy, there are competing interests among European countries, and within European countries. There is obviously the desire for a positive relationship with Russia, there are profound economic interests that are at stake, but at least from my vantage point, despite all of that, we've managed to remain remarkably united. And that's given even greater power to what we've been able to do.

Chancellor Merkel has been an extraordinary leader in this effort, and the -- her voice in everything that she has done with Russia, with her European colleagues and with us, I think, in this situation has been exemplary, and I also think it's fair to say that we would not be in a position -- the positive position we are in absent her leadership, along with that of other colleagues in Europe.

And the question is, can this be sustained? The good question about going in the winter, different pressures being exerted, and that's a great question, and I can't -- and right now my belief is that the answer is yes, but it also requires countries to take significant steps in the coming months to put themselves in a position to sustain and to also be able to resist competing pressures and influences.

You are exactly right, we've had energy jolts before, and the jury is out on whether this one will be different. My sense is it will. We had a very, very significant ministerial among the energy ministers in the G7 countries a few weeks ago, in which they agreed to a series of steps that I actually think can advance the ball including, significantly, basic stress tests in all of our economies to gage the extent of our energy security efficiency and independence. And the results of those tests, hopefully, will be translated into concrete action to meaningfully diversity sources of energy, supply routes,

connections within Europe, connections from the United States to Europe and elsewhere.

But I would acknowledge the jury is out on that, so maybe when we get together at the next Annual Conference I'll be able to answer the question.

MS. HILL: Well, I'll take that, Tony, as a commitment, that you will be back for the next Annual Conference, and I have lots of witnesses including CSPAN.

MR. BLINKEN: Good. Happy to do --

MS. HILL: So, anyway, we are very pleased that you could -- joined us today. We know you've got a very busy agenda, and you are going to have to dash out, and I hope the construction all the way down, back to the old Executive Office doesn't hold you up.

MR. BLINKEN: Thanks.

MS. HILL: Thank you so much for joining us.

MR. BLINKEN: Great to be with you. Thank you.

MS. HILL: I would like to thank all of our --

MR. BLINKEN: Thank you very much. (Applause)

MS. HILL: (Inaudible) our colleagues here who joined us for the event; to King's College for helping us put this on, and Anand Menon, and Jeremy Shapiro from Brookings who did all the hard work. And I'd also like to thank Clara O'Donnell, and Peter, for joining us today for what we all know, what is a very bitter, sweet moment, but we are really very pleased to see you here. And we also look forward to seeing everybody else here at other events, and hopefully to welcome whether it's the Clara Marina O'Donnell Fellow, when they come to Brookings from the Centre for European Reform.

So thank you, to everyone. And let's hope that indeed, as the question asks, there's a way forward, and some interesting and positive changes in all of the

crises of the moment. Thank you very much, everyone. Thank you. (Applause)

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