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Executive Summary

Introduction

This report was drawn up under a contract with DGXIII of the Commission of the European Communities for research into the 'Social and Public Service Implications of stimulating Applications of IT&T in Rural Areas'. It has been carried out in parallel with the ORA exercise of DGXIII during the period March to September.

0. Main Conclusions

Central to the report is a conviction that the **priority is the opportunity for rural areas that are offered by Information and Communications Technologies rather than the opportunities for ICT that are offered of rural areas.**

The report concludes that the social and public service aspects of Information and Communication Technologies in Rural Areas are as much concerned with the **social design of the technology itself** as with any perceived effects of that technology; ie, social and public service criteria have to be built into the design of the technology. This implies defining a political environment specifically aimed at inducing rurally favoured telecommunications facilities; this means looking at the interaction of the Community, national and regional dimensions.

1. Existing Experience of Rural Areas with IT&T

The report reviews existing experience of rural areas with IT&T and highlights the need of many rural areas for telecommunications infrastructure, not necessarily the latest high-technology but simply a good automatic telephone system. This is seen as the pre-condition for any further advances in IT&T.

2. Public Service Aspects of IT&T Applications in Rural Areas

The process of institutional change in the telecommunications environment may have the effect of increasing the disadvantages already experienced by rural areas due to a loss of political control over telecommunications services, the prohibition of cross subsidy; the definition of universal service, and, in some countries, the reduction of regional intervention in telecommunication services. Any actions designed to improve the access of rural areas to IT&T must therefore take into account these effects.

3. Social Aspects of Information and Communications Technologies

The design of IT&T applications is not simply a technical question but is also a question of social design, involving the interlocking technical, economic, regulatory and social options available for the development of a vital social resource. For this to be achieved, however, criteria are needed to guide the political decision makers and others involved; two criteria suggested in the report are **the role of the users** and the **role of 'universal service'**.

4. Structures to allow participation in IT&T Development

One of the most important tasks in considering the social and public service aspects of IT&T applications in the development of policy mechanisms and an institutional design to identify the needs of (the different groups in) the rural areas to activate a process of appropriate technological innovation. This involves at least four aspects: identification of relevant social actors, the information necessary for discussing options and needs, participatory mechanisms for articulating local needs, and a link between local actors and those responsible for developing and implementing facilities.

5. The Regional Dimension

In developing these policy mechanisms, a central role can be played by regional and municipal authorities: this needs to be linked to a regional policy for the development of local economic strategies and to decisions about the appropriate mix of resources allocated at regional, national and Community levels. There are a number of regional categories with specific needs, that could be taken into account when planning appropriate actions. This section concludes by looking at possible roles for IT&T applications in which regional authorities could play a key role.

6. Examples of IT&T Applications and Rural Areas

The report concludes by examining four applications of Information and Communication Technologies orientated towards social and public service criteria: Community Tele-Service Centres; User Orientated Regional Based R&D; Regional Decentralisation; Increasing the Power of Regional Actors.

Preface

This report was drawn up under a contract with DGXIII of the Commission of the European Communities for research into the 'Social and Public Service Implications of stimulating Applications of IT&T in Rural Areas.' It has been carried out in parallel with the ORA (Opportunities for Applications of IT&T in Rural Areas) Planning Exercise of DGXIII during the period March to September 1989.

The research also forms part of a wider project sponsored by the agenor Research Unit Asbl assessing the potential of the regional/municipal dimension for ensuring the autonomy of democratically chosen policies in relation to the interests and pressures of economic forces or of technological developments. The working hypothesis for the research is that regional measures, backed by supportive national/EC parameters, and using a combination of local resources and advanced technologies, may stimulate regional-based job-creating activities, related to local needs. This can contribute both to the autonomy of regional authorities and to that of the broader economic unit.

The Commission's concern for the potential of advanced information and telecommunications technologies in rural areas has its origins in part in a new recognition - on the part of all the Community institutions - of the implications of the decline in rural areas. This led the Commission to produce a Communication to the Council in 1987 on 'The Future of Rural Society'. This recognition includes a new awareness of the need to preserve and improve the level of economic activity.

The trend whereby increased productivity in farming is reducing the level of the rural population and eroding the basis of the rural economy preceded the existence of the Community and its Common Agricultural Policy, which merely exacerbated it. The fact that this awareness of a major social problem is belated, however, does not detract from its significance. Nor does the fact that it was accelerated, not caused, by the EC.

It was a natural reaction in these circumstances that those responsible for the promotion of new information and communications technologies as a growth sector in the economy, and as an area of competition with other major trading units, should wish to explore the potential of rural units as a market for those technologies.

A note of caution is needed however. As Quortrup notes: 'An enhanced telecommunication system may, other things being equal, provide external interests with easier access to the peripheral regions and a competitive advantage over local interests'¹, ie, local firms, services, local cultures. Though the warning has been heeded in part in the ORA planning exercise² it is one that needs underlining.

It is not impossible that the promotion of such technologies in a rural context might aggravate existing trends towards centralisation.³ It is therefore a sound approach that policy recommendations should result from a synthesis of concern for the level of activity and the quality of life in rural areas on the one hand and the search for new markets on the other.

Out of the synthesis may come new developments which may be of value to less developed areas, both inside the Community and in the context of the third world.

In the wider project on Autonomy, to which the present report will be a contribution, particular attention will be given to the social and public service potential of IT&T in the regional dimension, within which the inter-action of urban and rural areas has to be situated.

0. Main Conclusions

- * Central to the report is a conviction⁴ that **the priority is the opportunities for rural areas that are offered by ICT rather than the opportunities for ICT that are offered by rural areas.** There is a pragmatic justification for this. As the Draft Workplan stresses 'applications must satisfy real (users') needs' and 'understanding these needs is fundamental to understanding the opportunities for application of ICT in rural areas.'
- * Current developments seem to be guided in the first place by the interests of internationally orientated companies and oriented exclusively on urban areas.
- * There is a need for criteria for public sector support for development (infrastructure, hardware, software, training) of IT&T in rural areas deriving from a social and public service approach⁵:
- * It might be possible to activate the process of technological innovation in telecommunications by defining a political environment specifically aimed at inducing rurally favoured telecommunications facilities. In defining such a political environment, it is necessary to look at the interaction of the Community, national and regional dimensions.
- * The way technological innovations are imbedded in society depends not only on their technical characteristics but also on the degree to which they are accommodated to social innovations. Technical innovation means both technical and social transformation.
- * The 'user' should be given a broad definition, not simply as a commercial user of telecommunications or of consumers as clients of commercial services, but the 'user' as non-commercial services, private persons and local societies or associations.
- * The design of IT&T applications is not simply a technical question but is primarily a question of social design, involving the interlocking technical, economic, regulatory and social options available for the development of a vital social resource.
- * If this approach is correct then one of the most important things is to develop structures in which the needs of different groups in the rural areas can

be identified. This could then activate a process of appropriate technological innovation. The identification of IT&T needs should not be left to official bodies as though a group of civil servants could do the job without consultation with other groups.

* Instead an institutional setting has to be defined to combine a process of consciousness raising, improvement of knowledge in this area and the ability to define their own needs.

* Different institutional actors will have to be identified by the relevant agencies, at a regional, national and Community level, according to the role they could play in the process of defining local needs but also according to whether they form barriers to developing relevant policies for social/public dimensions of IT&T.

* In developing an appropriate institutional structure, there is the growing awareness of the potential of the regional dimension, reflected in the concern of the ORA research with rural areas. For the Community this is a development that is not occurring without difficulties. The nation states are jealous of their relationship with regions, and Community institutions have tended to avoid direct involvement with regions.

1. Existing Experience of Rural Areas with IT&T

Existing experience of rural areas with telecommunications facilities is largely one of 'marginalisation', in terms of infrastructure, of services and of tariffs.

Many rural, non-urban areas do not have access to subscriber trunk dialling, let alone the provision of digital exchanges. A not-insignificant number of rural communities, particularly in Southern Europe, are not even connected to the public telephone system.

Even when communities are connected to the telephone network, there are often few individual households that have a private telephone, which entails considerable costs in terms of travel and waiting to use the public facilities that are available, often only at Post Offices.

The cost of available telecommunications to individual rural users is usually greater than for subscribers in urban areas both because of higher installation costs and because a far higher proportion of calls or usage is likely to involve long-distance trunk connections than in large urban areas.⁶

According to the 'Exploratory Study on the Opportunities for the Applications of IT&T in Rural Areas,' commissioned by DGXIII the *'costs of supply and effective use will inherently be much higher than for concentrated urban conurbations. Within the next ten years these changes will be acting to reinforce many of the already substantial cumulative advantages of the urban areas.'*⁷

A further factor that needs to be considered is that in many rural areas, again especially in Southern Europe, the levels of illiteracy mean that there is only limited value in anything other than voice transmission, for users who cannot read or write. In this situation access to oral communication by telephone is the vital qualitative breakthrough.

In view of the poorly developed telephone infrastructure, and the benefits of telephones, both in terms of user friendliness, and ease of access, a priority for actions designed to reduce inequalities between urban and rural areas is (STD) access to the public telephone network.

Many reports and studies have identified the most serious gap in rural areas in relation to IT&T as the lack of infrastructure, not even the latest high-tech but simply a good automatic telephone system.

There have been repeated warnings that the application of a commercial approach alone for telecommunications will increase the disparities between urban and rural areas and will be socially divisive. According to KMG Informatics, small and medium sized enterprises will suffer most: large companies could install private networks.⁸ The effects for non-commercial users would be even more marked.

This pessimistic view of the effects of technological advance is reflected in a concern for development in the Third World - but it may also be justified in relation to rural areas in the Community:

*'Le simple telephone est un objet de luxe reservee aux citoyens les plus nantis. Les tendances actuelles d'evolution de la reglementation, le developpment des nouveaux services 'a valeur ajoutee' ainsi que l'evolution des technologies (fibre optique par exemple) ne sont pas de nature a reduire cet ecart. A l'inverse, on peut craindre un renforcement des disparites et une 'marginalisation' encore plus marquee du tiers-monde'*⁹

Urban areas benefitted from network extension strategies even when there was a strong influence of political actors (national governments, parliaments etc.) ensured a unified technical network with equally accessible mass services, because of the condition that expenditures had to be matched by revenue.¹⁰

The deregulation of telecommunications, freeing TAs from extra-organizational influences and unleashing market forces is likely to exacerbate the situation. According to the 'synthesis report' of the ORA Exploratory Study:

- the costs of supply and effective use will inherently be much higher than for concentrated urban conurbations. Within the next ten years these changes will be acting to reinforce many of the already substantial cumulative advantages of the urban areas.¹¹
- the absence of an adequate telecommunications infrastructure is a major constraint on the kinds of IT&T services which can be used in rural areas but administrative centralisation means that the revenue base for public sector investment within the rural areas is low
- To invest in infrastructure ahead of demand in rural areas is a difficult argument to sustain and entails support from funding agencies other than the telecommunications carrier.

According to Keeble the need is for low cost trunk routes, and more advanced and efficient telecommunications systems. For rural subscribers this is unlikely to be feasible without deliberate public subsidy, via national Government or European Community funding, to offset the higher costs and lower usage characteristics of rural networks. It needs to be determined whether such deliberate public subsidy for regional policy, at least at a national level, would be possible under the rules governing post-1992 European Competition.

2. Public Service Aspects of IT&T Applications in Rural Areas

There is a process of rapid change in the political, economic and regulatory environment for telecommunications in the European Community based on the need for Europe to compete successfully in the world market.

The ORA Exploratory Studies situate the applications of IT&T in Rural Areas within the *'introduction of the Single Market (which) provides an immense opportunity for realising the benefits of this otherwise fragmented market ... the creation of such an environment would set the basis for European industry to provide rural IT&T systems and applications throughout the rest of the world.'*¹²

Indeed, it might be said that it is the international markets that are the real goal of the ORA programme - the provision of services to rural areas within the Community being both a spin-off and a testing bed.

A central element of this process of change is the restructuring of Telecommunications Administrations. This has involved freeing TAs from their links with postal services as part of public utility GPOs or PTTs, something explicitly recommended in the studies for the 'Costs of Non-Europe' report.¹³

In some cases, Britain being the prime example, they have been sold into the private sector. In other case, ownership remains vested in the public sector, but the resulting corporation has been 'restructured' to compete in the market, with decisions being taken on a profit-and-loss basis rather than for politically determined public criteria. According to the research for the 'Costs of Non-Europe':

*'Such transformations tend to reduce Government constraints on procurement and tariff policy as the interest of private shareholders must now be considered.'*¹⁴

According to one study

*'The liberalisation and privatization of British Telecom has put business needs ... above those of consumers and [in London] threatens many of the 10,693 telephone kiosks and up to 18,000 jobs.'*¹⁵

The question of ownership, in itself, however, is not the determining factor - operation in the market place according to explicit market criteria is. As Murray remarks: *'The shift of ownership from public to private hands has attracted most attention. But it is the policies of sector liberalisation - the enforcing of market criteria - which have had the most far-reaching effects. Liberalisation has been the substance, privatization the form.'*¹⁶

These developments raise obvious questions about the role of political decision making over and public service criteria in the provision of information and telecommunication technology facilities and have a number of implications that can be clearly identified:

(i) There is a **loss of political control** over telecommunications services. This is not simply because of the 'marketisation' - if not privatization - of TAs. It is also because of the conditions entailed in the proposed regulation machinery, whereby more and more decisions will be deferred to international technical fora. Important decisions concerning tariff principles, the definition of reserved services and the definitions of network/customer interfaces seem to left to these fora. The instruments for adequate information to elected bodies, still less political debate and decision making at the international level, even in the Community.

Politicians at the EC level can be faced with *faits accomplis*, with no room for choice left. The technical lead the ISDN has taken in the past might be reinforced at the cost of national, and even European, policy making.¹⁷ The pressure to accept norms and conditions without debate could be even stronger in the case of European countries outside the Community but needing, economically, to be integrated as closely as possible to the Single Market.

Exploiting the margins of autonomy, that remain, however, implies investigating under what conditions different technological choices could be made, as a function of democratically-determined policy options.

(ii) The telecommunications reforms at both national and European level are moving in the direction of **prohibiting 'cross-subsidisation'**, whereby a high-revenue providing activity helps to subsidise other activities, which though perhaps socially desirable, do not in themselves generate profit. It should be noted however that studies in the United States, in connection with the de-regulation and liberalisation of the US telephone service, suggest that revenues collected from services including long-distance and telecommunications network based services provide a contribution to common costs, not a subsidy¹⁸

(iii) The **concept of 'universal service'** for telecommunications is defined in a narrowly restrictive way, being limited to speech telephony and telex. Apart from these two services, telecommunications should, according to the Commission, be opened to competition; the corollary is that services, which are not defined as universal, should be supplied according to market criteria. The whole thrust of the 'communication revolution', however, is that the whole

range of information and communication technology opens up new possibility for basic services.

The German Chamber for Trade and Industry (DIHT) has been quite explicit about its belief that the German Bundespost has been unnecessarily restricted by the political constraint that it has to make its services universally available geographically and to subscribers and at unitary tariffs.¹⁹

The result, of course, might be that new service providers, outside the traditional TAs, will offer services to the profitable telecoms sectors, though not to the geographically isolated areas without business potential (see section 3).

(iv) In some countries, the restructuring means a reduction for regional political intervention in helping to define needs and strategies for the provision of telecommunication services. Until now in the Federal Republic of Germany the inclusion of Laender governments in the decision-making structure of the Bundespost (as in all statutory regimes of German PTTs since 1918) meant that the influence of advocates of demand-orientated networks extension policies was countered by actors advocating an infrastructure approach²⁰

In the Netherlands, until the restructuring of the PTT, the regional boards of the Dutch PTT were composed of representatives of professional and private user organisations and of local and provincial government. Their influence was very limited, so a stronger but national policy board of representatives has been established. However, there is a vacuum at the local/regional level, which makes it more difficult to define and implement special telecommunications needs for particular areas.

(v) Finally, the result of these reforms is to create de-facto market orientated monopoly suppliers of basic telecoms services. In the UK, an attempt has been made to mitigate this by granting a license to Mercury Communications to provide services in competition with British Telecom; in other European countries, however, telephone subscribers will be confronted with an institution whose basic rationale is the creation of profit, over which political control has been reduced and to which there are no alternative suppliers.

3. Social Aspects of Information and Communication Technologies

The prevailing impression amongst lay people is that there is only one path of technological development, and that what counts is to advance along it ahead of one's competitors.

The concentration and internationalization of industrial decision-making and the universalisation of the media tend to result in certain technologies dominating. There is thus a sort of 'technological race' not unlike the arms race, particularly in the way it makes it hard to free resources for other fields than those which happen to form the object of competition at the time.

The pace of such technological developments often leads to an assumption of 'technological determinism', in which technological possibilities themselves define political, economic and regulatory parameters.

There is growing concern that society through political institutions should regulate the use of new technologies. However, even this approach sees technology as an exogenous, independent variable. Although the social dimension is taken into account it is seen as a secondary dimension.

What is needed is an interactive process: technology is not an independent variable to which society has to adapt but is a dependent variable which can make a contribution to resolving social problems. The use of technology has to be seen as a social process which has to take shape socially and politically.²¹

The approach is linked to the idea of 'constructive technology assessment', pioneered by the Netherlands Organisation for Technology Assessment, and defined as:

*The entirety of activities and the methods used therein for the earliest possible study of the various aspects and consequences of a technical or scientific development for (different groups of) the population, preferably in their mutual connection, for the sake of finding the suitable role in society for the technology or scientific discipline concerned.*²²

In other words,

*'the way technological innovations are imbedded in society depends not only on their technical characteristics but also on the degree to which they are accommodated to social innovations. Technical innovation means (both) technical and social transformation.'*²³

This shift of attention is necessary because the neglect of the social aspects will affect the cost benefit calculation and in the end will have negative economic effects.

This approach to the social aspects of technology affects the definition of advanced IT&T applications. This can have either a narrow or a broad definition.²⁴ Conceived of in the narrow sense, 'advanced IT&T applications' is the development of a number of specific technical applications for information and telecommunications technologies and the concrete economic, regulatory and industrial policies that this formulation and introduction entails.

Conceived of in a broader sense, however, the design of IT&T applications is not (simply) a technical question but is also a question of social design, involving the interlocking technical, economic, regulatory and social options available for the development of a vital social resource.

For this to be achieved, however, criteria are needed to guide the political decision makers and others involved; in this report we suggest two criteria that should be employed: the definition of the users and the definition of universal service.

a. The role of the users

In its report to the Second Chamber of the Dutch Parliament on 'The Social Aspects of Telecommunications', the Netherlands Organisation for Technology Assessment (NOTA) notes that the development of telecommunications which for a long time has been governed by the technology involved needs to become more and more orientated towards users.²⁵

In this context, the 'user' needs to have a broad definition. It is not simply a question of commercial users of telecommunications or of consumers as clients of commercial services, but the 'user' as non-commercial services, private persons and local societies or associations.

We do not want (neither do we offer) one definition of users' needs. The corporate users are organised, however, and have a quasi-monopoly in the definition of existing needs. This is not a comprehensive definition of the actual and potential needs

Different institutional actors will have to be identified by the relevant agencies, at a regional, national and Community level, according to the role they could play in the process of defining local needs but also according to whether they form barriers to developing relevant policies for social/public dimensions of IT&T.

There may be a general design of technology which may be good for different groups of users, but there may also be different technologies. There may be differences between local, regional and national needs or corporate v individual

may be a more relevant difference than between regional and non-regional contacts.

But corporate needs appear to overlap very much with the urban setting (apart from the corporations which have strong interests in distribution in rural areas - eg, fertiliser distribution.) Individual needs in urban centres probably can be satisfied with the infrastructure offered and installed to meet corporate needs. But the individual needs in rural areas are not catered for.

Neither is it a question simply of designing user applications. A central role needs to be given to user based innovation. According to NOTA there is still too little use made of the users specifications in the development process. A necessity is participation and innovation by users in research and development.²⁶ For this to happen successfully, however, appropriate structures need to be developed in which this process of innovation and development.

b. The role of 'universal service'

The concept of **universal service** plays a key role in the institutional framework governing the supply of telecommunications. Universal service obligations need to be established by law at the EC Level. The present rate of technological developments of new ICT networks, infrastructure and services raise the question as to whether the existing definition of 'basic services' (at present: voice telephony and telex) for which there must be a universal service is adequate. Fax already seems to be taking the place of telex.

There are a number of ways of ensuring that the right of access is guaranteed (no discrimination by provider as between potential users; regulation of pricing; possibility of public sector subsidy in case of special needs, eg, isolated, handicapped, aged..)

It is not only a question of the right of access, however, but also of the conditions for **supply** of public telecommunications facilities (infrastructure, peripheral equipment and services) should be established. This means that all (local/regional and national/international) providers of services can use the public infrastructure and restricted services in equal terms. Monopolies by a few national or multi-national service providers should be prevented²⁷.

It has already been noted that a major, if not the major, need in many rural areas is the provision of a connexion to what has been described in one study as the POTS²⁸ network, preferably using modern, direct-dialling digital exchanges.

Given such connections a variety of applications become possible. Indeed, there may be advantages, from the point of view of assuring and promoting universal service in rural areas in concentrating on the telephone network for applications and facilities:

The only feasible option for assuring rapid diffusion of new IT&T applications is

*that they are based either on the existing, universally laid out telephone system or on wire-independent Personal Computer (PC) applications. Any other option will of course be technically more impressive but it will lack the necessary speed of diffusion as most of them depend on PTT operating agencies.*²⁹

If this is the case, then it raises questions about ORA's emphasis that 'both users and service providers would base most of their applications on services made available by ISDN and IBC'.³⁰ It may well be that the ORA programme faces a choice between 'rapid diffusion' and 'impressive technology'.

And given the relative 'isolation' of some rural areas the key applications based on personal computers are preferable to applications based either on existing or future telecoms networks, what is sometimes known in the United States as a 'sneaker network' because data are exchanged by disk and thus physically transported between computers.

The introduction of advanced ISDN/IBC services raise further questions about consumer choice and preference. If ISDN can provide normal telephone services of higher quality as well as new services, for the same tariffs or cheaper, there will be many new options. On the other hand, if the cost of the advanced services forces up the cost of the standard service, users may well end up paying more for services of doubtful benefit.

In this case the option may be to offer ISDN services only (thereby reducing consumer choice) or to allow the free play of market forces and risk a take up of ISDN that is insufficient both in terms of network expansion and in terms of revenue generated. On the other hand, the introduction of ISDN could be the basis for a radical re-structuring of tariffs, as the main determinant of cost is the quantity of information transmitted rather than the distance over which it is transmitted. The introduction of tariffs based on costs independent of distance could play a major role in increasing the possibility of access to telecommunication networks from rural areas.

4. Structures to allow participation in IT&T Development

One of the most important tasks in considering the social and public service aspects of IT&T applications is the development of policy mechanisms and an institutional design to identify the needs of (different groups in) the rural areas to activate a process of appropriate technological innovation. The identification of IT&T needs should not be left to official bodies as though a group of civil servants could do the job without consultation with other groups.

Only if a framework of political choice is provided, through adequate institutions and public debate, can a positive contribution of Information and Communication Technologies to meeting public service and social criteria be envisaged.

The process of articulating local needs involves at least four aspects:

- a identification of 'relevant' social actors
- b information required for discussing options and needs
- c participatory mechanisms for articulating local needs (that are not necessarily uniform)
- d the link between local actors and those responsible for developing/implementing facilities (local government/suppliers)

Identification of relevant local actors

It is necessary to distinguish between formal structures on the one hand and the whole tissue of organisations at other levels, such as young farmers, women farmers, churches, parties, small business associations, etc. Existing traditions in formulating regional strategies should be looked at for guidance as to the chances for a regional approach.

The idea of a **social map of actors** that play or could play a role in defining needs for local IT&T facilities. In defining the social actors involved, there is a need to look not just at immediate users/providers but also wider groups trade unions, environmental organisations, and emancipatory groups.

Actors differ, however, not only in their respective interests, but often also in their perceptions of the problem and the context from which their needs arise

In this sense one should look not just at the social map but also the cultural map of actors - the way their cultural background and context affects their need for information and communication.

Different cultures of communication in different countries/regions should be taken into account in the elaboration of regional strategies.³¹

Information required for evaluating options and needs; participatory mechanisms for articulating local needs

Although the developments in the near future will affect the working and living conditions of millions of people, they are not asked about their own wishes and needs. Even for citizens who are interested, it is claimed, it is extremely difficult to obtain information that goes beyond the promotional literature offered by telecommunications providers. One scenario to involve people in debating these issues is that of the 'Buergerdialog'³²

The provision of the information and experience necessary to evaluate options and needs is closely linked to the existence of participatory mechanisms for articulating local needs.

The debate should be structured in terms of needs, whether they are conscious or not. Nobody can define needs in place of those affected - it cannot be defined by Government, industry or academics - instead an institutional setting has to be defined to combine a process of consciousness raising, improvement of knowledge in this area and the ability to define their own needs.

The role of User Groups

A key role for public service in the introduction of new IT&T services is that of empowering the users. One means of doing this is through support and funding for active user groups. There has been a growing recognition that stronger user groups are important as a means of upgrading industries, stimulating innovation and representing social needs which are not reflected in the market. Already in a variety of fields, strong user groups have pressed for new systems of delivery, diversity, quality and cross subsidy to benefit disadvantaged groups and localities. Local and regional authorities have helped to fund these groups and to work with them on particular issues.

Within rural areas there are likely to be different kinds of potential users of IT&T facilities. To achieve an optimal use it may be necessary to take specific account of the needs of groups who are in a minority position within the formal democratic decision making machinery. This is a challenge to established mechanisms for articulating local needs.

The role of regional structures

One idea may be for rural regional structures to be set up, similar to that of the Amsterdam Council on Information Technology which brings together civil servants, academics and interest groups in a board giving advice on further telecommunications needs and structures. But such structures need to emerge in an existing political and cultural framework, not to be called into being a consultation alibi from above (at the state/EC level).

The link between local actors and those developing and implementing facilities

It is also important to examine whether social and political structures enable potential users to define their needs. For example, a large banking corporation has the economic strength to define what it needs in terms of hardware and software and then to give a contract to appropriate firms to design this as a one-off. A rural peasant association, on the other hand, has neither the economic or political weight to do this, having to 'make do' with off-the-shelf hardware/software although it might not be entirely appropriate to identified needs. From the demand side, this could mean a slow take-up rate.

It is here that there could be a key role for the public sector. With the exception of applications for multinational firms, the vast majority of larger systems are commissioned by state institutions. Given this, the local economy could use its powers of public procurement as a tool of software (and hardware) development. The authors of the London Industrial Strategy suggested that this role could be used

*'to develop the specifications for 'bespoke' and semi-customized 'human centred' software directed towards particular generic applications e.g. for voluntary groups, management information services for cooperatives, workstation systems for professional staff.'*³³

The GLC proposed a review of the specific needs of local authorities and public services in general to *'identify existing, planned or possible systems which improve the service available to the user while at the same time improving the conditions of work and participation of the workforce in the provision of that service.'*³⁴

5. The Regional Dimension

a. The role of regions and regional administrations

An important starting point for an orientation towards local needs is that 'rural areas' should not be seen in isolation but in their concrete interaction with specific urban centres within and outside politically defined regions.

Regions are more than simply economic, cultural or geographic areas: they are also political units, and this opens up the possibility of a more active role for regional and municipal authorities in the development of local economic strategies:

*'With an interventionist approach to production, local authorities have an important place in national strategy ... They are in a position to support changes in the domestic economy and to support their own public economies. They can extend the influence of their public economies, through municipalisation and the use of purchasing power and pension funds, and intervene in the private economy through direct investment. Furthermore, if strategies and institutions are to be built from below then local councils form one of the principal building blocks.'*³⁵

There is, however, an ambivalence in the Community approach to regions. On the one hand, a dialogue with the regions is proposed, but on the other, at the operative level, there is often little attempt to involve the politically defined regions into their operations. National governments, for their part, may obstruct direct contacts/negotiations between the Commission and individual regions.

One of the key issues will be the **mix** of resources between public and private sectors in the development of rural areas. This will be influenced in part by the policies of regional authorities (in so far as they have resources at their disposal) but to a far greater extent by decisions taken centrally (nationally or EC level) about norms. In addition the way the available resources are shared will form the object of arbitration between regions -at the national or Community level. **How** the resources are used is a question for regional authorities and will form the object of negotiations about the mix at the local level - which will of course vary, potentially, from case to case, and technique to technique, according to economic viability, but also as a reflection of local power relations and political majorities.

b. Regional Policy 'from below'

Latnaik distinguishes between 'regional policy from above' and 'regional policy from below': regional policy from above refers to the regional policy of the 1960s and 1970s which was aimed at the development of the administrative efficiency of the administration (eg, through local government reform) and making the infrastructure more effective, through increasing transport links and the industrial development of peripheral and rural regions.

Regional policy from below refers to a regional policy in which there are regional means of influencing the way in which new technology is developed and applied, the stimulation of innovation within communities, the adaptation of new technology to local needs, links to research institutions to encourage the development of locally-relevant research.

This means building on the strengths of regions. Von Gleich et al (1988) point out that in considering the possible role of technology it is easy to define regions as 'backward' or in need of 'modernisation'.

One problem with the characterisation of rural areas, however, is the assumption of technological (and social) backwardness. Successful use of technology will depend on building on the strengths of rural areas.

High technology appears to need the stimulation of the world market and a comprehensive modernisation of the industrial society. From this approach to technology policy, regions are seen only as disadvantaged, backward or containing declining industry, as far as modernisation is concerned.³⁶

It is clear that this is a danger inherent within the ORA programme, which described rural areas as 'associated with changes in agriculture, poor infrastructure for business activities and inefficient public services.'

An alternative starting point, however, is not to begin with particular technologies but from the needs that they are supposed to meet.³⁷

In their own empirical study on a particular region in Nordrhein-Westfalen, von Gleich et al (1988) stress that:

*'wir bemuehen uns, nicht nur ihre Schwaechen bei der Diffusion von Hochtechnologien oder im Hinblick auf eine kommende Dienstleistungs- und Informationsgesellschaft zu sehen ... (und) ... die vom Aussterben bedroehnte Landwirtschaft ... Wir haben auch die Staerken dieser Region gesucht, die Ausgangspunkt fuer eine staerke eigenstaendige Entwicklung sine koennte ... Herrschende Vorstellungen von Strukturwandel, vom unaufhaltsamen Niedergang der Landwirtschaft (sind) viel zu pauschal.'*³⁸

In the case of applying IT&T to rural areas such an approach implies:

- specifying the images of different economic activities in different rural areas. This would in turn define the needs of specific information and (tele)communications devices (eg, agriculture, retail, transport, small manufacturing, soft energy, public service)
- outlining different economic models/background scenarios of future developments to relate to the information needs to these scenarios (but then on a small scale corresponding to a defined area - province).
- specifying non-agricultural activities in the economic base of a region. These should not be seen as necessarily separate from remaining agricultural production, however, and in fact are not normally independent from each other.

c. Regional categories with specific needs

It should prove possible to identify categories of regions where there are specific needs to be met by IT&T in a service context, for example:

a. geographically isolated regions, in particular island areas;

b. regions with specific educational needs (eg, minority languages; sparse population and long home-to-school distances);

c. regions with a large need to exchange information between rural areas with similar characteristics and problems (eg, market-gardening, factories)

d. frontier regions where the language barrier and divergent administrative and bureaucratic practices imposed by central national administrations, makes communication across the border difficult; this is particularly important in view of 1992.

d. Possible Roles for IT&T Applications

Some practical examples of IT&T application, where there is an identifiable need, but where a public sector input will be indispensable owing to the lack of an adequate basis for a viable private sector operation, are listed below. In these cases, the local/regional authorities will have a role to play in relation to priorities and to the mix between private and public sector financing and control:

-Role of Agriculture: The need here is for information (eg, price trends; market gardening may need telecoms for information on policies, weather etc.) Farmers and other agricultural workers might also benefit from environment monitoring facilities;

-The support of monitoring facilities to follow specific environmental develop-

ments, eg, the degree of pollution or regeneration in specific fields, such as water quality.

-Data banks and telecommunications facilities for local chambers of commerce or other public bodies in order to provide an information base for the expansion of existing firms, the establishment of new activities or develop access to new, more distant markets.

-The provision of educational programmes through modern IT&T to support the promotion of new forms of ownership, such as co-operatives.

-Facilities for local development banks as part of a process of popular planning at a local and regional level.

-The role of local (town/region) smart cards keeping processing activities in the regions concerned.

-Regional alternatives offered by public or semi-public bodies in the field of IT&T to enable competition with the specific advantages of MNCs (eg, access to data banks on new techniques; access to optimal financing, knowledge of potential markets etc.)

-Links with 'superior authorities' to enable tasks to be transferred to local authorities.

-Lateral links with other regions in particular adjacent regions in other member states, enabling 'complementary' economic, political and social strategies to be developed. hitherto (pre-1992) ruled out by technical, linguistic, administrative or other barriers. The relevance of this to preserving regions against the potentially negative impact of the Single Market³⁹ does not need to be spelled out.

-Additional information technology to enable local authorities to take on property, planning and infrastructure responsibilities currently taken care of central (provincial authorities).

-The local collection of information on the labour market to help unemployed persons become better informed about local opportunities (and opportunities in neighbouring regions).

-The use of information devices to help to use, and service pension funds and purchasing by local authorities to enhance local economic activities.

-Economic Activity: Telecoms may be of real use and importance to the small(er) firms who provide the matrix of services (installation, maintenance of technologies of all kinds) needed to maintain the minimum economic viability of rural areas (eg, installation and maintenance skills relating to small-scale use of bio-mass, wind energy, solar technology etc). Is there adequate demand or are subsidies needed?

6. Examples of IT&T Applications: Social and Public Service Aspects

In this section we consider three specific proposals for linking social and public service criteria to the development of IT&T Applications that may have a specific relevance for rural areas.

a. Community Tele-Service Centres

One proposal for promoting a social and community based use of ICT has been the idea of Community Teleservice Centres (CTSC) which have been particularly developed in Scandinavia.⁴⁰ CTSCs aim to provide village communities with access to data processing and telecommunications services, and to computer-assisted services. The idea is that instead of linking individual households to the network, IT facilities are concentrated within a teleservice centre containing telecommunications, electronic data processing and, sometimes, video equipment at the disposal of the entire community.

The basic philosophy of CTSCs can thus be seen as orientated towards promoting collective use of telecommunications, rather than the increased individualisation of society which can be seen in some ICT proposals, such as distance and home-based working.

The choice between a computerisation at the level of the home (home-working) and a computerisation at institutional level is a significant choice for the development of the information society. But there is little prospect of it being a political choice. The issue is more likely to be decided by the relationship between the amount of resources going into, respectively, the institutional centres, and the individual market.

A computerisation at the level of the household is linked to distance working at home, home-banking, home-shopping, computer supported education, electronic Post, newspapers or payments and increased choice of media in the home. A Computerisation at the level of institutional is more compatible with existing institutions in society such as the Post, Bank, School, Meeting places, library or Newspaper.⁴¹ Such a strategic choice is likely to affect the future networks that develop in society. Are we likely to see a new social and economic hierarchy: those able to afford the individualized version, and **alongside**, those who are only able, or only need, to use the public service?

The important element of CTSCs is this social orientation, rather than the

particular technologies upon which they are based. CTSCs could be based equally well on existing telecommunications services, given the availability of these services in the local community concerned. They need not wait for the implementation of ISDN/IBC services.

CSTCs can also help local small producers in participating in the new economy of 'flexible specialisation': in Jutland, a programme of ECU 4/5m, is helping small enterprises, employing between 5 - 10 workers, few of which in themselves have access to foreign language skills, to compete on the world market, eg through information services about products and markets.

A crucial factor in the success of the CTSCs is public sector involvement. Originally it was thought that given public sector support in the CSTCs, once up and running they could be 'privatised' as a local business. According to those involved in Scandinavian CSTCs, however, this was a mistake, and continued public sector support, involvement and participation is essential if CSTCs are to fulfill their original social aims.

A further element for the involvement of local political structures in the introduction of CSTCs - and other collective telecommunications facilities - is the 'catalyst' function of CSTCs. As far as political structures are concerned, one idea behind CSTCs, is that 'using telecommunications, you can access distant institutions, and by combining the services of these institutions at the CSTCs you can offer a new institutional framework.

CSTCs, if they are successful, will inevitably create a new social network in the community concerned, and one which might appear as a threat to existing social and political networks - from the local mayor to the head of library services.

There are societies where a single such centre is not conceivable: competing politico-social institutions, aware of the potential influence and attraction of such a centre, would provide a centre of their own (eg, in some countries two or more political parties, or church and secular versions, or even two church versions). Such a plurality might be a positive outcome from the point of view of the users, but would depend for its success on a solid publicly provided infrastructure.

There is a parallel here with the structure adopted by the French Teletel videotex: while the infrastructure is provided publicly the regulations, kiosk billing system, etc, enables a plurality of 'Information Providers' to coexist on the system.

b. User Orientated Regional Based R&D

An interesting experiment for regional technology R&D policy to 'empower the users' is the Sotech (Sozialvertraegliche Technologiegestaltung) programme in Nordrhein-Westfalen (FRG). This is a programme of 'Technology Assessment'

which has evolved, in particular, due to pressure from trade unions and the social democratic party. It is also the basis for other actions by the NRW Government in the field of information technology and telecommunications.

The Sotech programme deals specifically with microelectronic technology, but in relations to rebuilding the productive apparatus and associated services in humanising technology.

The main issue at the core of the Sotech programme is 'social compatibility' the priority of which is 'reinforcing the possibilities of stating those particular social requirements which are affected by developments in the fields of information and communications technologies and which, because of their structural conditions are not adequately protected against an uneven division of the social costs of technology development.'

The SOTECH programme aims to influence technological developments towards a socially balanced consideration of the interests at stake, thereby increasing the social and ecological benefit of technology and ensuring a more even distribution of such benefits.⁴²

The OPTEK ("Optionen der Telekommunikationen") Study⁴³, undertaken by an interdisciplinary research team commissioned by the Land Nordrhein-Westfalen, concluded that it was still possible to choose between different directions for the future development of telecommunications.

The sub-title of the study, 'Materials for citizens dialogue on technology policy', makes clear its intended use. According to the authors the present discussion is limited to a small circle of experts, who overwhelmingly have their own material interests in the developments.

Although the developments in the near future will affect the working and living conditions of millions of people, they are not asked about their own wishes and needs. Even for citizens who are interested, it is claimed, it is extremely difficult to obtain information that goes beyond the promotional literature offered by telecommunications providers. One scenario to involve people in debating these issues is that of the 'Buergerdialog'⁴⁴

c. Regional Decentralisation

An important criterion identified for the application of new information and telecommunication technologies is that they should help to make society more transparent and should contribute to the involvement of citizens in decision-making about matters that concern them.

The fact that many rural areas are isolated or remote from centres of political decision making suggests that modern IT&T could play a role in helping to decentralise administration. This could happen, for example, through 'one-stop' neighbourhood offices, dealing with the whole range of municipal and regional services (housing, social services etc), linked through IT&T to the vari-

ous levels of decision making. These may be linked to CSTSc.

Lower Saxony's 'Citizen Bureau' project, for example, intends to bring local public servants back to the grass-roots by moving their offices to small communities and linking these offices with a central computer to reduce mono-informational journeys by citizens to administrative headquarters.

Accessibility of information (available for municipalities), however, is not only a question of good storage and widespread hardware (and basic ability to use hard and software). It is above all a question of the political will on the part of those in charge to share this information and to make it accessible.

Thus Lacroix:

*'Si nous voulons conserver et elargir la democratie, il nous faut selectionner et encourager les technologies et les procedes qui concourant a ces buts. Cependant, rechercher des solutions techniquement apropiées aux exigences democratiques n'est que secondairement un probleme d'ordre technologique: c'est d'abord une question de volonte politique et d'imagination.'*⁴⁵

There is no point in stressing the potential of Information Technology and Telecommunications facilities in making possible further decentralisation if the political will is not there to do it (for example, if the financial constraints are such that no political leeway is given to local or regional authorities.)

As, Liesenfeld points out:

*'Zwischen dem oeffentlichen und dem privaten Dienstleistungs sektor gibt es einen bedeutsamen unterschied ... keine der grossen Dienstleistungsbranchen steht wie der oeffentliche Dienst seit 15 Jahre unter dem praegenden Diktat der Haushaltskonsolidierung.'*⁴⁶

At the same time, it is important to recognise that Information Technology and Telecommunications facilities have the potential to (re) centralise political decision making by contributing to and facilitating the exercise of political control. Indeed, this is one of the criticisms made of the introduction of the ISDN network in the Federal Republic of Germany.

Qvortrup (1989) distinguishes between 'superficial' and 'real' decentralisation. He points out that:

*'if only a telecommunications infrastructure is established, then the result will most likely be what one might call a 'superficial' decentralization, ie, a de facto social centralisation covered by a purely 'electronic' decentralization.'*⁴⁷

'Real' decentralisation entails combining 'infrastructural and organizational decentralisation' where a key role is 'not to destroy the very delicate formal and informal social networks of rural villages, for example by reinforcing the tendencies of individualisation.'

*'Furthermore, it is important that one does not, albeit unwittingly, let physical decentralisation become a cover for a real social concentration of economic and political power structures. Inhabitants of the villages must improve their influence on and their participation in society's decision making processes.'*⁴⁸

A similar point is made by Lange (1988):

*'Es sind nach wie vor politische Reformen notwendig, verbunden mit verbesserten technischen Analysefähigkeiten zur demokratischen Kontrolle von Entscheidungen. Eine in diesem Sinne demokratiefördernde Informatisierung ist nicht erreichbar durch bloße Informations-technische und Informationsrechtliche Politik'*⁴⁹

d. Increasing the Power of Regional Actors

Information and Telecommunication Technologies may also be able to play an important role in strengthening the power of regional actors vis-a-vis national and Community Institutions.

Given the inherent trend towards the world integration of IT&T facilities, it may well be that a conscious process of 'localisation', in which regions can play a part, is called for to provide a counterweight to excessive control of power at the centre. IT&T facilities and applications may well be able to assist this process of 'localisation'. Thus Lacroix:

*'La mécanisation du traitement de l'information recèle un potentiel d'élaboration décentralisée des décisions capable de former un centre-poids aux tendances à la concentration du pouvoir.'*⁵⁰

However, one of the elements of current telecommunications policy identified above is the increasing loss of power by regional actors. Regional planning boards and even national planning agencies can be powerless in the face of the direct influence of functional ministries such as the Ministries of Finance, PTT Ministries or in the face of large private Telecom Administrations. The question thus arises whether the situation will not be exacerbated at a Community level.

One proposal to strengthen the role of regional actors has been the establishment in Brussels of representatives of all Community regions, Laender, provinces etc and a standing conference of these representatives. Currently, some regions and Laender have responsibilities but there are also cases (such as in Italy) where the national Government has vetoed direct political contacts between regions and the Commission. Use of IT&T in their interests could be one of the goals of such a standing conference. IT&T facilities, such as an electronic mail/conferencing systems could help in the development and liaison of policies over the whole field of Community policy as it affects regions and rural areas.

With the move towards the Single Market of 1992, Community legislation will

impinge increasingly on all spheres of life, and all social groups and communities, urban and rural. The aim of a Citizen's Europe implies involving people in European affairs through their membership of organisations to protect their rights and promote social welfare, health and the environment. Yet of the 3,000 or so EC watchers, only a handful work for public interest organisations. The imbalance is on the increase as more and more firms and trade associations re-assess their strategies in relation to 1992. There is a need for transnational communication between activists, social movements and political communities and information and communication technologies can play an important role in facilitating this. Already, environmental organisations and movements throughout Europe and beyond are linked on the 'Green-Net' system. However, support for such transnational networks is as important as support for the communications technologies themselves. The Commission could do much to boost public service uses of IT&T at the Community level by assisting social networks.

The experience of Green Net demonstrates that in the beginning, it was those activists already computer literate who made use of the network while larger - and more established organisations - remained hesitant. It was only when a 'critical mass' of users was established, together with the political necessity for fast trans-European communication, that these organisations began signing up for the system.

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2. The ORA Requirements Statement, resulting from the deliberations of national administrations specifies the need 'to ensure that the applications of information and communication technologies in rural areas do not lead to further centralisation of business and administrative activities and a loss of the cultural and economic diversity of rural areas in Europe', Commission of the European Communities, DGXIII (1989), 'Draft Workplan for possible Community Action concerned with Applications of Information and Communications Technologies in Rural Areas of Europe': hereafter referred to as the Draft Workplan, p. 5
3. 'A service sector which employs a large proportion of rural workers will rely heavily on communications and such an advanced infrastructure may result in a further centralisation of activities', Draft Workplan p. 1
4. formulated by a Spanish participant in the ORA consultations.
5. For example, the London Industrial Strategy aimed to 'identify existing, planned or possible systems which both improve the service available to users while at the same time improving the conditions of work and participation of the workforce.' GLC (1985) p. 326
- Holvast (1989) suggests that 'bij gelijkblijvend beleid zullen zich gevolgen voordoen met betrekking tot de werkgelegenheid, tweedeling in de samenleving, de kwetsbaarheid, privacy van de burger, afstand burgerorganisaties'
6. Keeble (1988), Harrison (1988)
7. Analysys Ltd (1988), Recommendations p. 2
8. quoted in Keeble (1988)
9. Alter (1989)
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12. Analysys (1988) p. 7
13. see Mueller (1988) pp62-63/pp152-153
14. Mueller (1988) p. 62
15. GLC (1985) p. 27
16. Murray (1987) p. 97
17. Slaa (1988a) p. x
18. Slaa (1988a) p. 69
19. Wirtschaftswoche, 8.5.87, p. 79

20.Thomas F (1988)

21.Simonis (1988a) p. 13

22. Eureta Newsletter 1988/1. p. 7; see also Daey Owens, C et al (1988)

23.Slaa (1988a) p. 3

24.cf Slaa (1988a) p.2

25.NOTA (1989)

26.NOTA (1989)

27.Compare the situation in the field of wind energy in the Netherlands: people who own a windmill that produces more electricity than they consume for themselves only get a very low price for the electricity that sell back to the public electricity company. Setting universal tariffs in this respect would mean equal 'access' to the public facilities for big industry as well as small consumer producers.

See also the provisional ONP directives of the Commission

28.POTS = Plain Old Telephone System. Slaa (1988) p 29

29.Thomas (1988) p. 1

30.Draft Workplan. p. 23

31.There is, eg. a 'telephone culture' in the Netherlands - and even more so in Italy. It is hardly a caricature to say that in Italy you may send 5 letters and nothing will happen until you get the right person on the phone and talk to him/her. This simply emphasizes the isolation of Italian rural communities that have no access to direct dialling. In Germany, on the other hand, there is a letter culture - until something is confirmed in writing, all conversation at the phone is perceived not to have happened. To a certain extent, one can already note the emergence of a 'telefax' culture at the European level; see also Boehm et al (1988)

32.See Kubicek H/Mettler-Meibom (1988)

33.GLC (1985) p.326

34.GLC (1985) p. 326

35.GLC (1985) p. 60

36.Von Gleich et al (1988) p. 10

37.Von Gletch et al (1988) p. 10

38.von Gleich et al (1988) p 10

39.cf Committee for the Study of Economic and Monetary Union (1989), para. 14, line 15

40.see Qvortrup (1989b)

41. Kubicek H & Mettler-Meibom B (1988) p 41

42.See Simonis (1988a) (1988b)

43.Berger, P et al (1988)

44.See Kubicek H/Mettler-Meibom (1988)

45.Lacroix (1989)

47.Qvortrup (1989) p 66f

48. Qvortrup (1989) p 67

49. Lange (1988) p. 24f

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**The policy and institutional
implications of an
EC Central Bank and a
Community monetary and
economic policy**

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The Policy and Institutional Implications of an EC Central Bank and a Community monetary and economic policy

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1 - From the beginning of the ERA project it appeared that freedom of choice about the economic policy and above all of its monetary aspect was one of the main yardsticks against which the level of autonomy of any State or group of States was to be evaluated. It appeared also that no European country, not even the most economically powerful among them, the Federal Republic of Germany, could be considered to enjoy entire freedom of choice about its economic and monetary policy.

This situation is due partly to the growing internationalisation of the economy, particularly within the "free" market area, whereby an increasing level of interdependence leads to a rapid transfer of imbalances, economically, financially or politically motivated. Two factors have accelerated this tendency, the instantaneous telecommunications facilities and the huge liquidities of multinational companies, permanently on the move towards the most profitable short term investment. Equally important is the pressure exerted on the "free" market financial system by the political, military, economical and financial superpower status of the United States of America. The conclusion drawn from these evident considerations was to include the monetary and economic policy area within the scope of the ERA project.

At the same time the renewed political impetus of Western European economic integration - the EC drive for completing its Internal Market and the nearly simultaneous decision to establish an European Economic Space (EES), including the EC and the Efta countries - made clear that the search for European autonomy in the economic and monetary area could only be based on a transnational setup, thus sacrificing the concept of individual countries autonomy for the benefit of Europe as a whole.

2 - The process of Western European integration since the late '40s can be described as a long march toward autonomy, i.e. freedom of choice even when the objective concerned very basic freedoms. First came freedom from want; then, when Western Germany was brought back within the family of nations, freedom from fear of European wars; not much later, under pressures real or believed to be real, which future historians will have to scrutinise in depth, freedom from the "menace" of Soviet imperialism; now, with the end of the cold war a potential new concept of autonomy is at hand, no more freedom from some impending enmity, but freedom of choice about the European society and way of life.

During the long years since the beginning of Western European integration an attempt was made in the early '50s to rush the process with the bold move towards an hard core near federal structure responsible for defense and foreign policy. When this attempt failed, those who were still persuaded of the inefficiency of intergovernmental cooperation decided to bypass the political obstacle through economic integration.

So was born the concept of a Common Market, based on the four freedoms of movement of persons, goods, services and capitals; the only substantive addition within the Internal Market concept as stated in the Single European Act of 1986 is the definition of it as a space without borders.

Should this definition be taken at its face value - an interpretation which is legitimated by the ratification by twelve national parliaments - than it can be stated, as in the Padoa-Schioppa report of 1986, that if only for reason of technical feasibility the EC cannot enjoy simultaneously:

- freedom of capital movements
- stability of exchange rates
- twelve independent economic policies.

In other words it does not appear reasonable to create a single huge economic area, without taking the political and institutional steps to govern it.

Nearly forty years before this statement, another Italian leading economist, Luigi Einaudi who after having been a very successful Minister of Finance, finally was elected President of the Republic was even more blunt about the same issue. Angered by the maze of harmonizations and escape clauses suffocating the Franco Italian Custom Union Treaty, he simply wrote that the only necessary and sufficient condition enabling two countries to eliminate their economic borderline would be the merger of their Central Banks.

3 - Until now the development of the EC has enjoyed a large area of political consensus, with some extremist fringe exceptions on the right of the political spectrum - because of the permanence of nationalistic feelings - and on the left - because of an overall rejection of the present Western European society.

This situation is by no means a political blessing, because such a broad unanimity about "building up Europe" implies either that this action is politically irrelevant or that the conservative forces have lulled the progressive ones into an unanimity which is not in the interest of the latter.

In the coming years the completion of the Internal Market will raise, with all probability, a number of issues where the lack of strong reactions or an ones insufficiently transnationally coordinated by the progressive forces may play directly in the conservative hands:

- how to avoid intolerable consequences of competitive pressure areas which are less "productive" because of physical, social, or historical constraints;
- how provide effective economic and social shock absorbers in the case of extensive

restructuring induced by new competition;

- how insure a fair distribution of the expected new benefits in terms of net income, after investments;

- how to insure that the sharing of benefits will not accrue only to individuals, under the form of profits or wages, but will also be devoted to improve social services;

- how to guarantee that additional economic growth stimulated by the completion of the Internal Market will not further deteriorate the environment, but on the contrary will be partly used to remedy to the present state of environmental crisis:

All these are issues where a coincidence between conservative and progressive forces would be a pact against nature or a further indication of the lack of a progressive strategy at the European level.

The present tendency of the economic integration to evolve towards an Economic and Monetary Union will raise further issues with a high potential of division along political lines. As the Delors report clearly show, the institutional implications may have by themselves a strong divisive bias, if only because of the inevitable changes in many national institutional set-ups. But even more important appear to be the policy issues involved:

- which would be the general economic and monetary policy orientation of the whole area;

- how will the new economic and monetary unit behave in its relation with the outside world.

4 - The institutional implications of the projected Economic and Monetary Union (EMU) are manifold:

- a loss of national monetary sovereignty. The fashionable diplomatic expression is "pooling of sovereignties", which however does not alter the substance of the transfer of the right of decision to the new "federal" structure of the European Central Bank (ECB);

- a downgrading of the political direct influence over the monetary policy; two political concurring elements point in that direction, both relating to the German situation. On one hand the German economy and currency is the strongest in the Community, a fact which is already recognised in operational terms within the so called DM zone (Belgium-Luxembourg, Netherlands, Denmark, Austria): this fact gives Germany a strong negotiating position; on the other hand, the German Bundesbank is granted by law the freedom not to comply with instruction by the Federal Government, while being held by the obligation to support, within the extent of its duties, the general economic policy of the Federal Government. Given these two elements the choice is clear: either give-up the present governmental authority over the monetary policy, where it exists, or forget about the dream of monetary integration. The political independence of the German Bundesbank is underlined by its lawful mandate to safeguard the currency, a mandate which is currently translated into safeguarding the stability of prices. The key role of the German Bundesbank in the EC monetary integration process led the ERA Steering Committee to commission the Werres report, in order to acquire a better understanding of the working of the German system;

- political accountability; monetary policy is everywhere shrouded by a curtain of secrecy, the main reason of which is the risk that publicity may determine sudden currency credibility gaps, leading to runs on external reserves as well as on internal investments especially on State issued bonds. This risk is probably higher in smaller countries, especially where the financial situation is not very strong. On the other hand the accountability problem is politically more sensitive where the monetary authorities enjoy large discretionary powers; alternatively where their mandate is clearly spelt out in their statute, for instance to safeguard the currency, then the form of political and democratic control could be more flexible;

- the monetary policy being only one arm of the macroeconomic policy, the question arises of the management of the other arm, the fiscal policy, i.e. the utilisation by Government of the fiscal tools for income distributions, as incentive for choice between consumption and investment, both private and public; the Delors report plays down this problem under the cover of "subsidiarity", i.e. the minimisation of the "federal" decision making, and of "coordination" of national policy, however under the constraint of agreed limits on budgetary deficits. But coordination means action by national Ministers, subject to the pressure of national parliaments and of national electorates: in other words coordination may only mean loose arrangements and it is by no means certain that national fiscal flexibility even within agreed and respected limits to budgetary deficits will balance the unity of the monetary policy run by the ECB. After all, in the US as well as in the FRG, fiscal policy is run by and large at federal level, in parallel with monetary policy;

- political accountability should be set at the same level: even if the ECB arrangements in this matter will be flexible in substance, because of the statutory mandate of safeguarding the currency, the political counterpart will be the Community institutions; an unbalanced situation would develop if under the cover of coordination of national policy, the basic political orientation, of fiscal policy were not to be decided within the same Community framework; in this perspective the capacity of exerting political pressure by the private interests, be it employers, trade unions, consumers groups, environmental groups etc, should also be upgraded from the present situation of weakness, which can only profit to the naturally better organized conservative forces.

5 - The internal policy implications of the creation of the ECB relate mainly to the apparent alternative between stability of the currency and growth of the economy. A lively debate has taken place during the last years especially in France and Italy about the shortcoming of the "German model", where independence of the Central Bank and stability of the currency are equated with low growth, even at the expense of the possibility of reducing unemployment.

It is accepted that the German structural economic model cannot be reproduced elsewhere, at least for a large number of years. It is based on

- a very low population growth (but (a) a similar trend is occurring quite fast in other countries: (b) will not the turmoil in Eastern Europe modify the trend?)

- a solid industrial structure based on products of high quality largely in demand worldwide

- an oligopolistic corporate ownership thanks mainly to the power of the banks: it is

impossible to buy German companies if they are not for sale by decision of the management

- a broad and institutionalised social consensus creating machinery dealing with the distribution of income

The "German model" is deemed to imply a deflationary bias, in particular when applied in different political and economic structural situations. As such it has an evident conservative flavor, because it keeps a safety net of unemployment against wage claims which would reduce profits and moreover it implies "austerity programs" against budgetary expenditure and therefore against raising taxes on higher incomes or on wealth.

The question arises therefore whether there are viable alternatives to a monetary and macroeconomic policy based on the stability of the currency and of prices:

- a less rigorous monetary policy?

But i) It cannot be acceptable to German public opinion, let alone the German Bundesbank

ii) Moreover it is also a conservative solution, as inflation expands profits more quickly and therefore more than wages, in spite of whichever adjustment system is adopted. To this consideration it may be added that any proof of permanently increased employment thanks to inflation is lacking.

- an European "beggar thy neighbour policy" US style?

But who are the beggars in this perspective? Other Europeans? In the West they will follow the EC lead and cover themselves in this way; in the east nobody would dare in the next few years to increase the difficulties of the painful transition out of the centrally planned economies. The US? They are too strong and moreover quite skilful at this game. Japan? It is financially too solid and industrially too productive. So the only remaining candidate is the Third World, a politically and economically unrealistic prospect.

All in all, it seems that the path of further economic integration within the Community can only follow the German lead in its monetary sector.

This raises immediately the question of timing: while from the economic point of view France is very near to a German policy, and could in fact join the DM zone run by the ECB, gaining the institutional advantage of having a say in the management of the currency, this is not a case for a number of other Community countries.

Britain is keeping aloof for political reason, but at the end of the day the old Monnet say will apply: "Advance, the British will follow": Mrs Thatcher is a shrewd negotiator and moreover a certain amount of institutional criticism may be good medicine. More difficult is the situation of the southern countries. While Portugal and Greece are both a case for Community financial support, at a cost relatively light because of their small population, the Italian and Spanish case are much more difficult, especially the first.

It is not clear when Italy could realistically accept a serious limitation to its budgetary deficit: the renunciation to the broader fluctuating margin within EMS has been accompanied

by a programme of six months of delayed public spending, when a number of difficult situation in public services obviously require money. If the same medicine would be applied for a more difficult attempt to redress the internal financial situation without a serious attack to the deeply ingrained fiscal leniency, then grave social unrest could develop and would be cured with the usual budgetary means, thus making impossible to subscribe or implement any strong European commitment.

By contrast Spain may represent only a problem of timing, to the extent in which the present huge import of capital good will succeed in raising the production levels and accelerating the present trend to reduction of unemployment: here again however the problems of more equitable distribution of the benefits of growth and of a marked improvement in services, both social and public have to be addressed for the country to be able to join effectively the ECB system.

Admitting that the ECB may, at least at its beginning, assume a "variable geometry" when compared to the Community, and that its mandate would be based on stability of the currency at the end of a transitional period (covering phases 1 and 2 of the Delors report), then the necessary flexibility of the macroeconomic policy at the European level could only be assured by the fiscal policy either in a "coordinated" or in a "federal" form: here the political alternatives appear to be relatively clear:

- the conservative forces favor the maximization of profits through low demand induced by low public expenditure, (hence lower taxes) accompanied by an "efficient" income policy
- the progressive forces would favor shifting part of the profits towards public expenditure (investments and social services) by means of a reasonably active taxation policy, which may include an expansion of the Community budget with the double aim of have an impact on the macroeconomic policy and to operate appropriate resource transfers between the richest and the poorest areas of the Community.

Therefore the politicisation of the European integration would take the form of a trial of strength about fiscal policies; the conservative forces have a head start: will the progressive ones be able to raise to the challenge?

This question can only be answered through a careful research about the consequences of either policies, bearing in mind that on one hand the progress towards the monetary union will greatly reduce the foreign exchange risks and that given the opportunities offered by the prospects of European (in the geographical sense) unity, European capital would not be running away even if it would have to bear some additional constraints.

6 - The prospects have never be so favorable for Europe as a whole to recover a large part of its autonomy. The Superpowers are steadily losing their grip on the events and appear to be slowly accommodating themselves to their new situation, even among serious difficulties. Japan is not yet in this game, in spite of its remarkable industrial and financial success: it is farther, geographically and culturally from Europe than from the US. But the recovery of a wide margin of autonomy for Europe depends by and large by the capacity of the Europeans to overcome the huge differences, political, economical, social and cultural that forty five years of separation - nearly two generations - have created between East and West. Many scenarios can be sketched about how the prospects for a new European set up will materialise. At this point in time and within a large margin of uncertainty about how and when, a "realistic"

scenario could be described as follows:

- the EC continues its progress towards economic and political integration, including the completion of its Internal Market and the successful negotiation and ratification by a number of Member countries of a Treaty establishing, after a transitional period an Economic and Monetary Union substantively embodying the features of the Delors report, with some additions on the budgetary and institutional sides;

- the EC and EFTA countries conclude before 1992 a Treaty creating the European Economic Space which though largely eliminating the differences between EC and EFTA members, will still maintain large areas of difference; moreover EC does not make any major concession on its autonomy of decision: the time honored theory still holds according to which concession on this matter would alter the internal dynamic balance made up of reciprocal global concession; recognising from their side that the price to pay for not accepting the open ended commitment of full EC membership is EC de facto economic and political hegemony, many EFTA countries will open a full internal political debate about joining the EC or not;

- Eastern European countries will revert to democracy quite rapidly, but they will thread less rapidly the difficult path leading from centrally planned economy to a decentralised market approach. EC will provide support in finance, market opening, technical assistance. Step by step, with different speeds according to their economic social and cultural structure they will reach the stage where a close political relationship with the EC will become operational either on a form similar to that existing with EFTA countries or as full members (a technical note: it is a mistake of talking of "associated membership": until changed, the EC rules only know membership, association - which is a political agreement between two sovereign entities - , or trade and cooperation agreements). Of course GDR may become rapidly a full member as such or being absorbed de facto or de jure by FRG - for instance through the German Economic and Monetary Union: the political aspects of the German unity will be discussed and agreed either in conjunction with the four former wartime antinazi allies or within the framework of Helsinki II.

What will be the political power relationship within the reshaped Europe hangs only partly on the institutional setup and in the diplomatic solutions: much will depend within this scenario on the way in which Western European progressive forces will (a) counteract the conservative pressure within the EC and (b) prove jointly with their Eastern Europe counterparts to European peoples that the concepts of political democracy and of marked oriented economy are not the preserve of the Western conservative forces.

7 - The above scenario is based on the hypothesis of the continuation of the EC integration drive, including Economic and Monetary Union. This will have wide consequences outside Europe:

- a more balanced relationship between the EC and the US, not only because of the increased economic and institutional strength of the EC but also because a lessened need for European societies to rely on the US for their security: the common enemy would not be there anymore;

- trade frictions, probably financial frictions, possibly legal frictions over the positions of US multinational corporations, will continue to develop

- international economic coordination would probably be strengthened and probably rationalised: would a Group of Seven make better sense than a Group of Three?

- a great question mark concerns the economic and financial relations with the third world: the EC will have the institutional and economic strength to help to improve the situation; it is by no means certain that it will use it either because Eastern Europe will attract not only resources but also attention or because the absence of an internationally agreed action devoting to third world part of the resources liberated by the disarmament.

European Economic and Monetary Union and the Struggle for Resources

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European Economic and Monetary Union and the struggle for resources

I will try to argue briefly that the story about monetary unification is a story of a struggle for resources and I shall try to end up by linking this to the debate about security issues.

Why is it a question of a struggle for resources? The EMS started and was a success story until 1987 as a disciplinary device. This is the way it was perceived in Italy and France. It was used by Italian monetary authorities to import discipline from the strong German monetary policy and to impose that discipline on business behavior especially, to get firms used to having fixed exchange rates and thus no longer devaluation or inflation to allow them greater profits. This was a success in that Italian industry responded by adapting to the new environment.

After 1987, however, things changed. The last major realignment in the EMS took place in January 1987. Since then the system has transformed itself slowly into a natural fixed exchange rate system. The major issue there was that capital liberalisation was started first in France then in Italy. This produced the surprising effect that the weak and inflation prone countries such as France and Italy became both strong currency countries and with declining inflation, though still with higher inflation rates in respect to Germany. In order to do this monetary policy in France and Italy became much tighter than in Germany. In terms of real interest rates this attracted resources to Italy and France. Italy and France became capital importers while Germany became a capital exporter. Paradoxically, this allowed a greater policy autonomy in the sense that Italy and France, and especially Italy, could enjoy a higher rate of growth financed by funds coming in from outside. This was reflected in the structure of trade imbalances in Europe which today still stand as having a trade surplus, a large and growing trade surplus in Germany, and trade deficits elsewhere, especially in the larger countries.

So there was a phase in which resources, given the overall monetary stance, were attracted from the previously weak countries, now strong currency countries. Today Italy is a strong currency country, believe it or not, and this is the reason why it entered the narrow band and was ready to do that a year ago. The Delors report was developed in this context. If one looks at the foreign policy of the central bankers one finds that the Italian central bank and the French central bank were the most eager supporters of the Delors report. They pushed for greater monetary cooperation which they understood as greater monetary

discipline, no longer being imposed from the outside, however, but being imposed from the inside. In other words, increasingly after 1987 the tightness of monetary policy in Italy was attached not so much to the fact that Italy was a member of the EMS but that it was a member of a process leading towards greater monetary unification.

Now this has produced, as I said, a paradoxical result: more autonomy for growth in Italy. Italy could grow and develop trade deficits and budget deficits because resources came from outside, and because people found it profitable to invest money in Italy, - and I mean essentially Italian people, who in contrast to their attitude in previous years found it profitable to put their money back into Italy rather than place it outside.

So one untold story about monetary unification is that the issue is not so much about the amount of price convergence as about the amount of resources countries are able to attract from the overall financial market, enabling them to pursue apparently uncoordinated fiscal policies. That is one of the reasons behind the Italian paradox: why do we keep on building up the public debt ? Because we are financially more credible given the tighter monetary policy ? It is a sort of "Reagan effect", where there is an expansionary fiscal policy and a very tight monetary policy which produces an appreciating currency. That is the Italian story of the last fifteen months.

Now the problem is, what will happen next ? The big issue is: who will get the resources in the next few years - and this is related to German monetary unification. Everyone is agreed that German monetary unification, given an overall financial constraint, will mean that more resources are attracted by Germany, so flows of funds will be reversed. So the struggle for resources again arises because countries like Italy which were attracting resources will be in a position where they are no longer financed by the leading core country - Germany - which once used to generate resources going out, but will now need resources coming in.

If you add the EuroFed story to this, the story of a European Central Bank which is completely 'independent' and which sets say, a monetary target for the rate of growth of monetary supply in ECUs, or whatever, then one sees that there is an overall constraint and a struggle for those limited resources.

Now the point I want to make, in conclusion, is that if this were the end of the story, then monetary integration would be a story of struggle for resources in the European context, especially given expectations from eastern Europe, and the resources being poured into eastern countries, East Germany in the first place, but not only East Germany.

This is the point where in my view the 1992 affair comes in. The 1992 affair has a number of effects. One is to enhance growth. I think we all agree that not only is the Cecchini report correct, but new reports show the growth effects will be even higher than those in Cecchini. So there is going to a growth effect which in some sense will ease the general resource constraint. Secondly, however, resources will be attracted from outside, I mean perhaps the United States and Japan. There is a policy issue there. What kind of policy for investment coming from Japan, Korea and non-EC industrialised countries should the Community adopt in this respect ?

Third point: there is going to be some trade conflict for the obvious reason that any process of integration by definition changes resource flows from one direction to the other. This is what is known as a 'trade diversion' effect such as was produced by the first steps in the European Community and will probably also be produced by the completion of the internal market. There is some empirical support for that. So even if the EC did not take any trade policy action to complement 1992 it would have some trade effects on the rest of the world. And so it will have some effect on the struggle for resources again.

And I come to the final point. Who will undergo the toughest pressure for resources? The south! When I think of the south I think first of all of the southern flank of the Mediterranean. We are already experiencing pressure for resources not only in the obvious fact that the south asks for financial support (which is now partly being crowded out by the support for the east). But I am thinking in the medium term of demographic pressures - immigration pressures which are subjecting Italy to the same kind of pressure as movements of labour from East Germany are imposing on the West German government. You either have immigration or you give them resources. And if one thinks of pressures in the next ten years coming from North African countries and the Arab world, Italy is one of the obvious candidates to face those pressures.

In more general terms, so long as there is no change in the balance between private and public management of overall financial funds in world financial markets, and insofar as the great mass of funds is on the private markets, there is a pure profit maximization choice in deciding where to put your money. Then it is obvious that resources will not go to the south. They will go to the east. To Germany and then to the east.

To conclude: the effect of monetary unification is to put an overall constraint on fiscal policy autonomy but also to put an overall resource constraint on the outside of Europe. And this will put political, and if you wish, security problems on the agenda if security is given a wider definition, involving not just a strict military confrontation. In the medium term the security

and economic issue will arise at least on the southern flanks of Europe.

The Deutsche Bundesbank and its relationship to the Federal Government

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THE DEUTSCHE BUNDESBANK
AND ITS RELATIONSHIP WITH
THE FEDERAL GOVERNMENT

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1. Introduction: context and subject of the study

In April 1989, the Committee examining economic and monetary union under the leadership of EC Commission President, Jacques Delors, produced a report on the concrete stages towards the achievement of economic and monetary union in the European Community. One of the proposals in this report concerns the establishment of an independent European Central Bank, which would be closely based on the German central bank system, particularly as regards independence from governments¹. With regard to the organisational structure of this European Central Bank, the one-tier, decentralised German central bank system has probably also been used as a model, but it is not very clear from the Delors report how distinctively federal the future European central bank would be. The operating methods and experiences of the German central bank system could therefore provide an important basis for judging the organisational form of a European central bank.

The subject of this study is the independence of the German Bundesbank vis-à-vis the Federal Government. The strict separation between monetary policy and the Federal Government's general economic policy raises the question of how this relationship works between the Government and the Central Bank. The study also concentrates on identifying the limits and possibilities of government influence on monetary policy on the one hand, and policy coordination of monetary and fiscal policies on the other.

The first part of the study describes the independence, tasks and organisational structure of the Bundesbank both as laid down in the Bundesbank Law (Bundesbankgesetz), and as this occurs in practice. The second section deals with the activities which the Bundesbank and Federal Government are able to carry out in association with each other. The relationship between the two bodies is clearly presented in the light of past conflicts. The

¹ See item 32 of Delors Report.

practical implications of the split between monetary and general economic policy are clearly described by taking as an example three notable conflicts between the two bodies. An elementary prerequisite for German monetary policy is also mentioned in passing. The independence of the Bundesbank and its effect on the pursuit of a currency value-based policy would not be quite so pronounced were it not for the extensive public backing which the Bundesbank enjoys. This fact will make it difficult to transfer the German system to European level.

I have collected the material for this study from the relevant literature available, a list of which is given in the appendix. In addition, I had a whole series of talks with leading Bundesbank officials, ministerial civil servants and other experts, all of whom contributed to my understanding of this subject. I would like to thank all of these people again. In order to protect my informants, I shall not name or give the positions of the people I interviewed. Only the gist of their opinions are given where these are particularly relevant to the study.

2. The status of the German Bundesbank

The institutional and personnel independence, tasks and instruments, as well as the organisational structure, of the Frankfurt currency authorities are regulated by the Bundesbank Law of 26.5.1957.

2.1 The independence of the German Bundesbank

2.1.1 The institutional independence of the Bundesbank

The basis for the institutional independence of the Frankfurt monetary authorities is to be found in art. 2 of the Bundesbank Law²:

"The German Bundesbank is a public law body ("Person des öffentlichen Rechtes") , directly accountable to the Federal authorities".

By giving it this legal form, the Bundesbank law avoids endowing the Central Bank with one of the other legal forms for public law institutions - institute, corporation or foundation - therefore leaving a certain amount of scope as regards the legal

² The autonomy of the Bundesbank is subject to the reservations of the Bundesbank law. A parliamentary majority can officially limit or even abolish the independence of the German issuing bank. In fact, however, there is a wide social consensus that the Bundesbank must be, and remain, independent. Apart from the fact that the Bundesbank practically has unwritten "psychological constitutional status", as my interviewee put it, there are also legal arguments which derive the need for Bundesbank autonomy from Art. 88 of the Constitution (Grundgesetz - GG) (see Uhlenbruck 1968, p. 22 ff).

interpretation of the exact position of the Bundesbank'. It is indisputable that this formula gives the Bundesbank a degree of autonomy which is unique in the German legal system⁴.

Whenever the independence or autonomy of the German Central Bank is discussed, the main point is usually its relationship with the Federal Government. Paragraph 12 of the Bundesbank Law states that the Bundesbank

"when exercising the powers granted it by virtue of this law, is is not obliged to comply with instructions issued by the Federal Government", nevertheless it is "obliged, in observing its duties, to support the general economic policy of the Federal Government".

The fact that this freedom from compliance with instructions is expressly mentioned means that, in specific cases, Federal Government monetary policy objectives cannot be legally enforced vis-à-vis the Bundesbank⁵. As the "general economic policy" of the Government is not defined in the Law, this obligation of allegiance does not limit the Bundesbank in its freedom of manoeuvre, neither de facto nor above all de jure, provided the

³ Uhlenbruck 1968, p. 40. Talks about the establishment of an "institutus sui generis"; Lampe 1971, p. 34 and following, describes the Bundesbank as a public law institution (Anstalt öffentlichen Rechts), whereas Samm 1967, p. 28 and following, leaves the legal classification open.

⁴ See Robert 1978, p. 5.

⁵ The freedom from complying with instructions does not apply with regard to those tasks which the Bundesbank can carry out by virtue of laws other than the Bundesbank law, or through other agreements. Such instructions may affect in particular certain Bundesbank functions as the bank for the public authorities (particularly of maintaining the market quotes for public securities and its activities in the context of international agreements and organisations, where the Bundesbank is simply the fiscal agent of the Federal Government (see below).

issuing bank continues to "observe its duties". Thus the obligation of allegiance has in fact no foundation in law and is no more than a kind of rhetorical formula.

The Bundesbank's independent position vis-à-vis the Government is also underlined in the provisions in paragraph 19 of the Bundesbank Law, which states that the two main organs of the Bundesbank, the Central Bank Council (Zentralbankrat) and the Directorate (Direktorium), have "supreme Federal authority" status⁷.

Apart from freedom from compliance with instructions, the Bundesbank is also free from any State supervision, in other words legal or technical supervision, to which legal persons under public law⁸ are normally subject. The Bundesbank is free from parliamentary control: the legal relationship between the German Bundestag and the Central Bank is not mentioned in the Bundesbank Law. Parliamentary debates and decisions regarding explicit monetary policy questions are possible in theory, but in the final analysis they have no legal power, and in practice they rarely occur⁹.

⁶ See Caesar 1981, p. 169 and after.

⁷ "The status of a supreme Federal authorities reflects (...) the very highest ranking of the authority in question and gives it freedom from accountability vis-à-vis all other authorities. Supreme Federal authorities include the Federal Ministries, and the central authorities which are not under the responsibility of the Ministries, but which are "co-ordinate" with them and therefore free from ministerial supervision, particularly the Federal Auditor General's Office" - thus Samm 1967, p. 33.

⁸ Samm 1967, p. 31 and after.

⁹ Monetary policy is not discussed in isolation but usually in connection with parliamentary debates on financial policy, sometimes in the context of the introduction of the budget or of tax laws with due observance of the general economic environment. However, the object of policy or discussions in the Bundestag has not been to admonish the Bundesbank or criticise its actions.

The only control to which the Bundesbank is subjected is the examination of its annual accounts by the Federal Auditor General's Office (Bundesrechnungshof)¹⁰. The Bundesbank must also produce a report four times a month informing the public about its business activities¹¹. Apart from that, the German Bundesbank is not subject to any controls or authorisation procedures.

As regards the possibility of influencing the decisions of the German Bundesbank via the courts, while the monetary policy decisions of the Bundesbank are not deemed to constitute an extra-judicial acts of sovereignty (justizfreie Hoheitsakte)¹², at the same time the independence of the Bundesbank is not affected by jurisprudence. Only the Federal Constitutional Court can declare a Bundesbank decision is contrary to the constitution, and can cancel it if it can be proved that a person's basic rights are violated because of a specific Central Bank decision¹³.

2.1.1.1 The position of the Bundesbank vi-à-vis the Federal Government

Apart from the issuing bank's freedom from compliance with instructions and limited obligation of allegiance vis-à-vis the Government, the Bundesbank Law summons the Bundesbank and Federal Government to cooperate. Here, in place of the principle of "sub-coordination" governing the relationship between the

¹⁰ See para. 26 Bundesbank law.

¹¹ See para. 28 Bundesbank law. In addition, the Bundesbank publishes monthly reports, statistical supplements and special publications which appear irregularly.

¹² Lampe 1971, p. 41.

¹³ Lampe 1971, p. 44.

Government and other sections of the Executive, we have the principle of "co-ordination". Paragraph 13 of the Bundesbank Law prescribes reciprocal consultations in monetary policy matters. The Central Bank must therefore provide the Federal Government with information on demand. This obligation to provide information does not in any way reduce the issuing bank's freedom from instructions, but rather gives the Bank the opportunity to put its monetary and economic policy proposals directly to the Cabinet.

In addition, all the members of Government are entitled to take part in Central Bank Council meetings. In view of this, the Bundesbank regularly invites the Finance and Economics Ministers to Central Bank Council meetings. In practice, however, ministers attend these meetings only very irregularly. At least one of the two ministers is always present when the annual money supply targets are being set¹⁴. Government members have the right to speak and propose motions. However, in practice, a Minister has never proposed a motion. The Ministers' ideas and wishes are usually explained before the meeting¹⁵. Moreover, by law, the Federal Government can, on demand, suspend the decision-making process of the Central Bank Council for up to two weeks. But this has never happened in practice either. On the contrary, "the Federal Government shall invite the President of the Bundesbank to its discussions on matters of monetary policy significance".

¹⁴ It can also happen that other departmental heads may take part in Central Bank Council meetings, such as the Minister of Labour for example, if relevant issues are being discussed.

¹⁵ Moreover, as a member of the Bundesbank Board of Directors told me, it is tactically undiplomatic for a Minister who, for instance, does not wish interest rates to be raised, to request this at a Central Bank Council meeting, as the members would take this as a provocation, and would do the opposite to what the Minister wished.

The Bundesbank Law contains no provisions covering conflicts between the issuing bank and the Government¹⁶. The Federal legislator has deliberately avoided establishing a mechanism to resolve conflicts. The so-called Scharnberg Report by the Finance and Credit Committee in 1957 states, with regard to the establishment of such a mechanism, that "no institutional precautions should be taken and that "the 'dramatisation' of the conflict is the best way of avoiding a conflict"¹⁷. According to the current interpretation of the law, in the case of insurmountable conflict there is no legal solution available; the only solution would be to amend the law¹⁸.

It should be pointed out at this stage that the Federal Government has regularly profited materially from the Bundesbank in recent years. Under para. 27 of the Bundesbank law, the Bundesbank must forward to the Federal Government its net profit after deduction of reserves and contributions to the Equalisation Fund¹⁹. The Länder do not receive anything from this distribution of profits²⁰.

¹⁶ For this reason, various proposals have been made to set up a conciliation committee or arbitrator. See Spindler/Becker/Starke 1973, p. 255.

¹⁷ Scharnberg Report, 1957, p. 5.

¹⁸ See Uhlenbruck 1968, p. 69 and after.

¹⁹ From 1980 to 1988, the following amounts were transferred (in billions of Deutsch marks): 1980: 2.3; 1981: 10.5; 1982: 11.0; 1983: 11.4; 1984: 12.9; 1985: 12.7; 1986: 7.3; 1987: 0.2; 1988: 10.0. See Süddeutsche Zeitung of 7.4.1989.

²⁰ There is almost a vertical financial balancing out between the Federal Government and the Länder: the Länder pay interest to the Bundesbank for cash loans (see p. 9 below), which is later credited during the transfer of profit to the Federal Government. The exceptional transfers to the Federal Government are criticised on these grounds and with reference to the federal nature of West Germany, for example in Köhler/Pohl, 1985, p. 38 and Filc 1989, p. 405. An alternative suggestion is that the Länder should participate directly (Pohl) or that the Bundesbank's profits should be transferred to a structural fund for

An excursus: the relationship between the Federal Ministry of Finance and the Bundesbank

Regular contact with the Federal government is maintained primarily by the Bonn Finance Ministry. There are regular talks between the Secretary of State and the Minister on the one hand, and the members of the Directorate on the other. All monetary policy questions are discussed there - though this does not mean that fiscal and monetary policies are coordinated. On the contrary: the independence of the currency custodians means that in practice the Directorate informs the Federal Ministry essentially only about its intentions, which carry the uncertainty factor of not having yet been voted in the Central Bank Council. Of course, individual measures are also discussed during these talks. In principle, however, each side does what it considers right and what lies within its power. There has never been planned economic policy coordination between monetary and fiscal policies²¹ in the history of the Federal Republic (see chap. 3.1). The few exceptions have been more or less accidental and have not lasted long. The reason was that the Bundesbank has always refused being directly implicated in economic policy, stating that it must safeguard its independence.

If there are any differences of opinion, these should not be made public. This is the working principle applied following the controversy between the Bundesbank and the Government at the beginning of the 80s (see chap. 3.1).

financing investment in regions with particularly high unemployment (Filc).

²¹ Claus Köhler, a Member of the Bundesbank Board of Directors, has been campaigning for years for his concept of a potential-oriented economic policy, however he has been unable to have this accepted by the Central Bank Council.

2.1.2 The independence of Bundesbank personnel

The possibility of Government influence on Bundesbank personnel is considerably greater than on the Bundesbank's operations : as the nomination of Central Bank Council members lies totally with state bodies. Under the Bundesbank Law (para. 7 and 8), the members of the Directorate are proposed by the Federal Government, the Presidents of the Länder central banks and the Bundesrat - after consulting the Central Bank Council - and nominated by the Federal President. The Vice-President and the other Members of the Boards of the Regional Central Banks (Landeszentralbanken - LZBs) are appointed by the Bundesbank President, at the proposal of the Central Bank Council.

The impression given of a pluralistic nomination procedure is in practice considerably neutralised. The Federal President's right of nomination with the official, material right of investigation and the associated power of veto is a pure formality, given the smooth nomination procedures. And for the Central Bank Council, the right to be heard is not linked in any way to a right of veto²².

The Bundesrat does not on its own initiative have the right to propose LZB Presidents; the Bundesrat merely approves the nomination proposals (if necessary, after previous rejections of other proposals) for the positions within the competence of regional law, and transmits these to the Federal President²³.

²² With regard to the choice of candidates for the Presidents of the Länder regional banks, the Bundesbank President appears to be able to act quite self-confidently, as shown by the latest nomination of a new LZB President in Hessen by the regional government. Mr Pöhl intervened to say that it was not the sole task of the Hessen region to choose the candidate, he would like to have a say too, therefore before candidates are so to speak presented in public, he should be consulted.

²³ Robert 1978, p. 12; also see Tresor 1981, p. 30.

Thus it is the Länder governments which have the right of nomination, while the Bundesrat simply acts as a filter. The respective regional governments can therefore choose the President of their Regional Central Bank on the basis of party political considerations²⁴. In any case, the strong party political orientation of the Regional Central Bank Presidents does not often lead in practice to a corresponding politicisation of the Central Bank Council staff; in fact, this is considerably neutralised by the atmosphere and power of assimilation of the Bundesbank so that there is almost an "de facto political neutrality about the German Bundesbank"²⁵. The motto is: anyone who is a member of the Central Bank Council is no longer committed to the institution which nominated him, but only to the Bundesbank and its objectives.

²⁴ This has led to the regional Central Bank Presidency positions being given to "ex-politicians", "former Ministers, Secretaries of State, Ministerial officials", "with the right party ticket, of course", says the Frankfurter Rundschau (see edition of 25.3.89). For this reason, some regional Central Bank Presidents were reproached for being incompetent. In the 60s and 70s, the Bundesbank itself often voted against candidates if, in its view, regional government were using their nomination rights to provide respected and financially lucrative ministerial positions to long-serving party friends with insufficient experience in monetary and credit policy.

²⁵ Klasen, 1978, p. 4.

When the Federal Government is nominating the members of the Directorate, the Bundesbank Law expressly refers to the need for special "technical suitability"²⁶. The practical qualifications clearly take precedence over party political considerations, and a consensus with the Central Bank Council is always sought. Moreover, in personnel policy in recent years it has become the norm to guarantee a certain political party proportion. Thus in 1970 the socialist-liberal coalition nominated the Social Democrat Karl Klasen as President, and the independent candidate (who was however supported by the CDU), Otto Emminger, as Vice-President. In 1977, the same coalition promoted Emminger to the Presidency, and the Social Democrat, Pöhl, to the Vice-Presidency. Then Pöhl became President, and the CDU-sympathetic Helmut Schlesinger became Vice-President. The Social Democrat, Otto Pöhl, was given a second term in office under the liberal-conservative government.

The dominance of government influence with regard to personnel must be seen in relative terms, in the light of the contracts concluded with the Central Bank Council members. The term of office usually lasts eight years, ie. two parliamentary terms. Dismissal is practically impossible, and theoretically can only occur in the event of major breaches of duty or incompetence in managing the bank according to the rules laid down²⁷. In addition, the Bundesbank freely decide the liberal remunerations for the members of the Central Bank Council: salary scales are not linked to civil service scales²⁸. This regulation permits the issuing bank management to obtain highly qualified staff, without fearing that they will leave for financial reasons²⁹.

²⁶ See para. 7, Bundesbank law.

²⁷ See Caesar 1981, p. 174; Robert 1978, p. 7.

²⁸ See para. 7 and 8 of the Bundesbank law.

²⁹ According to the Frankfurter Rundschau of 25.3.89, Central Bank Council Members receive an annual salary of DM 250,000 plus house and car.

2.2 Bundesbank Duties, Functions and Instruments

2.2.1 Safeguarding the currency : the supreme duty of the Bundesbank

The duties of the German Central Bank are laid down in para. 3 of the Bundesbank law in very general wording:

"With the help of the authority in matters of monetary policy granted to it by virtue of this law, the German Bundesbank regulates the circulation of money and the supply of credit to the economy with the aim of safeguarding the currency, and ensures that domestic and foreign payment transactions are properly concluded by banks."

"Safeguarding the currency" is therefore the main objective of the Bundesbank. There is no mention or explicit consideration of the objective of full employment or attempts to equilibrate the balance of payments, as mentioned in the recitals in the Government draft of Bundesbank law³⁰. The reason given is that, as it is frequently impossible to achieve these objectives simultaneously, the issuing bank would be led into unresolvable conflicts, and too much would be expected of it. The discussion on the priority objectives of the Bundesbank has never completely subsided. Since the introduction of the Law on Stability and Growth in 1967, repeated attempts have been made to include the Bundesbank among the targets of the Stability Law, therefore weakening the priority objectives laid down in the Bundesbank Law. In any case, it has been agreed that under the current interpretation of the law, para. 3 of the Bundesbank Law has precedence, and the provisions of the Stability Law merely underline the fact that the Bundesbank also carries

³⁰ See the quotation in the passage in Uhlenbruck 1968, p. 57; Original: Governemnt draft bill governing the German Bundesbank (BT-Printed mater 2/2781)

responsibility for economic growth via its monetary policy". In recent times, people have started calling for a full list of objectives of the Stability Law to be explicitly included in the Bundesbank law²².

An equal level of controversy remains today about what is meant by "safeguarding the currency", nevertheless it is generally agreed that, in any case, the objective of price stability carries priority²³.

As far as the Bundesbank itself is concerned, the matter is quite clear: it has been basing its policy one-sidedly for over 30 years on price stability and foreign purchasing power stability²⁴, where it has a tendency to give priority to domestic price stability in the event of a conflict over objectives. One of the people I interviewed put it like this: a conservative law

²¹ See Caesar 1981, p. 169.

²² Rüdiger Pohl, Member of the Council of Experts (Sachverständigenrat), shares this view, cf. Köhler/Pohl 1985, p. 36.

²³ See Caesar 1981, p. 170.

²⁴ See among others Deutsche Bundesbank 1989, p. 11 and after; Deutsche Bundesbank 1967, Management Report, p. 29. The Bundesbank took the view that its stability policy was not blocking the employment objective in the medium and long terms, and that trade unions and employers simply had to adapt accordingly. Thus the Bundesbank is tackling the current unemployment problem. Köhler, Member of the Board of Directors, says: "With the current challenge of higher unemployment, the Bundesbank is attempting to create a monetary context which will permit appropriate economic growth and contribute to the elimination of unemployment, while at the same time maintaining approximate price stability" (Köhler/Pohl 1985, P.21 and after). For a criticism of this interpretation, see Rüdiger Pohl in Köhler/Pohl 1985, p. 32 and after). However, it must be added that in the past, there were also phases in which the Bundesbank pursued economic and employment policy objectives. See p. below.

naturally produces a conservative policy³⁵.

2.2.2 Functions of the Bundesbank

From the systematic point of view, Art. 3 of the Bundesbank Law allows us to distinguish four different functions of the German monetary authorities: it is the bankers' bank, the issuing bank, the State bank and the custodian of currency reserves.

As the bankers' bank, it is responsible for the refinancing of commercial banks, in other words supplying credit institutions with Central Bank credit which can be changed into cash, so that the commercial banks are always liquid vis-à-vis their customers. Commercial banks are also dependent on Central Bank money supply policy via their obligation to keep minimum reserves at the Central Bank. In addition, the Bundesbank settles part of the non-cash payment transactions at home and abroad (in 1987, about one-third of German credit institutions' credit transfers and collection activities were carried out through Bundesbank facilities³⁶). Finally, the Bundesbank is also involved in banking supervision, however, this function lies primarily with Federal Supervisory Office for Credit (Bundesaufsichtsamt für das Kreditwesen) which reports to the Federal Minister of Economics³⁷.

In this connection, the function of the Bundesbank as a State bank is particularly important. In this capacity, the Bundesbank looks after the technical side of the Federal Government's and the Länder's monetary transactions, and grants them so-called cash credits to a limited extent in order to bridge short-term

³⁵ Moreover, it should be remembered that the Bundesbank is part of the banking sector, and banks always prefer high interest rates as they then earn more.

³⁶ See Deutsche Bundesbank 1989, p. 20)

³⁷ See Caesar 1981, p. 178 and Deutsche Bundesbank 1989, p. 20.

deficits in the budget³⁸. For instance, the Federal Government's tax deadlines lead to momentary cash fluctuations as government credit with the Bundesbank is generally exhausted just prior to the tax deadlines. In order to continue with expenditure, the government falls back on cash credit for a few days. The cash credit ceiling amounts to DM 6 billion, with the Länder being assured of a total of DM 2.6 billion. In addition, state monopolies such as the railways and the post, as well as the Equalisation Fund and the ERP special fund, also have small ceilings. These are in any case only upper limits, and do not form the basis for any rights³⁹. The Bundesbank may acquire bonds issued by the government to finance the budget only on the open market and at its own discretion. Para. 21 of the Bundesbank law states expressly that the Bundesbank can only acquire these bills in order to regulate the money market. To finance their budgets, the Federal Government and the Länder must borrow money on the open market⁴⁰. In most cases, the Bundesbank acts as a fiscal agent⁴¹. Thus the Bundesbank has a very strong position as regards the fiscal component of Central Bank money creation. The government cannot finance its budget with Central

³⁸ See para. 20 Bundesbank law

³⁹ Any treasury bills purchased by the Bundesbank are also included in the calculation of the credit ceiling. The Bundesbank can refuse to permit use of the ceiling for monetary policy reasons, or subject this to conditions.

⁴⁰ For the creditor structure of state indebtedness, see Duwenddag, *inter alia*, 1985 p. 346.

⁴¹ This is the case for loans, treasury certificates and treasury bills. For these there exists the Federal loan consortium. Conditions governing public securities are set in close cooperation with the Bundesbank. With regard to promissory note borrowings (Schuldscheindarlehen) cooperation by the Bundesbank is not provided for in law. Nor does the Bundesbank issue any Länder bonds. Issuing of bonds is organised by the Länder themselves, in agreement with the Bundesbank.

Bank credit ⁴².

With regard to international monetary policy, the powers of the Bundesbank and of the Federal Government are more evenly divided than in the national arena. The Bundesbank administers the national currency reserves and therefore controls the currency intervention instrument. In the EMS, it must keep currency fluctuations within the range laid down, by means of intervention and monetary policy, and must ensure "orderly conditions" in the area of flexible exchange rates ⁴³. However, the fixing of exchange rate parity, decisions concerning control of capital movements and participation in international organisations lie within the remit of the Federal Government ⁴⁴. The Bundesbank merely has a consultative right as regards changes in parity ⁴⁵. Thus the Bundesbank only functions as a technical executive organ as far as external monetary policy is concerned.

Finally, the Bundesbank has the sole right to issue DM banknotes, and therefore functions as an issuing bank ⁴⁶.

⁴² In any case, the discussion regarding the financing of public works by means of interest-free issuing bank credit is still being carried on by Keynesians.

⁴³ See Köhler/Pohl 1985, p. 40.

⁴⁴ The division of power between the Bundesbank and the Government in the area of exchange rate policy is in any case not clearly regulated. Thus, the Bundesbank can pursue an exchange-rate oriented strategy, as it did in periods during which the DM tended to devalue. government has never stopped it from doing this in the past.

⁴⁵ However, this right is regulated only internally in an unpublished administrative agreement between the Federal Government and the Bundesbank as the successor to the Bank deutscher Länder at the time of the Federal Republic's accession to the IMF. Cf. Caesar 1981, p. 172, Ana. 7.

⁴⁶ SEe para. 14 of Bundesbank law.

2.2.3 The Bundesbank's monetary and interest policy instruments

The instruments granted to the Bundesbank in paragraphs 15 to 17, 19 and 21 to 25 cover all the monetary policy tools which would usually be characterised as global⁴⁷. On the other hand the founders of the Bundesbank specifically avoided giving the Bundesbank direct and selective instruments, a position taken also during discussions on the extension of issuing bank powers to include active minimum reserves or credit ceilings in the 60s and 70s⁴⁸. The reason: the Bundesbank, scientists and also politicians feared that the independence of the Bundesbank would be jeopardised by this⁴⁹ - either through an expected increase in political pressure on the issuing bank, or through the envisaged direct participation by the government in the decision-making process⁵⁰.

The starting point for the German Central Bank monetary policy is the inter-bank money market. By means of its interest and liquidity policy, the Bundesbank influences the money market rates and therefore the behaviour of private investors and

⁴⁷ Moreover, para. 15 contains a general clause for the currency policy instrument, by virtue of which the Bundesbank determines "the bases of its credit and open market business"; thus the law also provides for new variations. The pension security operations successfully implemented by the Bundesbank since 1978 to control the money market is not mentioned in the law but is covered de jure by the general clause.

⁴⁸ See Caesar 1981, p. 177 and after.

⁴⁹ See the detailed documentation by Robert 1978.

⁵⁰ Thus when discussing the 1967 credit ceiling, it was envisaged that the Bundesbank would be expressly empowered to do this by the Federal Government. Similarly, the 1973 draft Bundesbank law contained the requirement, applying the so-called two-key theory, that a decree setting up an asset growth reserves or credit limitation required the approval of the Federal Minister of Finance.

consumers. The Bundesbank's global instruments: in the context of its refinancing policy (providing credit to credit institutions), the Bundesbank can, at its own discretion, determine interest rates as well as the quantitative (quotas) and qualitative limits (requirements to be met for bills to qualify for rediscounting) for rediscount business (purchasing of bills, inter alia) and loans on securities (or "Lombard" loans) ⁵¹.

Para. 16 of the Bundesbank law allows the Bundesbank to require credit institutions to place certain interest-free minimum reserves with it to influence the circulation of money and the granting of credit. Minimum reserves (current account assets on a Bundesbank giro account) must be held against the obligations arising out of sight deposits, fixed deposits and savings as well as borrowed money, with the exception of obligations towards credit institutions also subject to minimum reserve obligations ⁵². The Bundesbank can lay down the reserve rates within legally fixed ceilings ⁵³.

⁵¹ The way in which banks share out the rediscount quotas (see for instance Fuhrmann 1986, p. 184 and after), in the view of some critics, benefit some banks. Rüdiger Pohl writes in this connection: "Certain bank structures are rewarded, as it were, while others are penalised. It cannot be global monetary policy instruments to produce structural by-products in the banking system." (Köhler/Pohl 1985, p. 38). On the refinancing practice, see Köhler/Pohl 1985, p. 12 and after.

⁵² In the spring of 1986, the minimum reserve system was readjusted. Since then, compulsory reserves have been extended to book obligations with maturities of under four years, and bearer bond obligations maturing within two years. See Deutsche Bundesbank 1989, p. 59.

⁵³ See para. 16 indent 1 of Bundesbank law.

Another Bundesbank instrument is the open market policy which is mainly used for short-term refinancing⁵⁴. The open market policy includes the buying and selling of bonds by the Central Bank for its own account, in other words purchasing them with Central Bank money, on the open market.

Foreign exchange policy instruments include the so-called currency swap transactions and currency pension deals transactions (transactions to safeguard exchange rates)⁵⁵, which have been practised since the summer of 1979.

Such transactions are not explicitly mentioned in the Bundesbank Law, but are covered by the Bundesbank's powers regarding currency transactions (para. 19 indent 1 no. 8 and 9 of the Bundesbank Law).

Finally, deposit policy is mostly used as an instrument by the Bundesbank. Under para. 17 of the Bundesbank Law, the State, the Special Equalisation Fund, the ERP special fund and the Länder are obliged to keep their liquid resources at the Bundesbank. Any deposit or investment with a credit institution must first be approved by the Bundesbank. The reason for this provision is mainly to prevent public bodies structuring their investments in a manner which would run counter to Bundesbank policy. As this instrument only gives the Bundesbank slight possibilities of control, and in addition it cannot influence the time and extent of the availability of public resources, it would be more correct to speak about a "public investment policy"⁵⁶.

⁵⁴ See Köhler/Pohl 1985, p. 16.

⁵⁵ In a swap transaction, the Bundesbank buys or sells currencies in the spot market, and simultaneously sells or buys them on the future market. The difference between the futures rate and the spot rate, calculated as a percentage per annum of the spot rate, is the swap rate. The swap policy is usually applied by the Bundesbank to ward off influxes of speculative currency. See Deutsche Bundesbank 1989, p. 79ff.

⁵⁶ Following Caesar 1981, p. 177.

Thus far, I have described the autonomy of the Bundesbank as laid down in the provisions in the Bundesbank law. To summarize, we can differentiate between the following characteristics of issuing bank autonomy:

1. Unlike all other state bodies - with the exception of the Federal Auditor General's Office - the Bundesbank does not have a supervisory body. Under the provisions of the Bundesbank Law, it is answerable only to itself.
2. Not only is the Bundesbank not obliged to comply with government directives, but through the obligation of allegiance, which was planned as a compensatory measure, the Bundesbank cannot be forced to take any particular measures.
3. The Central Bank Council is particularly independent from the point of view of staff, since it is practically impossible to recall its members during their eight-year terms of office.
4. The Bundesbank Law gives the custodians of the currency the widest possible scope of interpretation as regards their central task of safeguarding the currency.
5. The Government cannot finance the budget through Central Bank credit.
6. The Bundesbank possesses indirect, flexible monetary policy instruments which allows it to maintain complete independence.

2.3 The organisational structure of the Bundesbank

I shall now go on to describe the internal structure of the German Central Bank. In this description the decentralised nature of the Bank and the resulting decision-making structures are of special interest.

The foundation stone for the current Central Bank system was laid down by the Western Allies. In West Germany in 1948, they established a two-tier central bank system similar to the US Federal Reserve. There were legally independent Länder Central Banks in the individual regions, and a head institute, the Bank deutscher Länder (German Länder Bank), which had the sole right to issue banknotes and whose Central Bank Council laid down monetary policy. Under Art. 88 of the Constitution, which came into force in 1949, the Federal Government was obliged to set up a currency and issuing bank in the form of the German Bundesbank, and to replace the occupation law applicable until then with German law. There were controversial views expressed during the legislation procedure to set up the Bundesbank. The question arose as to whether the two-tier structure should be maintained or whether one should return to the concept of the earlier Reichsbank. The result was a compromise in the Bundesbank Law of 1957: by law, the Bundesbank is a unitary bank, but at the same time it is organizationally decentralised. There is a Directorate at the Bank's Frankfurt headquarters, and a Regional Central Bank (Landeszentralbank) in each region. The Regional Central Banks, which until then were institutions with their own legal status, balance sheets and income statements, were changed into non-independent administrative head offices of the German Bundesbank, whilst maintaining the "Landeszentralbank" designation.

The supreme Bundesbank body is the Central Bank Council. It approves the Bank's monetary and credit policy, draws up management and administration guidelines, and governs the Directorate (Direktorium) and the Management Boards of the Regional Central Banks. In certain cases, the Central Bank Council can issue instructions to the Directorate and the Management Boards of the Regional Central Banks. Because of its decisive function in the Bundesbank's opinion-forming structure, the Central Bank Council is also known as the "legislative body"⁵⁷.

The following people sit on the Central Bank Council: the President of the Bundesbank who is Chairman, the Vice-President (deputy chairman) and the other (up to eight) Members of the Directorate as well as the eleven Presidents of the Regional Central Banks. The Central Bank Council takes its decisions as a collegiate body on the basis of a simple majority, without the President having a deciding vote. Each member has one vote. To adopt decisions, at least two-thirds of the members must be present⁵⁸.

Central Bank Council meetings are held every two weeks, and in exceptional cases extraordinary meetings can be convened. Meetings always follow the same procedure: first of all, the President reports on international meetings, for instance, or meetings with the Cabinet. Then, the Head of the Directorate's Department of the National Economy, Vice-President Helmut Schlesinger, describes the general economic situation. Then come the Heads of the Credit, Money and Capital Market Department

⁵⁷ See Spindler v. Becker/Starke 1973, p. 114.

⁵⁸ As a rule, the Central Bank Council members must all be present, although deputies (in the case of LZB Presidents, their Vice-Presidents) can be sent only as observers with the right to speak but not to vote. In addition, the Council members consider that it is their duty to attend these meetings.

(Claus Köhler) and of the Currency Department (Leonhard Gleske⁵⁹). Proposals are usually made by the respective Heads of Department. Decisions are generally prepared at the Frankfurt Directorate, where the Bundesbank's staffs are also established⁶⁰. Indeed, it can happen that Regional Central Bank Presidents make proposals⁶¹, but as a rule their initiatives are dealt with outside Central Council meetings.

The taking of sides between the Directorate on the one hand and the group of Regional Bank Presidents on the other does not apparently play a decisive role as natural groupings are usually broken down when it comes to voting. In fact, both the members of the Directorate and the Presidents between themselves come to an agreement before each Central Bank Council meeting, but the meetings proceed like "open warfare", as one of the people I talked to put it. Neither the Directorate members nor the Presidents allow themselves to be convinced one hundred per cent of a common viewpoint in advance, and during the meetings further work must be done to convince people of a particular view, and to swing them towards a majority, and it is still possible for proposals to be rejected⁶². In any case, as far as persuasiveness

⁵⁹ Gleske will be retiring in the autumn. His successor will probably be Hans Tietmeyer (CDU), the Secretary of State in the Federal Finance Ministry.

⁶⁰ The regional Central Banks may also establish their own staffs, but all more or less take into account, depending on the ambition of the LZB President, that they are part of one Bundesbank and that in any case decision-making is the job of the Central Bank Council.

⁶¹ This was confirmed to me by all the people I talked to. For example, some decisions regarding the lowering and raising of discount rates are taken by the regional Presidents. When the contango exchange business is carried out, communications from the regional Presidents are presented which practically amount to petitions, as they had hoped for a different arrangement.

⁶² The fact that the LZB Presidents occasionally vote against the Board of Directors is demonstrated in a Central Bank Council Resolution of April 1989, when the Presidents managed to increase the bank rate against

and valid arguments based on advance information are concerned, the Directorate has the upper hand⁶³. How much influence an Regional Central Bank President can have in the Central Bank Council depends on his personality and ambitions. Although, as a rule, only majority decisions are taken in the Council, there is the principle that all the Central Bank members must publicly support the resolutions of the Council.

The Directorate, which is the "central executive organ" " of the Bundesbank is responsible for implementing Central Bank Council resolutions. The Directorate consists of the Bundesbank President and his Vice-Presidents (they also fulfil this function in the Directorate), and up to eight other "suitably qualified" members. The Directorate is responsible for all transactions of an inter-regional nature in the central area of its activities. The following are expressly mentioned in the Bundesbank law⁶⁵:

- "1. Transactions with the Federal Government and its special funds
2. Transactions with credit institutions which have centralised tasks throughout the country
3. Foreign exchange transactions and transactions with other countries
4. Transactions on the open market."

The Directorate usually meets once a week, as and when required. Decisions are taken on the basis of a simple majority; at least half of the members must be present for the vote. Unlike the procedure in the Central Bank Council, the Chairman has the casting vote.

the wishes of the Directorate. See Die Zeit, No. 18/89 (28.4.89).

⁶³ In particular, Vice-President Schlesinger appears to be an opinion leader.

⁶⁴ See Spindler v. Becker/Starke 1973, p. 142.

⁶⁵ In para. 7 indent 1 of the Bundesbank law.

Other executive bodies are the Managing Boards of the Regional Central Banks ". The Bundesbank maintains an administrative head office (Regional Central Bank - Landeszentralbank) in each region, with a Managing Board consisting of a President, a Vice-President and one or two other Members depending on its statutes. The Managing Boards of the Regional Central Banks are to be seen as regional executive bodies of the Bundesbank. The Regional Central Banks are responsible for carrying out the issuing bank's tasks in the individual regions⁶⁷. Their duty is to refinance the banks located in their respective regions, provided that transactions with credit institutions are not reserved for the Directorate. They also conclude transactions with the region and its local authorities, are in charge of the clearing systems in their respective regions, and participate in banking supervision⁶⁸. Meetings of the Regional Central Bank Managing Boards are held on demand. Particularly before each Central Bank Council Meeting, the Presidents allow themselves to be advised by the Management Board. The President also has a casting vote here. It should also be pointed out that the Regional Central Banks also maintain a number of so-called advisory committees (Beiräte), consisting of representatives of the commercial banking industry, trade, agriculture, workers and employee organisations. However, these are merely fora through which the

⁶⁶ See para. 5 and 8 of the Bundesbank law.

⁶⁷ To this end, the Regional Central Banks maintain contacts with the commercial banks, with the Managing Boards of commercial enterprises, with the economic policy bodies in the relevant region, ie. the regional Finance and Economic Ministries. The Central Banks do not have direct contact with the Bonn Ministries. The Central Banks take part in the dialogue between Bonn and the Bundesbank exclusively through their membership on the Central Bank Council.

⁶⁸ Para. 8 of the Bundesbank law expressly states: "1. Transactions with the Land and with the public authorities there. 2. Transactions with credit institutions in their areas, provided these are not reserved for the Board of Directors under para. 7 intent 1 no. 2".

Bundesbank can publicise its policies.

The President of the Bundesbank is not an organ of the Bundesbank, but to the public, he often appears to be its strongest spokesman⁶⁹. Among other things, he chairs the press conferences after the Central Bank Council meetings. The President also has a special position as he acts as Bundesbank representative vis-à-vis the Government and in the area of international monetary policy, however he is always tied to the decisions of the Central Bank Council. The President has no power to issue instructions or guidelines to the Central Bank Council, but he does have a kind of moral and technical authority. As a rule, the President belongs to the majority faction in Parliament⁷⁰.

In summary, it should be noted that:

1. The German Bundesbank is a single bank. Its federal basis is limited to the regional implementation of its duties and resolutions.
2. The Directorate has the most power as regards the preparation of decisions and passing of resolutions in the Central Bank Council.
3. The Regional Central Bank Presidents as a group operate to a considerable extent as a corrective mechanism within the Central Bank Council.

⁶⁹ The other Central Bank Council Members are to a large extent not known to the public - see Sann 1967, p. 45.

⁷⁰ A Bundesbank President cannot allow himself to be permanently voted down in the Central Bank Council. He must adhere very closely to the deliberations which precede decisions, and act accordingly. Moreover, according to the views of independent observers, the Vice-President currently has a significant influence on Bundesbank policy. The Vice-President, with his very close contact with the apparatus, has a certain information and argumentation advantage, whilst the President acts more as the representative and seller of policies. The fact that this division of work has a method behind it was also demonstrated by the Klasen/Emminger team.

3. The relationship between the Bundesbank and the Federal Government

The Bundesbank and Government measures to control macro-economic processes are extremely closely interlinked in two areas: in monetary and fiscal policy and in the area of foreign exchange policy. As far as the relationship between the Bundesbank and the Government in these two contact points is concerned, this is shaped by changing underlying economic conditions and changing concepts in economic and monetary policies. The experiences of the German Central Bank system can best be understood from a historical perspective. As we go on to look closer at three chronological phases of this relationship, special attention should be paid to the conflicts, from which it becomes obvious that the Bundesbank has always been able to assert its views -- even on occasions when these have gone beyond the Bundesbank's scope of responsibility - and that stability policy always has priority over other economic policy objectives in the Federal Republic.

3.1 The phase of mutual stability policy up to the 1966/67 dispute

Undoubtedly, the Bundesbank is one of the cornerstones of the West German export model par excellence⁷¹. Right back in the days of the Bretton Woods fixed exchange rate system, its steady and permanent commitment to price level stabilisation⁷² (particularly after the inflation phase of the first years following the currency reform, with its massive devaluation in the DM), alongside a year-long under-evaluation of the DM with a dollar parity of 4.20 DM, made German goods very competitive on world markets. The Government's economic policy in turn provided support with a restrictive budgetary policy, and with a system of tax incentives ensured investment and good return on capital. In this way, in the early 60s, the Federal Government and Bundesbank were equally interested in stable prices.

With regard to the question how stability could best be achieved, the Bundesbank and Government had their first clash at the beginning of the 60s, from which for once the Government emerged as the winner. At the end of 1960, the Government placed exchange rate stability (with a deliberate acceptance of the risk to price level stability) in the forefront of its policy. The reason: its restrictive policy pursued since the spring of 1959

⁷¹ For a description of what they call the "neo-mercantilist export model" of the Federal Republic, see Altvater/Hübner 1988.

⁷² How low the devaluation of the Federal Republic's currency has been may be demonstrated by a single figure: since the 1949 monetary reform, the DM has only lost an annual average of 2.7% in value at home. Moreover: the Bundesbank's defence of stable national prices is, contrary to the interpretation given here, generally related to the German people's special fear of inflation. Undoubtedly the Bundesbank law and Bundesbank policy are the products of previous experiences involving two periods of inflation. This fact does not however deny the more or less conscious use of this policy to deliberately strengthen exports.

was being undermined by the external economic situation. The Government recommended a revaluation in order to check the upward trend in prices. In March 1961, an insignificant revaluation was finally carried out (which was followed by other countries), after the Bundesbank, clearly under massive pressure from the Government⁷³, had agreed to this.

However, the disputes between the Bundesbank and Government in 1966/67 were considerably more serious. The reason for this was that the underlying economic conditions had changed. Labour had become scarce, and the unions had at the same time turned to an "active wages policy" (Victor Agartz). As the growth rates for labour productivity levelled out throughout the economy, firms had to invest ever greater amounts of capital to increase productivity, and unit wage costs increased⁷⁴. The result: capital productivity and profit rates fell. Firms were then obliged to compensate for falling profitability by increasing prices. Inflation rose from 2.4% (1964) to 3.6% (1965) and finally to 4.5% (1966).

The Erhard Cabinet declared that stability must have priority, and directed calls for moderation to the two sides of industry, at the same time, however, as pursuing an unambiguous pro-cyclical financial policy. The excessive, inflationary demand for credit in 1965/66 was also caused in part by the considerable credit demands of a deficit public budget. The Bundesbank saw itself as compelled to counteract the price increases, and to introduce credit restrictions. The momentary negative balance of payments came to its assistance. Unlike in other years when excessive domestic demand had been accompanied by high balance of payments surpluses, the Bundesbank was able to effectively reduce the demand for credit. In May 1966, the Bundesbank raised

⁷³ The former Economics Minister, Erhard, stated briefly to the press if the Central Bank Council had rejected the revaluation proposal, he would have vetoed the planned reduction in minimum reserves (quoted in the *Industriekurier* (18.3.61)).

⁷⁴ See Altvater/Hübner 1988, p. 16.

the discount and Lombard rates⁷⁵ in spite of the emerging economic downswing. The effect of this was that investments fell, as did the Gross National Product, and unemployment rose, at the highest point of the recession, from 150,000 to 600,000.

For the first time, the Bundesbank was in the firing line for criticism. Sharp attacks came from special interest groups and also from an otherwise supportive press⁷⁶. The Committee of Experts, set up in 1963 to assess general economic developments, laid the blame for the recession squarely on the shoulders of the Bundesbank, as it had increased the recessionary trends with its pro-cyclical, restrictive monetary policy. The growing dispute with the Federal Government⁷⁷ turned into open disagreement in November 1966, when the Ehrhard Government called on the currency custodians to abandon its restrictive measures, which the Bundesbank refused to do in spite of an easing off of prices. Thus the Bundesbank in some ways helped to bring down the Erhard government, which was followed at the end of 1966 by the "Big Coalition" - although this was certainly unintentional. At that time it also became clear that the Bundesbank considered itself as a kind of "secondary government" ⁷⁸. The Bundesbank President at that time, Karl Blessing, said that the recession was healthy, among other things, for labour discipline, and in spite of public criticism, involved the Bundesbank deliberately in a field

⁷⁵ In 1965, it had already raised the discount and Lombard rates twice, by half a percent each time.

⁷⁶ See the references to this in Caesar 1981, p. 189.

⁷⁷ One element of potential conflict between the Bundesbank and government was for the first time the increasingly difficulty of the task of Debt Management due to the Government's restrictive policy, a problem which became a lot more serious in the 70s and early 80s. The reason: as a result of the stabilisation process, government revenue dropped and at the same time the capital market was not anxious to finance public borrowing.

⁷⁸ See Robert 1978, p. 19.

obviously outside its scope".

With the fall of Ehrhard, the principles of global control of the national economy, as practised in the US and in almost all western countries, were taken on board in the Federal Republic too. The change in economic policy model was expressed in the "Stability and Growth Law" of 1967. This obliged the Federal Government and the Länder to pursue the objectives of an anti-cyclical fiscal policy, but contrary to Keynesian logic, left Bundesbank autonomy untouched⁷⁹.

From then on, the priorities of the Bundesbank and the Federal Government were no longer identical. The Bundesbank continued with its objective of safeguarding the currency. On the other hand, the new Government under Chancellor Kiesinger, with Karl Schiller as Economics Minister, stressed their responsibility for the national economy, a clear departure from the line taken by their predecessors. Based on systematic planning they looked to play an active role in the economy in order to safeguard currency stability, but also to promote the foreign trade balance, growth and full employment. To this end, they created "Concerted Action"⁸¹. This opened up to the Federal Government the

⁷⁹ See Robert 1978, p. 19.

⁸⁰ See Scharf 1987, p. 153.

⁸¹ Concerted Action lasted until 1977 when a complaint of unconstitutionality by employers about the 1977 worker participation compromise gave the trade unions the opportunity to refuse to cooperate. Already in 1969, Concerted Action had passed its peak, and after Schiller's resignation in 1972, the Government did not want to have anything more to do with this instrument. The reason for the erosion of the Concerted Action was that, at the outset, the discussions between the chairmen of the big industrial unions and the central industrial and employers' associations on the one hand and the relevant ministers and the Bundesbank President on the other, required mutual understanding on the assessment of the economic situation and its requirements - and for the constraints each party was working under. However, this function was lost to a considerable extent as the number of participants increased on the principle of "must-be-there-also".

possibility of bringing together the two sides of industry and the Bundesbank in a wide-ranging but formally non-binding consensus on their respective economic policy demands.

As a result it was possible to overcome the recession with an initially sluggish but all the more effective concertation. Under pressure from the Kiesinger Government and public opinion to relax its interest rates, and after hesitating for a short while in order to demonstrate its independence, the Frankfurt monetary authorities reduced these initially on 5.1.67, with further reductions following. At the same time, the Bundesbank reduced the minimum reserve rate by gradual steps thus releasing more liquidity. The Bundesbank tackled the Federal budget with cut-backs and increased income. This in turn induced the Bundesbank to approve an economic growth promotion programme (a so-called emergency budget). The trade unions did one more thing: they kept their wage agreements at times below the Government's annual economic targets.

The Bundesbank's doggedness in pursuing its price level stability objective was revealed by the differences of opinion between the Bundesbank and the Government in 1967. In April, the Bundesbank - with full support from employers, but under continuing attack from the unions - rejected the need for a second emergency budget. For his part, Economics Minister Schiller branded "the policy of halpercentage toddler's steps" as one of the reasons for the low investment trend in the German economy⁸². It is clear from Schiller's statements how restricted the Big Coalition felt in its economic policy during the first months of its government

What had started as serious discussions carried out in small groups and aimed at mutual understanding, gradually turned into mass meetings, at which only prepared statements were read out. The dialogue between the German Trades Union Federation (DGB) and the Bundesbank as good as petered out after the end of the Concerted Action. The DGB Committee and the Bundesbank's Board of Directors simply meet every two years for an exchange of views.

⁸² See Deutsche Bundesbank 1967a, p. 4.

due to the activity of the Central Bank.

3.2 The joint struggle against inflation in the early 70s: the controversy over the question of safeguarding the external trade position, the temporary division of tasks between the Bundesbank and the Government and the transition to economic policy coordination under the leadership of the Bundesbank

With the revival in the economy, inflation again started at the beginning of the 70s. The strengthened labour movement was able to obtain considerable wage increases, and the rise in unit wage costs was significantly above the inflation rate. This domestically-produced inflation was fuelled from abroad by the pressure of the US dollar. This was because the American government had financed the Vietnam war with central bank loans instead of tax increases, thus increasing the amount of dollars available worldwide and inflation in western countries. Countries with above average price stability, such as the Federal Republic, suffered from threatened revaluations and attracted speculative money inflows.

Whenever the Bundesbank tried to neutralise this inflationary influx with a restrictive monetary policy, the only effect was to further enhance the attractiveness of the DM. The only solution would have been a massive revaluation. This was refused firstly by the CDU/CSU partners in the Big Coalition and later by Economics and Finance Minister, Schiller¹³. Consequently, the Government and Bundesbank jointly forced the trade unions to accept wage constraints. In the course of its reform and expenditure policy, the social-liberal coalition temporarily abandoned the stability policy in 1971.

¹³ See Scharpf 1987, p. 159 and Robert 1978, p. 22. This policy was also fully supported by the industrial associations.

There was also agreement on the need to safeguard the foreign trade position. Despite this a dispute flared up between Minister Schiller, then Minister of both Economics and Finance, and Bundesbank President Klasen, on the measures required for this. Schiller argued for, among other things, a tightening of the cash deposit "Bardepot" regulation under which domestic borrowers were obliged to immobilise at the Bundesbank a certain percentage of any money borrowed abroad. Klasen in turn pleaded for controls on capital movements. The Cabinet, which in matters of currency policy interest, is advised by the Bundesbank President, implemented Karl Klasen's demands after a dramatic meetings, and agreed to apply exchange controls. For the first time, a Central Bank President caused the Federal Minister concerned to be defeated in a Cabinet vote, which resulted in Schiller's resignation in the summer of 1972⁴⁴. The confrontation between Klasen and Schiller finally reached its peak with a mutual settling of accounts in the form of several newspaper articles⁴⁵.

But the dilemma remained: the exchange rate adaptations delayed by the Government for political reasons led to a further inflationary foreign currency inflow, which also increased import prices. The Bundesbank was powerless to counter this effectively. Only with the lifting of exchange controls in 1973 did the Bundesbank finally gain the currency policy freedom for which it had been hoping for a long time. With the floating of the mark, the Government's ability to fix exchange rates became insignificant on a practical level. From then on, the currency markets have determined exchange rates, and the Bundesbank can influence these through its interest and money supply policies, and by means of direct intervention⁴⁶.

⁴⁴ See the assessment of this in Robert 1978, p. 2ⁿ.

⁴⁵ See Muthesisus 1972, p. 807.

⁴⁶ Free floating was however limited by the so-called currency snake (in which the Federal Republic, France, the Benelux countries, Denmark, Norway, Sweden and de facto Austria, took part) and since 1979 by the

With the end of speculative currency inflows, the Bundesbank and Government decided on a new stability policy approach (consumer prices had risen by 7% in April 1973). The Bundesbank raised the discount rate in steps from 3.5% in October 1972 to 7% in June 1973, and kept it at this very high level until October 1974. Lombard credit was stopped between 1973 and 1974, and temporarily replaced by so-called "Special Lombard credit" which could be stopped at any time and the interest rates for which were fixed on a day-by-day basis". In addition, Banks' rediscount quotas were further reduced. The Government contributed to cutting back on the money supply by depositing the proceeds of a stability loan with the the Bundesbank. In May 1973, the Government decided on a second stability programme, under which private investments were subjected to taxation and a stability supplement was added to income and corporation taxes. At the same time, public expenditure was cut back or stretched out over time". The result was so-called stagflation (stagnation plus inflation).

As inflation continued unabated, the Bundesbank became the first central bank in the world to establish an annual money supply target in December 1973", thus openly declaring its support for a monetary policy concept. The direct cause of this lay in the

EMS. Since 1985, the major western industrialised countries (the Big 7) have been trying to keep exchange rates within certain ranges (Plaza Agreement). The various Finance Ministers and Central Bank Governors met at Economic Summits and meetings of the IMF and World Bank to discuss this, thus the Federal Government must convince the Bundesbank with good reasons, and cannot force it to intervene.

- " See Deutsche Bundesbank 1989, p. 52; the special securities credit rate reached a record level of 13%.
- " See Scharpf 1987, p. 163.
- " It developed the so-called concept of potential money supply control which limited increases in money supply to the expected growth in real productivity potential plus the unavoidable inflation rate.

effects of the first oil crisis in the spring of 1973.

Up until the middle of 1974, there was uncertainty as to whether the slow-down in the economy was only temporary or whether it would lead to a recession. The Finance Ministry decided to pursue a cautiously expansive finance policy, as an initial reaction, in order to compensate for existing gaps in demand due to price increases. At the end of 1973, almost all the measures aimed at depressing private investment activity were suspended. Only the stability supplement remained until the middle of 1974. In February and December 1974, the Government decided to take additional measures to promote investment.

On the other hand, the Bundesbank stuck to its restrictive policy. The Frankfurt currency custodians were mainly concerned that the oil crisis would bring a risk of further accelerated price increases. They were of the opinion that the transfer of income towards OPEC could only be absorbed by reduced income expectations on the part of industrialised countries, and could not be replaced by artificially produced demand⁹⁰. Consequently, one of the most serious disputes ever occurred between the Bundesbank and the trade unions, which had started a wage policy offensive.

It is likely that the Bundesbank and Government policies, although they obviously clashed, were based on a wide degree of mutual agreement. At that time, the Bundesbank was speaking about a division in the respective functions of monetary and financial policy, with the role of monetary policy being to maintain stability, whilst it was the "task of financial policy" to compensate for the drop in domestic demand caused by the increased oil prices by pursuing a cautiously expansive policy⁹¹. This led to criticism of the social-liberal coalition and the Bundesbank (but not to the same extent), particularly from the

⁹⁰ See Deutsche Bundesbank 1974, p. 8.

⁹¹ Deutsche Bundesbank 1974, P; 18.

trade unions, because of the resulting massive unemployment.

Thus to some extent, the Bundesbank's independence made the Government's political responsibility easier to bear and even gave it more room for manoeuvre: in the FDP-led Economics Ministry, as well as in the Finance Ministry and Chancellor's Office, there were a series of politicians and leading civil servants who considered that the SPD's expenditure policy was as dangerous as the trade unions' inflationary redistribution policy". "They considered that strict corrective measures were necessary, and as neither Parliament nor the Government was politically in a position to apply these, then a strengthening in the Bundesbank's autonomous powers (in the context of its new money supply policy) could only be welcomed - in any case, so long as the personal relations with the leading members of the Directorate remained as good as they were at that time."²²

On the other hand, economic developments were demonstrating that a restrictive monetary policy was in a position to neutralise the impetus of an expansive fiscal policy and on its own to produce unemployment". This historic realization contradicted the theoretical concepts of the Keynesianism applied in the Federal Republic and enshrined in the Stability Law, by virtue of which fiscal policy was by far the most important instrument of anti-cyclical overall control. In this concept, monetary policy had only an accompanying and supporting role. Under the Federal Republic's institutional conditions, the predominance of fiscal policy was not at all certain. The SPD Bundestag group, under pressure from the trade unions, intended to oblige monetary policy to comply with all four stability law objectives in future, and it prepared a corresponding amendment to the Bundesbank Law.

²² See Scharpf 1987, p. 170 and after.

²³ Scharpf 1987, p. 171.

²⁴ See Scharpf 1987, p. 175.

In this situation, the concept, supported by the Committee of Experts, of potential-oriented control of the money supply control took on strategic importance for the Bundesbank. It gave the Bundesbank the opportunity, as Fritz Scharpf impressively states, "to withdraw from the coordination process but to uphold the demand for coordination, thereby placing the adaptations necessary for successful coordination (...) firmly on the shoulders of the Government and the trade unions". From now on, it was able, with complete authority, to plead for better economic policy coordination - the two sides of industry and the Government were now informed in advance about the monetary supply basis for the coming year. It was then their job to decide in the light of this constraint"⁵.

It was public opinion which in the end made it impossible to amend the Bundesbank Law. Responsibility for the economic recession was attributed to the trade unions as well as to the "oil sheiks". In addition, the Government was forced to seek the support of the Frankfurt monetary authorities in order to manage the crisis. These in turn began to relax their interest rates straight away.

3.3 The clash between monetary and fiscal policies (1979-1982)

In 1977 and 1978, medium-term stable coordination between the Bundesbank and the Government was successfully established. The expansive fiscal policy (4-year "Investment in the future programme" of almost DM 4 billion, tax concessions for house building and industrial investments, increases in children's allowances and tax relief on salary, income and trade tax) was underpinned by a moderate monetary policy (reduction of discount rate to 3% and higher money supply targets). From the stability policy point of view, this was eased by a constant revaluation of the German mark and by moderate wage agreements, with the rise

⁵ Scharpf 1987, p. 176.

in unit wage costs dropping below the inflation rate. The demands by the other industrialised countries that the Federal Republic should act as an economic driving force for the rest of the western world forced the Government expenditure policy further forward.

When the second oil crisis occurred in 1979, and with the US high interest policy placing pressure on international interest rates and currencies, the Bundesbank felt obliged to take solo economic policy action and departed from the path of economic policy coordination. Whereas the Bundesbank had decided of its own accord in 1974 to pursue a high interest policy in Germany, it found itself this time under pressure from rising US interest rates. The interest advantage of the Dollar could have compensated for a second revaluation, but after 1979, there was no longer any reason for this. The German mark was already overvalued. Under the double burden of excessive exchange rates and the latest oil price increases, the German balance of payments suffered a deficit (1979: 6 billion; 1980: 16 billion marks). The result was that the Bundesbank had to act. It reluctantly pursued a strict policy of domestic deflation. The bank discount rate was raised from one quarter to another to its highest level of 7.5% in the summer of 1980, at which it remained until the summer of 1982. In 1981, Lombard credit was temporarily unavailable, and replaced by special Lombard credit at rates of up to 12% this time. The exchange rate stabilised. However, when US interest rates rose once again, this type of defence was no longer sufficient. The Bundesbank reacted by restricting money supply growth. Thus the growth in money supply in 1980 remained under the 5-8% target band laid down by the Bundesbank, and in 1981 was at the lower margin of the reduced 4-7% target. Interest rates peaked at 11% for bonds and 15% for overdrafts in the first months of 1981.

Unlike in 1974, there was no agreed division of roles this time between financial and monetary policy: the development of public finances was placed on an expansionist path in the 1979 and 1980 budgets. The Bundesbank's sharply restrictive policy neutralised

the impetus provided by financial policy. In addition, the steep rise in interest rates pushed up the cost of servicing the interest on the increased government debt. Thus to a considerable extent, these government deficits were incurred as a result of high interest rates⁶⁶. The then Chancellor Helmut Schmidt in particular repeatedly criticised Bundesbank policy but no longer had the political power to win an open dispute with the Bundesbank. Thus the Federal Government was powerless: it was forced to abandon its expansive budgetary policy. As Fritz Scharpf writes: "The extremely restrictive monetary policy in 1980 and 1981 necessarily ran counter not only to the Government's economic and employment policy objectives but also its political survival interests. Nevertheless, in talks one gets the impression that in the last two years of the social-liberal coalition, the Bundesbank's policy was seen as a necessity that could not be refused and a misfortune that was inevitable."⁶⁷ In any case, the Federal Government was also forced for political reasons to do a u-turn. Talk of "national bankruptcy" was circulating widely among the public and the Minister of Finance in particular was forced to consolidate the budget. Once again the lesson had to be learned that government economic policy geared to employment targets is only possible with the support of the Bundesbank.

The historical account given above allows us to draw the following conclusions on the limitations and possibilities of macro-economic control by means of monetary and fiscal policies

⁶⁶ In this connection, mention should be made of the still unresolved Crowding-Out Controversy. This started around 1975 when the public budget increased by leaps and bounds. It was assumed that the Government's high demand for credit with uncertain credit available would lead to a increased interest rates. As rising capital market interest rates produce reductions in the value of securities, there is a risk of depositors leaving the capital market. In fact, the opposite has occurred: since the early 80s, non-investive capital investments have provided greater yields than real investments.

⁶⁷ Scharpf 198è, p. 191.

in the presence of an independent issuing bank:

1. The influence of the Bundesbank on economic policy has increased since it was established. The reason for this is to be found not in the growing self-confidence of the bank, as this was pretty large in any case from the outset, but rather in the liberalisation of exchange rates in 1973 and the establishment of money supply targets.
2. Orderly economic policy coordination of monetary and fiscal policies is in principle not possible as both policy areas pursue different objectives and can take decisions independently of each other.
3. A certain amount of economic policy coordination is possible only under the Bundesbank's conditions, whereby the Government and social partners have to take account of the money supply policy of the Bundesbank, which, while only providing signals, is significant as the Bundesbank can threaten with a restrictive monetary policy if money supply targets are exceeded.
4. The willingness of the Bundesbank at certain stages to coordinate its policy with that of Bonn only occurs in periods of calm and when good personal relations exist with the Federal Government.
5. It has on several occasions proved true that an expansive financial policy is possible only with the support of, and not against the wishes of, the Bundesbank. Fiscal policy is not given priority.

Excursus: the importance of public opinion

The independent status of the Bundesbank and its steady and deliberate policy of maintaining the value of the currency enjoys immense public support within the Federal Republic¹¹. So long as it knows that public opinion is behind it, the Bundesbank does not fear conflicts with the Federal Government. On the contrary: the Central Bank is seen as a kind of institutional counterforce whose job it is to keep a tight rein on the Government's inflationary expenditure policy. This fact provides the Bundesbank with considerable political room for manoeuvre. Occasional criticism of the Bundesbank represents a minority opinion¹², and is expressed mainly by academics, trade unions and the parliamentary opposition.

The reason for the kind of taboo on discussing the independence of the Bundesbank and the high status of price stability which is inseparable from this, is generally attributed to the two German experiences of high inflation. This historical experience appears to be internalised so strongly that the Bundesbank can successfully justify its policy in public by stating that stronger monetary impetus will only create inflation - which

¹¹ A survey exists which provides evidence of this image of the Bundesbank in public opinion. The Bundesbank itself had the survey carried out. It was prepared for internal use and thus I could not gain access to it. However, it appears that the survey confirms the Bundesbank's positive image among the public, as can be read in Der Spiegel no. 5/88. It also appears that the Bundesbank President is better known than most Bonn politicians. The existence of this survey is also an indication of how seriously the Bundesbank takes public opinion.

¹² See Caesar 1981, p. 200. At the moment, public controversy is concentrated on Bundesbank policy in the light of mass unemployment, to what extent the Bundesbank is obliged or should be obliged to contribute to the fight against unemployment.

corresponds to an antiquated view of the Phillips curve¹⁰⁰. A conservative economic press also contributes its bit to the continuous reproduction of this way of thinking. The high rate of savings (15%) in the Federal Republic compared with other countries certainly has a role to play here. Anyone who tends to hoard money is naturally interested in maintaining monetary value and high interest rates. The generally positive attitude towards the Central Bank and its policy are also due in part to the Bundesbank's ability to fulfil the expectations placed in it, and the fact that the inflation rate remains comparatively low.

¹⁰⁰ See Köhler/Pohl 1985, P; 36.

4. Annex

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Bush, US Strategy and Western Europe

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**A REPORT COMMISSIONED IN THE
FRAMEWORK OF THE AGENOR AUTONOMY PROJECT**

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INTRODUCTION

This paper discusses the impact of the Bush administration on the USA's relations with its European NATO allies. It focuses on strategic issues, but necessarily ranges wider in constructing the context in which they must be examined. It is particularly difficult to undertake such an analysis during the early period of an administration as the policies unfold and almost before their consequences can be identified. One lacks the advantage of hindsight. Therefore this paper belongs to a genre Moshe Lewin calls

"the history of the present". What distinguishes such an account from a mere inventory of episodes and incidents - what makes it history - is that the events are observed as belonging to a process, a continuity that has some direction, passes through stages, and crosses some thresholds.¹

My aim is precisely that, to fit episodes and incidents into their longer term context. The process I focus on is in part the continuing relative decline of the USA as a world power and the tensions it induces, in part a series of other major changes in world politics, including in the USSR with the perestroika reforms and in western Europe with the approach of market integration in 1992.

Part I explores the tone of the Bush administration's foreign and security policies in its first eight months. **Part II** briefly describes the issue which lurks behind immediate policy questions - the continuing feasibility of US grand strategy. **Part III** examines the economic and budgetary problems which raise questions about the strategy's durability and form the background to debates about US military spending. **Part IV** discusses trends in US foreign and security policy, focusing on issues important in the trans-Atlantic context. **Part V** considers the decision-making mechanisms of US politics. **Part VI** reflects on the feasibility of making major change in grand strategy and assesses prospects for US-European relations. **The Conclusion** summarises the analysis and argument.

This paper is a contribution to the AGENOR Autonomy project. Research for it was conducted from January to September 1989 and took the form of monitoring Bush administration policies and actions during that period together with the public debate about them, supplemented by a series of off-the-record interviews in Washington. Naturally I take full responsibility for all factual reporting, analysis and conclusions.

¹ Moshe Lewin, *The Gorbachev Phenomenon* (Berkeley/Los Angeles, University of California Press, 1989) pvii.

PART I

BUSH: THE BRUSSELS NATO SUMMIT AND BEYOND

In 1980, Ronald Reagan was elected US President partly by accusing his predecessor and rival of having permitted American world power to decline. The dominant theme of his administration's foreign and security policy was the effort to renew US power through reasserting leadership over the allies, reinvigorating opposition to Third World adversaries and, until the beginning of a new détente after 1985, a new phase of confrontation with the USSR.

In retrospect, the Reagan era appears not as an effort to deal with the problems of the USA's relative decline, but as an eight year attempt to ignore it. In 1988 concern about US decline reappeared, sparked off in part by the October 1987 Wall Street crash and by the scale of the deficits in the Federal budget and the US balance of payments. Wrapped up in these worries is a package of issues related to both domestic and foreign policies, to economic performance and budgetary priorities, to US relations with both allies and adversaries. How President Bush addresses them will do much to define crucial elements of his policies at home and abroad.

Early interpretations

When he was elected it was hard to know how Bush would address them. The election campaign offered little guide. It was largely trivial, focused on personalities and simple slogans at the expense of policies. As candidate, Bush promised not to raise taxes and appeared distinctly less enthusiastic about détente than Reagan was. Otherwise, he was studiously vague, for example on how he would deal with the Federal deficit - his proposal for a 'flexible freeze' in spending seemed deliberately crafted for ambiguity - and how he would implement his slogan of 'a kinder, gentler America'.

But there were other indicators of the new administration's likely approach to foreign policy. Bush's own record strongly suggests pragmatism in all things. Combined with the careful way he downplayed détente, without going back to Reagan's Cold War rhetoric of the 1981-5 period, his record implied his administration would be cautious and conservative - pragmatic rather than visionary. He could be expected to eschew the radicalisms of his predecessor, first as evangelist of anti-Soviet confrontation, then as apostle for détente.

This reading gave little hint of the administration's detailed policies but it did set a framework and characterise the expected tone. From it one could conclude that it would be less prone to the dramatic initiatives and

changes of course which marked Reagan's tenure. Among other things, there seemed likely to be a deliberate deceleration in the pace of détente.

Early actions confirmed these expectations. The majority of appointments in the field of national security were of men marked by pragmatism, by managerial rather than ideological instincts. As Secretary of State, James Baker lacked experience in foreign affairs but, from his record as White House Chief of Staff and Treasury Secretary under Reagan, the key term which emerged to describe him was, indeed, pragmatic. A *Time* magazine profile commented that, 'Baker is uncomfortable with what he and Bush call the "vision thing"'.²

The nomination of Lawrence Eagleburger as Baker's Deputy was in the same theme. Eagleburger was a career official at the State Department, rising to the third highest position there before he retired in 1984. When he was nominated, he was president of Kissinger Associates, the former Secretary of State's consultancy company; Kissinger has long been regarded as the arch-pragmatist of American foreign policy and Eagleburger was rightly seen as being cut from the same cloth.

As National Security Adviser, Bush appointed Brent Scowcroft who held the same position under President Ford in the mid-1970s. He was also connected with Kissinger Associates and is again universally regarded as a pragmatist who will avoid the Reagan era radicalisms. Scowcroft's deputy is Robert Gates, formerly Deputy Director of the CIA, regarded as rather more hawkish, but still viewed as sitting comfortably within the dominant tone of the Bush foreign and security policy team.

The exception to this tone was John Tower, unsuccessfully nominated to be Defense Secretary, described by a former colleague as 'a man who never met a weapons system he didn't like'.³ The eventual choice was Richard Cheney. His reputation is hawkish, but less so than Tower, and he has a record of being willing to compromise when need be.⁴

In this early period, US-Soviet relations were not treated as an immediate priority. For Baker, the first priority was Third World debt.⁵ An inter-agency strategic review was set up to develop policy on arms control and given a leisurely timetable. Initial reports about these deliberations once again emphasised the themes of pragmatism and caution.

² 'Playing for the Edge', *Time*, 13 February 1980.

³ Flora Lewis, 'For a Better Man of Defense', *New York Times*, 8 March 1989.

⁴ Andrew Rosenthal, 'Cheney, a Conservative, Is Also a Compromiser', *New York Times*, 12 March 1989.

⁵ 'Playing for the Edge', *Time*, 13 February 1980.

The approach became known as 'status quo plus' or 'stand pat'. It was based on an interpretation of Soviet politics which questioned the durability of the reform process in the USSR, either because Mikhail Gorbachev might be toppled by more conservative forces, or because he would himself have to rein in the reform drive he had unleashed.⁶ It meant resisting what were seen as the seductions of his diplomacy, refusing to reciprocate his unilateral initiatives and declining to expand the arms control agenda.

This approach fitted not only what Bush had said during the election campaign, but also the preferences of Cheney, Eagleburger, Gates and Scowcroft, all of whom are sceptical about détente. In August Cheney stated that the Soviet threat had grown not diminished.⁷ Eagleburger has said that Gorbachev's purpose can only be understood as being 'to create a stronger, more efficient Soviet Union.'⁸ While at the CIA, Gates presided over a review of the prospects of *perestroika* which concluded it would fail, a view associated in official US circles at the time with scepticism about détente and an emphasis on not lowering the West's guard.⁹ And Scowcroft's view was summarised in a television interview in January when he flatly stated,

The Cold War is not over ... Gorbachev is interested in making trouble within the Western alliance, and I think he believes the best way to do it is a peace offensive, rather than bluster the way some of his predecessors have.¹⁰

There are differences between these analyses of the USSR, revolving around whether the central issue is Gorbachev's sincerity, his durability, or the effects of possible success. But those differences were all reconciled within the same policy - to wait and see, not to rush, to cool off the enthusiasm for détente. These were the clear signals from official Washington in the early months of the Bush administration.

⁶ See Martin Walker, 'Gorbachev reforms threatened' and 'Bush unwilling to bet on perestroika', *The Guardian*, 15 February 1989, and 'Do-Nothing Détente', *Time* 15 May 1989.

⁷ Cheney Criticizes Cuts in Military', *New York Times*, 24 August 1989.

⁸ The New No. 2: Heavyweight With His Guard Up', *New York Times*, 20 March 1989.

⁹ Martin Walker, 'Why Mr Bush isn't really going KGA', *The Guardian*, 25 January 1989.

¹⁰ 'Washington signals tough approach to Gorbachev', *The Guardian*, 23 January 1989.

Criticisms: reckless timidity and inertia

This approach quickly fell foul of two factors. One was in NATO because of opposition to the planned deployment of new short-range nuclear weapons in Europe. The other was the atmosphere in the USA. Bush's lack of response to Gorbachev's diplomacy appeared mean-minded, stodgy, unimaginative and out of touch with the spirit of the times.

There was a remarkable degree of impatience in some sectors of the US media. It only increased when the strategic review produced a painfully obvious lack of new ideas: in Bush's first major foreign policy speech based on it in May, the headline item was a repeat of President Eisenhower's 'open skies' proposal which is not only old but outdated and unnecessary. During this period, *Time* accused Bush of being 'almost recklessly timid'.¹¹

Bush was also accused of slowness. For example, the administration was getting through the nomination procedure much more slowly than its predecessors. By mid-June only six of sixteen Assistant Secretaries in the State department had been confirmed and numerous ambassadors had not even been nominated.¹² Different observers attribute this to different factors; blame is laid variously at the doors of the administration, the FBI and the Senate. The truth seems to be that, in different cases, different factors predominate; as the case of the missing ambassadors shows, the administration cannot be exonerated of a share of responsibility.

The administration was also charged with being slow on policy - US-Soviet relations being the outstanding but not the only issue. Whereas the fast start made by the Reagan administration in early 1981 on both foreign and domestic policies was characterised as 'hitting the ground running', the Bush administration was widely characterised as having hit the ground limping. Hedrick Smith argues that presidents who make a fast start, and set the terms of debate and action in a way which favours them, have the best chance of running a successful administration. Those who do not have little or no chance. His prime positive examples of presidents making quick starts are Roosevelt, Johnson and Reagan in 1981. Kennedy, Nixon, Ford, Carter and Reagan in 1985 are his prime negative examples.¹³

Judged in those terms, the auguries for Bush in the spring of 1989 were not good. He had not set the terms of debate and action in either foreign or domestic policy. The general view of the administration at that

¹¹ 'Do-Nothing Détente', *Time*, 15 May 1989.

¹² Elizabeth Drew, 'Letter from Washington', *The New Yorker*, 26 June 1989.

¹³ Hedrick Smith, *The Power Game* [London, Collins, 1988] pp 333-44.

time was that it lacked a sense of direction and purpose, that it lacked ideas and agenda. This was the negative side of its dominant tone of pragmatism, perhaps best summed up by a government official: 'Our people don't have an agenda; they have mortgages.'¹⁴

There were some who applauded Bush's slowness, seeing it as a welcome change from the dramatic changes of course and flashy 'video politics' which marked the Reagan presidency. They found in it not a lack of direction and purpose but, as the editor of *Foreign Affairs* did, for example, a wise caution in the face of great challenges on profound issues.¹⁵ A similar tack was taken by Bush himself, announcing that his agenda was aimed not at today's headlines but at the approach of the next century, and by Vice-President Quayle who accused critics of preferring 'razzle-dazzle' to substance.¹⁶ The tone of the remarks by the President and Vice-President, however, was clearly defensive; they had a case to make, but they knew it was an uphill struggle to make it.

Indeed, when Bush shifted ground on policy towards the USSR and on arms control, it was directly in response to the growing criticism of his inactivity: 'I need something,' he is reported to have told his aides; 'I want to do something.'¹⁷

In fact, by then, he had done something. The deal with Congress on the Nicaraguan *contras* in March more or less laid to rest one of the most explosive and controversial features of US foreign policy under Reagan. It provided the *contras* with \$4.5 million per month in non-lethal aid until the end of February 1990, subject to Congressional review in November 1989. The trial of Colonel North ensured that the Iran-Contra scandal stayed in the news, with further court cases to follow, and in the summer of 1989 there continued to be debate and some friction about whether aid to the *contras* should be extended. But the issue is unlikely to carry the same resonances in the forthcoming period that it did throughout Reagan's presidency unless there is some dramatic new twist in the evidence.

In addition, though it was little noticed, Bush had made two innovations in foreign policy. By not singling Mrs Thatcher out for special attention in the period before or after his inauguration, he had set a different tone for trans-Atlantic relations. The US-UK 'special relationship'

¹⁴ Hugo Young, 'Presidential mystery tour hits the road', *The Guardian*, 19 January 1989.

¹⁵ William G Hyland, 'Bush's Foreign Policy: Pragmatism or Indecision?', *New York Times*, 26 April 1989.

¹⁶ 'Bush Says His Agenda Is Preparing for 21st Century' and 'Quayle Defends Bush on Agenda, Saying the Critics Prefer "Dazzle"', *New York Times*, 17 March 1989.

¹⁷ 'Mr. Consensus', *Time*, 21 August 1989.

had been remarkably close during the Reagan years. Bush's lack of special treatment for Britain indicated the relationship was entering another of its 'not-so-special' periods. By attending the funeral of Emperor Hirohito, meanwhile, Bush had also signalled the importance of US-Japanese relations. This, however, has been given an at best ambivalent character by disputes with Japan over trade - and especially the naming of Japan as an unfair trading nation - and the FSX fighter deal.

Neither of these re-orientations nor the *contra* deal, however, was enough to dispel the sense of inactivity and lack of direction. East-West relations and intra-NATO disputes about short-range nuclear weapons were grabbing the headlines all through March and April in the major newspapers. Action in other areas of US foreign policy were beside the point.

The pressures on Bush at this point were intense. The momentum of Gorbachev's diplomacy was continuing. Most European NATO states were unwilling to accept deployment of new short-range nuclear weapons. The volume of criticism against Bush within the USA was growing, buttressed by a view that the world had changed but the administration hadn't noticed. Is the Cold War over? the *New York Times* asked in a series of articles which it concluded by editorially announcing that indeed the Cold War is over but Bush policy was trapped in the old framework of thinking.¹⁸

The Brussels summit

This was the background against which Bush produced his arms control proposals at the NATO summit in Brussels at the end of May. It reached wider and sought larger cuts - at least for US and Soviet forces - than NATO's previous negotiating position. On both sides of the Atlantic, press headlines trumpeted the boldness of the initiative, with applause far outweighing nagging questions about the feasibility of reaching agreement in a year as Bush wanted.

What Bush did in terms of his image is comparable to his achievement in the 1988 televised debates with his election opponent, Michael Dukakis. Bush's campaign managers had reduced expectations of his performance almost to zero. When Dukakis failed to wipe the floor with Bush, it was a victory for the latter. In Brussels, the mere fact of producing an initiative made him look bold.

Some administration officials tried to claim that that was, in fact, a deliberate strategy, that the inaction was only apparent, the administration

¹⁸ *New York Times*, 2 April 1989.

was waiting for the right time to strike. This is, apparently, but a *post hoc* justification. Washington insiders confirm that what was visible up until mid-May - caution to the point of inactivity - was the real policy.¹⁹

The impression given in some press reports was that the proposals Bush announced in Brussels were dreamed up one evening in a fireside chat. That was wrong, but the process was extremely fast - two weeks. It began when Baker returned from Moscow in mid-May, having again been upstaged by Gorbachev's diplomacy. So fast was it that the proposals were altered even after Scowcroft began to brief selected Members of Congress.²⁰

In the press, Bush's proposals were treated as a triumph, routing critics on both sides of the Atlantic, seizing the initiative from Gorbachev, laying out the administration's agenda. For many people who had been so deeply uneasy over the administration's inactivity and lack of imagination, the summit solved the problem. Bush had responded to the spirit of the times; he had at last come up with the 'vision thing'.

This impression was underlined when, he followed the summit with a speech in which he called for 'self-determination for all of Germany' and said, 'The Cold War began with the division of Europe. It can only end when Europe is whole.'²¹ This was taken by some observers in Europe as endorsing not only an end to East-West division in Europe but also German re-unification. That would be a major watershed in US policy since the 1940s and a profound innovation.

Yet there are also indications of continuing pragmatic conservatism. *The Economist* remarked that the initiative 'contains rather less than meets the eye'.²² NATO had previously decided against including aircraft in the Conference on Forces in Europe, but would probably have had to accept their inclusion sooner or later. The proposed cuts in Soviet forces are large - 325,000 men, all combat troops - but in US forces in Europe, they are more modest. The proposal requires withdrawing some 30,000 to 35,000 combat troops, about 20 per cent of US combat troops currently stationed in Europe, but only 10 per cent of total US forces there.

Proposals for more ambitious cuts were blocked by the Pentagon which feared they would alter the basic terms of the USA's strategic position in Europe and of NATO's strategy.²³ An important influence within

¹⁹ Elizabeth Drew, 'Letter from Washington', *The New Yorker*, 26 June 1989.

²⁰ 'Bush Gives NATO a Lift', *Newsweek*, 12 June 1989.

²¹ *The Guardian*, 1 June 1989.

²² 'Peace in their time, trouble to come', *The Economist*, 3 June 1989.

²³ Elizabeth Drew, 'Letter from Washington', *The New Yorker*, 26 June 1989.

the administration was a study done by a wargame centre run by Boeing Aerospace. Including the December 1988 unilateral Soviet reductions announced at the UN by Gorbachev together with his latest proposals on conventional arms control, the conclusion of one expert was that, 'After 30 days of war against this kind of Soviet force, we would have taken Warsaw and be heading into the Ukraine.'²⁴ In short, the policy changed and a new proposal was generated, but the underlying premises were unaffected.

The same reading can be made of NATO's 'Comprehensive Concept' for force posture and arms control which was released at the summit. The speed with which the Bush initiative was generated meant there was no time for it to go through the NATO machinery. On including aircraft in the CFE and defining ground force cuts in terms of troop numbers, the new position directly contradicted what had been thrashed out in NATO over the previous two years. The working group which produced the 'Comprehensive Concept', moreover, had been unable to resolve differences over short-range nuclear weapons. Disputes continued about the timetable for deployment and whether they should be included in arms control talks. So the last details of wording had to be haggled over through the small hours of the night.²⁵ That process and the final product bore all the hallmarks of hard and hasty horse-trading, with compromises finally conceded because of the need to get something on the table for the media.

The 'Comprehensive Concept' is a fundamentally conservative document. Its emphasis is not on change but on continuity - and not only with the past but, in a repeated phrase, into 'the foreseeable future'.²⁶ The Bush proposals completed a compromise on short-range nuclear weapons which had been developing across the previous year: no early decision to deploy, continued development of the relevant weapons systems and agreement to seek partial reductions in these systems through arms control once conventional forces have been cut. To emphasise the continuity built into this compromise, the word 'partial' was underlined.²⁷

What Bush did was to lay an innovative patina over the conservative essence of the 'Comprehensive Concept'. The Brussels initiative will help keep arms control on track towards conventional force reductions; it resolved, temporarily at least, a severe dispute within NATO; it reasserted US leadership of NATO; it beat off domestic critics and restored Bush's

²⁴ Martin Walker, 'Washington decides it is time to deal on arms', *The Guardian*, 29 May 1989.

²⁵ *The Independent*, 30 May 1989.

²⁶ *A Comprehensive Concept of Arms Control and Disarmament*, Press Communiqué M-1 (89) 20, NATO Press Service, 30 May 1989.

²⁷ *Ibid*, p12.

image. All these are significant effects. But the applause for the initiative implied it was highly innovative. In fact, its innovativeness was heavily circumscribed by adherence to orthodox assumptions and policy frameworks.

The very production of an arms control initiative at that time bore all the hallmarks of pragmatism. Without it, the summit would have been in difficulty, as would US leadership within the alliance, Bush's position at home and the administration's military budget in Congress. It was a timely shift in policy. It was also well-managed. The administration allowed very few leaks to the media of its plans immediately before the summit - and what leaks did get out were inaccurate - and thus increased the element of surprise and the consequent admiration for Bush's boldness.

The real Mr Bush

The contrast between the Bush administration's performance before the summit and at it makes it legitimate to ask, Which is the real Mr Bush? The answer is probably both. Pragmatism is the dominant theme: the approach is basically conservative, but prepared to innovate as necessary in the name of that conservatism.

The same ability to combine conservatism and innovation was shown with the appointment of General Colin Powell to be Chairman of the Joint Chiefs of Staff. This move looks bold - at 52 he is relatively young for the position and, more striking, he is the first Afro-American to hold it. On the other hand, Powell's record suits him well for the dominant tone of the administration in foreign and security policy. He was Reagan's last National Security Adviser and was involved in arms control talks but opposed restricting the Strategic Defense Initiative.²⁸ He is known as a shrewd manager and a 'team player', a pragmatist who is neither very hard nor very soft on the USSR.²⁹ Because of his extensive experience in Washington, in the Office of the Secretary of Defense before he went to the National Security Council, Powell is a wholly 'known' quantity; there are no risks in his appointment.

One of the criticisms made of Bush before the Brussels summit was that the world is changing but the administration hadn't noticed. Study of the lead-up to the summit suggests otherwise. The administration has noticed. Equally, however, that change in policy suggests it will respond to the new international situation to the least extent necessary. The way the

²⁸ 'Bush Plans to Name Colin Powell to Head Joint Chiefs, Aides Say' and 'Top Military Man: A Model General', *New York Times*, 10 August 1989.

²⁹ 'A "Complete Soldier" Makes It', *Time*, 21 August 1989.

administration handled the Brussels Initiative suggests it may use careful political management to promote the view that its responses are bold and deeply innovative. It will consistently be necessary to go behind administration's rhetoric and behind the headlines to grasp the nature of each initiative as it comes.

Beyond the summit

The world is indeed changing. In the USSR, western Europe, Japan and the USA itself - especially with regard to its economic capacity - the changes may be enough to challenge the basic theme of US global strategy which, for all the numerous disputes about and variations on it over the years, has been essentially unchanged since the late 1940s. These trends in world politics have been developing for some time, but there is a strong case for arguing that they are now coming to a head.

One effect of Gorbachev's diplomacy and the lessening of East-West tensions is the much lower perception in the West of a Soviet threat. Western Europe and Japan are major commercial and economic rivals to the USA. EC Market integration in 1992 is widely seen in the US business community as a challenge and even a threat. Meanwhile, the economic strength which underwrote the USA's global grand strategy for 40 years, though it has not yet withered to the point that the USA is an economic cripple, has eroded to the point that the feasibility of that strategy has come into serious question.

This issue goes well beyond the issues at the Brussels summit. In historical perspective, the important judgements about the Bush administration's foreign policy will all revolve around how it addresses it. Will it be a conservative administration, seeking to resist and retard decline everywhere, putting off change in grand strategy especially if such change is either difficult [which it is] or unnecessary in a short-term perspective [which it may also be]? Or will it seek to remodel US grand strategy to meet changing world politics and altered US economic circumstances?

To assess the administration's prospects and prospective policies in the light of that issue, it is first necessary briefly to characterise current US grand strategy

PART II

US GRAND STRATEGY

The concept of 'grand strategy' expresses a triangular integration of policies - military strategy, diplomacy and the allocation of resources. It is not about how state interests in world politics are determined, but about the broad terms in which they are expressed in practice and acted on in that triangle of strategy, diplomacy and economics. The USA's grand strategy has remained essentially unchanged since the late 1940s.

Form: extended deterrence

The term 'grand strategy' is not often used in American strategic debate - perhaps precisely because the strategy has been so durable. An exception was the Commission on Integrated Long-Term Strategy. Its report in January 1988, *Discriminate Deterrence*, was largely ignored in the US media, though it created a considerable stir in western Europe. It described US grand strategy as:

'[F]orward deployment of American forces, assigned to oppose invading armies and backed by strong reserves and a capability to use nuclear weapons if necessary. Resting on alliances with other democratic countries, the strategy aims to draw a line that no aggressor will dare to cross.'³⁰

This combination of worldwide military deployments and alliance commitments constitutes extended deterrence. It is characteristic of American debate that strategy is always put in terms of deterring and resisting aggression.

Edward Luttwak describes US grand strategy as 'an accumulation of ad hoc reactions to the successive manifestations of Soviet aggrandizement':

The present array of U.S. military forces ... embodies both the second-phase response of counter-invasion capabilities, originally designed to support containment, and the third-phase response of intervention forces designed to resist Soviet-supported opponents in the Third World. The overall quality of

³⁰ *Discriminate Deterrence: Report of the Commission on Integrated Long-Term Strategy* [Washington, DC, US GPO, January 1988] p5. The Commission was set up by the Reagan administration, chaired by Fred Ikle and Albert Wohlstetter, and contained other such notable members of the US strategic community as Zbigniew Brzezinski, Andrew Goodpaster, James Holloway, Samuel Huntington and Henry Kissinger

equipment and infra-structures, on the other hand, reflects the post-1979 response to the Soviet Union's "vertical" aggrandizement, which took the form of qualitative enhancement rather than numerical expansion (the obvious exception, of course, is the U.S. Navy).³¹

By "vertical" aggrandizement Luttwak means what US commentators generally call the USSR's military build-up of the 1970s. He lists the 'phases' of Soviet aggrandizement as, first, territorial expansion lasting till 1946; second, imposing control on the eastern European satellites; third, the winning of Third World clients; and lastly, military build-up.

Aims: containment and power

When American grand strategy has been discussed, the norm has been this discourse based on the Soviet threat.³² The term most commonly used to characterise the overall aim is 'containment', coined initially by George Kennan in a paper written in January 1947 and published anonymously, almost unchanged, six months later.³³ It is directed entirely against the USSR, its aggression and its capabilities. Other challenges to US interests and policy have consistently been attributed to an underlying, hidden but active Soviet threat - as Reagan put it, 'The Soviet Union underlies all the unrest that is going on in the world'³⁴ - or to the difficulties other governments have in seeing that threat.

³¹ EN Luttwak, 'Do We Need A New Grand Strategy?', *The National Interest*, No. 15, Spring 1989, pp 6-7.

³² There have been exceptions. Richard Barnet offered this view of US grand strategy - without using the term - in 1987:

'Between 1944 and 1954, four pillars which undergirded postwar United States foreign policy were put in place:

- (1) A war-prevention system known as deterrence...
- (2) A global coalition whose purpose is to contain Soviet power and Communist ideology, and which is maintained by a network of political and military alliances.
- (3) A commitment to intervene - by military means if necessary - in internal wars and insurgencies, mostly in the Third World...
- (4) A liberal international economic order...'

[Richard Barnet, 'Reflections: The Four Pillars', *The New Yorker*, 9 March 1987.]

This description encompasses grand strategy in its first three 'pillars', serving to sustain the fourth, the economic order in which the USA held the paramount position.

³³ G Kennan [X], 'The Sources of Soviet Conduct', *Foreign Affairs*, July 1947.

³⁴ Anthony Lewis, 'Reagan on War and Peace', *New York Times*, 20 October 1980.

Casper Weinberger described US policy under Reagan as the third phase of containment. In a typological chronology similar to Luttwak's, he listed the three phases as ideological [protecting western Europe and some other countries from subversion], geopolitical [preventing Soviet domination of the Eurasian land mass], and military.³⁵

The concept of containment, like extended deterrence, encapsulates the view that US foreign and security policy is to be understood simply as resistance to Soviet expansionism. This perspective creates deep problems. It results in avoiding the fundamental truth that US policy after 1945 was also directed at sustaining and expanding US power. That makes it harder in American political culture to grasp what is happening when US world power declines and so makes it harder to generate realistic responses.

This habit was not reflected in NSC-68, one of the founding documents of US grand strategy. Despite its propagandistic nature - an internal document, its role was described by Dean Acheson as 'to so bludgeon the mind of "top government" that not only could the President take a decision but that the decision could be carried out.'³⁶ - it denied that US interests were based solely on opposing the threat from the USSR:

'In examining our capabilities it is relevant to ask at the outset - capabilities for what? The answer cannot be stated solely in the negative terms of resisting the Kremlin design.'³⁷

Though NSC-68 contains an extremely grim view of the Soviet threat, it also says that 'creating a healthy international community' - 'a world environment in which the American system can survive and flourish' - is a goal 'we would probably pursue even if there were no Soviet threat':

'In a world of polarized power, the policies designed to develop a healthy international community are more than ever necessary to our own strength.'³⁸

NSC-68 thus united its conceptions of world interests and US interests as one, an approach generally taken by the leaders and ideologues of great powers. It did so in the context of what it saw as 'a world of

³⁵ CW Weinberger, *Annual Report to the Congress: Fiscal Year 1987* [Washington, DC, US Department of Defense, 1986] pp 28-9.

³⁶ D Acheson, *Present at the Creation* [New York, Norton, 1969] p374.

³⁷ *United States Objectives and Programs for Security*, National Security Council Memorandum 68, 14 April 1950, reprinted in *Naval War College Review*, May/June 1975, p69.

³⁸ *Ibid*, pp 67-8.

polarized power'. For all the statements which have been made over the years about the growing multi-polarity of world politics, US grand strategy and all the policies which flow from it, including the scale of military spending and structure of the armed forces, derive from a core of bipolarity. To the extent that such a worldview is untenable, so is current US grand strategy inappropriate to world politics.

American interests in the aftermath of World War II set several clear grand-strategic priorities. The first requirement was a politically stable and economically prosperous western Europe allied to the USA. From this flowed the Marshall Aid Plan and NATO. From it also flowed the need for a large US military presence in Europe and for Germany to remain divided, its western 'zones' absorbed into western Europe.³⁹

The fulcrum of US policy in Europe was defeated Germany. In similar terms, the fulcrum in Asia was Japan. In the case of both, notions of reducing them to pastoral countries, denying them the industrial basis of future power, had been entertained during the war and were dropped shortly after it. Japan became a focal point for US policy in Northeast Asia, of all the more importance after the Communist revolution took power in China in 1949. From the US role in Asia came the commitment of forces to prevent South Korea becoming socialist by revolution or conquest.

Elsewhere - especially in Southeast Asia and the Middle East - the fulcrum was not defeated enemies but weakened allies. The need was to prevent the decline of the British and French empires from leading to an exclusion of western and especially US capital, commerce and influence. From that came the decisions to replace the British role in Greece in 1947, provide aid to France fighting in Indochina and, over a longer period, commit forces into Vietnam, Laos and Cambodia. From it also came US interventions in the Third World, whether in the form of CIA-backed *coups*, or direct military interventions, or the development of client relationships with a series of states, especially with their armed forces.

It is indeed, as the authors of *Discriminate Deterrence* wrote, 'a grand strategy of extraordinary global sweep'.⁴⁰ It is expressed through an array of alliances and security agreements, military forces and facilities - the strategic nuclear arsenal, tactical nuclear weapons deployed in

³⁹ This was not a US objective when the war ended, French policy set the pace. US policy evolved after the war and reached a landmark at the Moscow conference in March 1947, though General Clay, commanding the US occupation zone, took steps towards division in 1946. The key moment came with the inclusion of the western zones in the Marshall Plan in summer 1947. Hugh Thomas, *Armed Truce* [London, Sceptre, 1988] pp 482 & 485-7.

⁴⁰ *Discriminate Deterrence*, p5

Europe, in Northeast Asia and in the fleets of the US Navy, a worldwide system of strategic communications, a global network of bases, over half a million members of the armed forces overseas, high technology weapon systems. Only a power of the USA's enormous economic weight could have aspired to and implemented such a strategy.

Conditions of possibility: conditions of change

The feasibility of US grand strategy has been based on a compound of several different elements.

First has been the economic capacity to carry it out. This has meant both the ability and the willingness to finance large armed forces deployed globally encompassing all aspects of advanced military technology. It required not only the economic weight of the USA, but a domestic consensus in favour of relatively high military spending.

The second element has been the ability to intervene in the Third World. Intervention has taken a variety of forms, ranging from economic influence, through military assistance and training programmes, to the subversion of unfriendly governments, to supporting the pro-American or anti-Communist side in civil wars, to direct involvement in combat by US forces. Again, both the ability to intervene and political support have been necessary, and the latter has been required both at home and abroad.

Thirdly, international support for US policy and action was not *ad hoc*. The USA's global system of political and strategic influence has been sustained by weaving the thread of approval into the fabric of formal alliances, of which the most important has been NATO, in which US leadership was explicitly accepted.

The final element is found in the need to explain to political audiences both at home and abroad why this whole enterprise is necessary, and to do so in a language which is not one of pure power, one which at its strongest gives a sense of missionary purpose. To do this, a credible threat has been required - the USSR, which was not only a rival for power first in Europe and later globally, but was also an oppressive state obnoxious to democratic opinion, even after Stalin was dead and the mass murder of the purges was over.

The importance of these elements varies. Without the USA's economic capacity and the requisite willingness to mobilise it, a global grand strategy would have been impossible. However, had there not been support

for Third World interventions, or had other states not been so willing to join US-led alliances, or had there been no single rival for world power which was quite as obnoxious as the USSR, the USA might well have had a global grand strategy but it would have been different.

The conditions which require and make possible change in grand strategy are essentially changes in each of the elements which previously made it feasible:-

- The economy is weaker and willingness to keep raising military spending has practically evaporated.
- US political opinion remains extremely wary of military interventions in the Third World.
- US alliances are coming under stress.
- The USSR looks a great deal less threatening than in former years.

PART III ECONOMIC RESOURCES

Economic weight made US grand strategy possible; economic problems are likewise at the heart of its current difficulties. The US share of world output is less than half of what it was when the strategy was initiated. Concern about the consequences crosses the partisan divide. Henry Kissinger and Cyrus Vance, Secretaries of State in past Republican and Democrat administrations respectively, wrote in 1988, 'The weakness of the US economy may be among the most serious and urgent foreign policy challenges to the next president.'⁴¹

The issue has two sides: one is anxiety about the US economy, commonly focused on the trade deficit; the other concerns the Federal budget, again focusing on the deficit. The two deficits together create what might be called anti-conditions for US grand strategy. The trade deficit represents resources flowing out of the USA, which makes the outflow associated with extended deterrence a relatively greater burden. The Federal budget deficit has led to steady military budgets which seem inadequate to fund ever more costly weapons programmes.

The deficits also store up future problems for the US economy, especially in the event of a world trade recession. Its effects would enter the US economy via the trade deficit, and the Federal budget deficit would make it that much harder to construct and sustain a social safety net to protect those hit particularly hard by recession.

Trade and the economy

Commerce Department figures for May 1989, when the trade deficit leaped spectacularly, show that the USA was then running balance of payments deficits with all the other members of the Group of Seven - the richest advanced countries - as well as with newly industrialising countries and some less developed countries [Table 1].⁴²

⁴¹ H Kissinger & C Vance, 'Bipartisan Objectives for Foreign Policy', *Foreign Affairs*, Summer 1988.

⁴² The May figures were the worst of 1989. By contrast the August figures were the best for five years ['World bank steps in as lower US trade gap drives up the dollar', *The Guardian*, 16 September 1989], the trade deficit, however, will endure.

TABLE 1: US TRADE FIGURES, MAY 1989⁴³
 [figures in millions of US dollars]

	<u>US Exports To</u>	<u>US Imports From</u>	<u>US Deficit</u>
Britain	1,629.0	1,681.6	52.6
Canada	7,399.5	8,138.8	739.3
France	1,015.4	1034.7	19.3
FRG	1,555.3	2,086.1	530.8
Italy	598.2	979.8	381.6
Japan	3,602.9	7,884.2	4,281.3
Hong Kong	519.4	743.3	223.9
South Korea	1,152.2	1,661.2	503.0
Taiwan	1,004.9	2,062.0	1,087.1
Brazil	304.9	627.1	322.2
Mexico	2,091.7	2,543.7	452.0

What is most serious about the trade deficit is the problem which underlies it - the declining competitiveness of US industry. This could not only threaten the resilience which the US economy has shown in the face of past downturns in world trade. Even in the absence of recession it could create extremely serious long-term problems.

Lester Thurow argues that the 'post-industrial age' is drawing to a close as the expansion of service industries approaches its maximum. It will be followed, he says, by a new economic era based on

'old-fashioned manufacturing with a modern, robotic face. The only question is whether the manufacturing will be done by American companies or foreign.'⁴⁴

And that, of course, is a very big question to which US industry may not be able to give a strong answers.

If dominant positions are taken by non-US corporations, structural unemployment in the USA will grow unless foreign investment keeps the economy relatively buoyant. In the latter event, key decisions affecting

⁴³ US Department of Commerce figures, cited by '\$10.2b May trade deficit worst of year', *Boston Globe*, 19 July 1989.

⁴⁴ Lester Thurow, 'The Post-Industrial Era Is Over', *New York Times*, 4 September 1989.

prosperity will be taken outside the USA and the US economy would be as fully subject to the vagaries of the international system as the economies of other countries. The era of US economic predominance would then be decisively closed - which could also spell a decisive end to the post-1945 era of US grand strategy.

But short-term US economic prospects are far from catastrophic. Although in the summer the Chairman of the Federal Reserve Board, Alan Greenspan, announced a shift in focus of economic anxiety from inflation to the threat of recession,⁴⁵ general expectations are for a more or less stable level of GNP growth over the next year in the region of 2.5 to 3 per cent.⁴⁶ The most recent economic indicators at the time of writing show a declining rate of unemployment⁴⁷ and economic growth of 2.7 per cent, which is the rate predicted for the next year by both the Bush administration and the International Monetary Fund.⁴⁸

These figures represent a reasonably comfortable 'soft landing', the term in vogue to describe modest but not unacceptable economic prospects. The expectations are a sharp contrast to the wishful thinking which dictated the Reagan administration's economic forecasts.⁴⁹ Bush administration forecasting is currently more in line with majority views among corporate and academic economists - though the budget presented to Congress in February was based on 3.4 per cent economic growth.⁵⁰ But neither the actual figures nor the expectations suggest that economic growth will provide a way out of the problem of the Federal budget deficit.

Deficit, debt and interest

Chart 1 shows the historical development of US Federal budget deficits. Those of the Reagan era are larger than the USA has experienced at any time since the end of the deficits associated with financing the US war effort, 1941-5. Though President Carter oversaw a major rise in budget deficits, Reagan outdid him. His deficits were considerably smaller than those run up

45 'Greenspan Shifts Focus To Counter Recession Threat', *New York Times*, 21 July 1989.

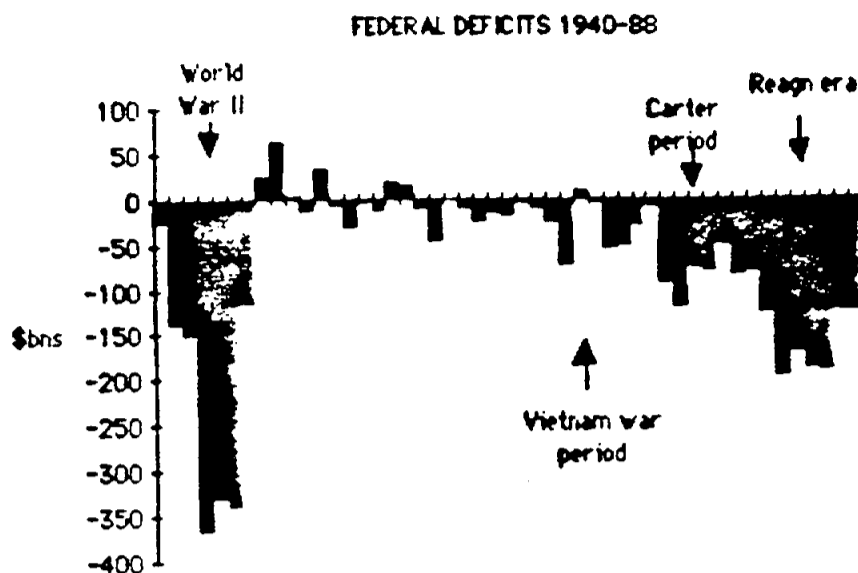
46 'Recession? Maybe Yes, Maybe No,' *New York Times*, 20 August 1989.

47 'Economy Shows Moderate Growth As Jobless Rate Declines to 5.1%', *New York Times*, 2 September 1989.

48 'Strong Growth in Quarter Viewed as Sign Economy No Longer Lags' and 'World and U.S. Growth Data', *New York Times*, 30 August 1989.

49 Described by Richard Stockman, *The Triumph of Politics* [London, Coronet, 1986].

50 'Greenspan heading for confrontation with White House over economy,' *The Guardian*, 6 February 1989.

CHART 1: THE DEFICIT⁵¹

during World War II but the budget was able to recover quite quickly after 1945 because of rapid demobilisation. Currently, no such run-down of the military effort is planned

Each year's Federal deficit augments the national debt. Charts 2 and 3 show the trends, first in dollars, then as a percentage of GNP. Two features are notable here. First is the near tripling of the national debt during the Reagan period. But the more important one is to be found in Chart 3: against previous trends, the national debt in the 1980s has climbed as a proportion of economic output.

⁵¹ Notes to Charts 1-4:-

a) Sources: *Historical Tables, Budget of the US Government, Fiscal Year 1990* [Washington, DC, US Government Printing Office, 1989]. Chart 1 is derived from Table 1.3, Charts 2 and 3 from Table 7.1; Chart 4 from Table 6.2.

b) Figures In Chart 1 the figures are in constant dollars, Fiscal Year 1982 values, as in the source table. In Chart 2, the figures are in current dollars - i.e., they have not been adjusted for inflation.

c) Transitional Quarter: Between Fiscal Years 1976 and 1977, the dates for the fiscal year were changed to run from 1 October to 30 September. In budgeting for that period, and in tables of expenditure, deficits etc, a Transitional Quarter was inserted. In all these four charts, the Transitional Quarter has been omitted for convenience. The omission has no effect on the trends

CHART 2: THE DEBT⁵¹

FEDERAL DEBT, 1940-88

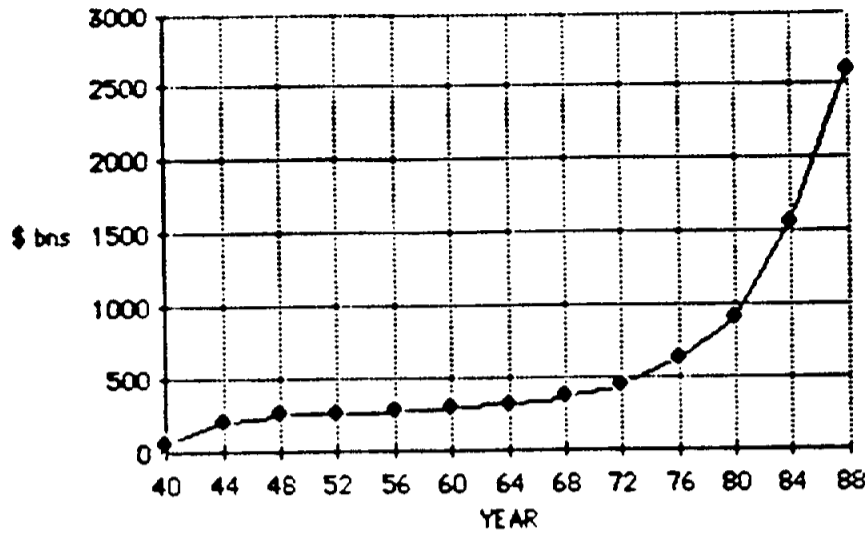


CHART 3: DEBT AND ECONOMIC OUTPUT⁵¹

FEDERAL DEBT AS % OF GNP 1940-88

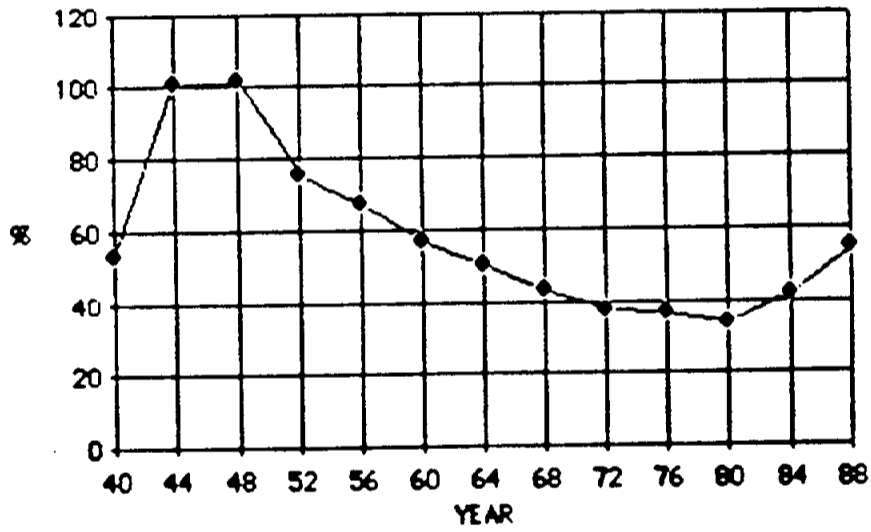


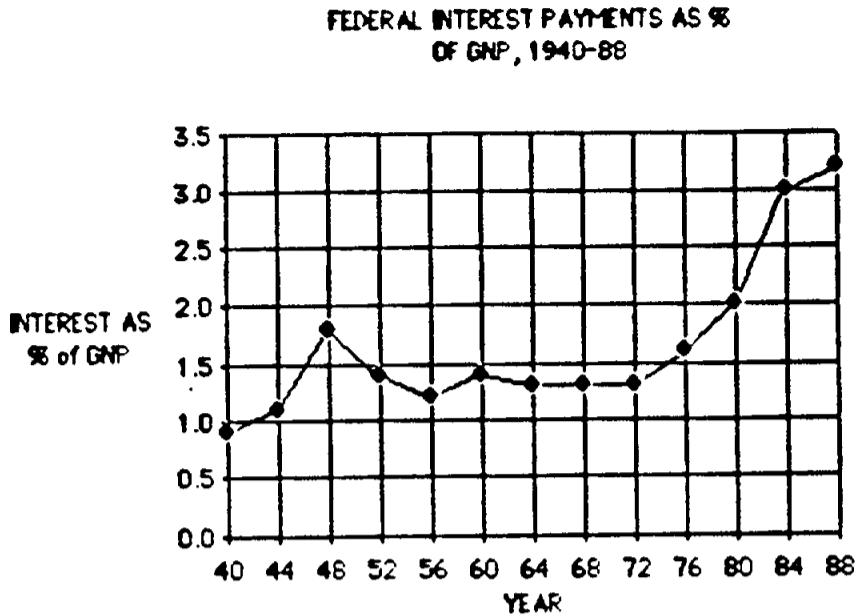
CHART 4: INTEREST⁵¹

Chart 4 depicts the current consequences - the growing burden of interest payments. As with the growth in Federal deficits, the upward trend began before Reagan but accelerated under him. It now far exceeds the economic burden of repaying debt incurred during World War II. Perhaps equally impressive, the economic burden of repayments on the national debt is about the scale which characterises the military efforts of several western European countries.

In 1988 political debate and public opinion began to identify the deficit as a major issue. It is not clear, however, that its effects will be serious within the next four to five years, unless there is a world recession. Though there is general agreement that remedial action cannot be deferred forever, the conditional and long-term nature of the consequences makes it hard to generate immediate steps to cut the deficit.

The Congressional Budget Office forecasts that, on current economic trends (about which it is somewhat more gloomy than the administration), and existing budgeting plans, the deficit will average \$140 billion at current values for the next four Fiscal Years.⁵² This is despite the Gramm-Rudman-Hollings law which obliges Congress and administration to reduce the deficit to zero by 1993 and sets targets to be met in the interim. Failure to meet each year's target would bring in automatic across-the-

⁵² 'Congressional Panel Fears Long-Term \$140 Billion Deficits', *New York Times*, 18 August 1989. NB this figure is in current dollars; the figures in Chart 1 are in FY1982 dollars.

board cuts in spending. However, the law contains a flaw.

The reduction targets set by the GRH law are for *projected* deficits at the start of each financial year. Projections are done by the government Office of Management and Budget. All that is required to fulfil the law on 1 October each year, therefore, is relatively optimistic economic projections. Thus, according to the law, the target for the deficit in Fiscal Year 1989 of \$136 billion was met, but the actual deficit for this financial year will be about \$160 billion.⁵³ How long this evasive action can continue is open to question; according to the CBO forecast, the crunch may come in FY 1991. The effect of the GRH law so far has not been to enforce hard choices, but to increase the incentive each year for avoiding them. And each year they are avoided, the more attractive it is to avoid them the following year.

Congress is not blind to this. In May 1989, a budget framework for FY 1990 was agreed; it sets total spending at \$1.17 trillion and the deficit at just under the \$100 billion target imposed by the GRH law. Congress voted for it with numerous Senators and Representatives complaining about the way it avoided hard choices by using dubious economic assumptions and accounting procedures. A former director of the Congressional Budget Office commented, 'Usually you distort the numbers to fool the public, but now there is not even a pretense of that.'⁵⁴

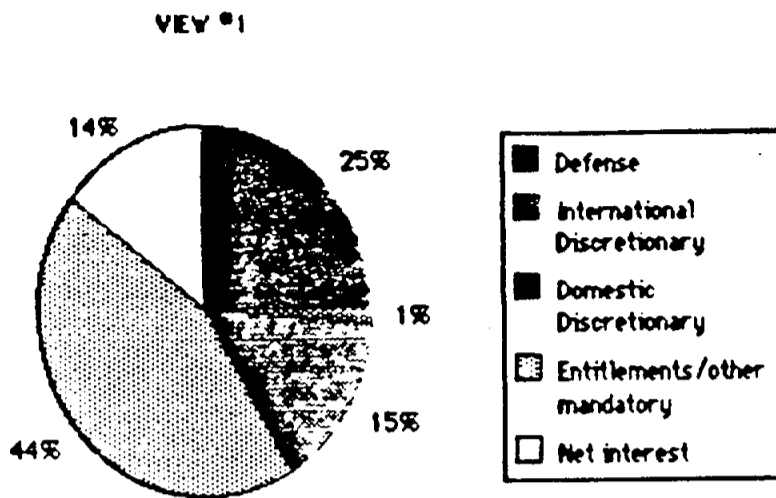
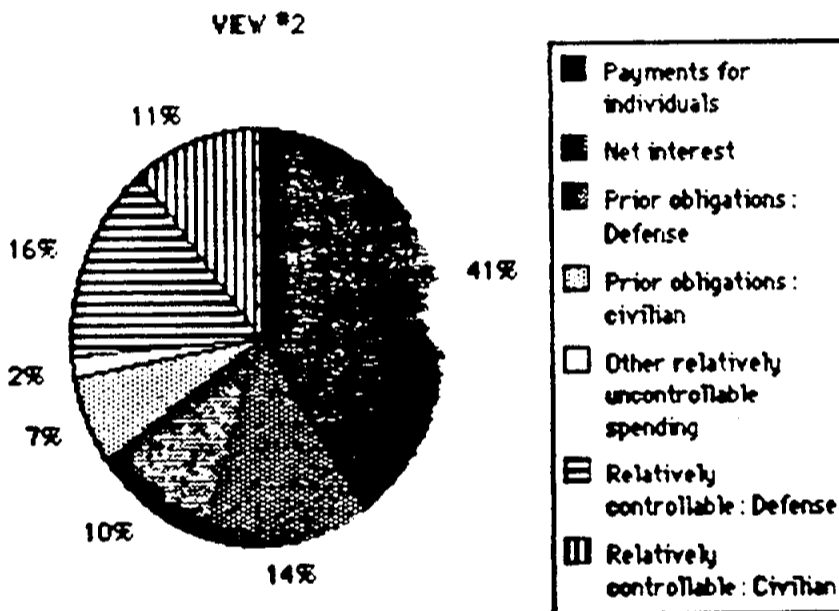
Military spending in budgetary context

There are three possible ways out of the budgetary impasse. One is much faster economic growth which is almost certainly not going to happen. The others are to raise taxes and to cut expenditure. Although one should not underestimate the capacity of Congress and administration to avoid hard choices, it seems possible that the Fiscal Year 1991 budget will include a combination of very small tax increases and cuts in spending.

Spending cuts bring the military budget to the centre of attention because of the proportion it consumes not just of the total Federal budget - \$305 billion out of \$1.17 trillion, or about 25 per cent - but because of the much larger proportion it consumes of expenditure which it is relatively straightforward for Congress to affect. Charts 5 and 6 give two views of the situation. Both use the budget for FY 1989 since the final budget for FY 1990 has yet to be completed.

⁵³ Herb Kohl & Charles S Robb, 'Counterfeit Budget-Cutting', *New York Times*, 21 April 1989. Again the figure is in current dollars, so not compatible with Chart 1.

⁵⁴ 'House and Senate Approve \$1.17 Trillion Budgets', *New York Times*, 5 May 1989.

CHART 5: COMPOSITION OF THE FY 1989 BUDGET⁵⁵CHART 6: COMPOSITION OF THE FY 1989 BUDGET⁵⁵⁵⁵ NOTES TO CHARTS 5 AND 6:-

- Sources [Chart 5: *The United States Budget in Brief, Fiscal Year 1990* (Washington, DC, US Government Printing Office, 1989) p20. [Chart 6: *Historical Tables, Budget of the US Government, Fiscal Year 1990*, Table 8.1.
- Relatively controllable/uncontrollable spending: This concept expresses the degree of ease or difficulty in changing spending plans which derive from previous decisions, through legislation setting individuals' entitlements in social programmes, or through contracts which been entered into but for which the full expenditure has not yet been made.
- Totals do not add up due to rounding

Chart 5 shows that mandatory spending and interest payments constitute some 58 per cent of the budget. Chart 6 indicates that the room for budgetary manoeuvre is even more restricted than that; on its definitions, the 'relatively uncontrollable' portion of the budget constitutes some 74 per cent of the whole. Despite the differences between the charts, the outcome is almost exactly the same. Of that part of US Federal spending which it is relatively easy to affect, military spending constitutes about 60 per cent.

Thus, although the problem of the budget deficit cannot be solved only by reducing military spending, nor can it be solved without reducing military spending.

Managing the military budget

Détente would appear to create the opportunity for cutting US military spending relatively painlessly. It has already made one treaty to reduce arms possible - the Intermediate Nuclear Forces Treaty, signed in 1987 and ratified in 1988 - and negotiations are in progress on strategic nuclear weapons and conventional forces in Europe. As one Congressional official summed it up to me, 'If the deficit makes it necessary to cut spending, arms control makes it possible.'

A favourable domestic context also exists, partly in response to détente, partly because of much-publicised Pentagon inefficiencies - small items costing thousands of dollars, technical problems in major programmes, the record of cost over-runs. These were what made it politically feasible to stop the Reagan military build-up from 1985 on. During 1989 the perception of inefficiency at the heart of the USA's military effort has been strengthened by a series of failures. The MX inter-continental ballistic missile, the Trident submarine-launched ballistic missile and the Stealth bomber are all in technical difficulties.⁵⁶ One major test in the Strategic Defense Initiative ['Star Wars'] programme also failed though a different one succeeded.⁵⁷ There are defects in the US Air Force's latest generation of air-to-air missiles while the Navy's latest destroyer has been launched eighteen months late, well over budget and only 38 per cent complete.⁵⁸ All of this makes it considerably more difficult to

⁵⁶ 'MX test launch ends in failure', *The Guardian*, 15 September 1989; 'Navy Trident 2 Missile Explodes In Its First Underwater Test Firing', *New York Times*, 22 March 1989; 'First Flight of the Stealth Put Off, and Its Future Remains Unclear', *New York Times*, 16 July 1989

⁵⁷ 'Anti-Missile Test Fails in Space', *New York Times*, 28 March 1989; 'Atom Particles Fired in Test heralding Space Shield Era', *New York Times*, 15 July 1989.

⁵⁸ 'US anti-aircraft missiles join list of failed weapons', *The Guardian*, 16 September 1989.

hold the line for military spending in the region of \$300 billion a year, and gives politicians who want to cut the budget plenty of grist for their mill.

Other factors, however, make it difficult to cut military spending. The first can be seen in Chart 6: almost 50 per cent of military spending is 'relatively uncontrollable' because it has already been committed. There is a backlog of expenditure, funds which have been appropriated by Congress but not yet spent. This budgetary 'stern wave' is a result of heavy funding for weapons development and production, since Congress tends to fund weapons programmes in a single appropriation, but the money is spent over a period of years in incremental payments to contractors.⁵⁹

As well as the 'stern wave' of past commitments, the budget also contains pressures for a new 'bow wave' of spending on future procurement. Funding for Research and Development grew by 93 per cent after inflation in Fiscal Years 1981 through 1988 and continued to grow even after Congress halted increases in the overall budget.⁶⁰ This process is a general feature of military budgeting, but was particularly marked in the Reagan years. It means that numerous weapons programmes are now approaching the point where, unless cancelled, they will move from development to production.

Both bow and stern waves are pressure for higher spending contained within the budget and past decisions. A similar pressure is to be found in the pattern of the Reagan years of military planners over-estimating the future availability of funds and casting their plans accordingly.⁶¹ As a result, by the criterion of those plans, the budget is already tight. Spending has to increase for the military effort to stand still.

The second set of problems is closely related to the momentum within the budget. Major procurement programmes develop support from large and often quite varied lobbies. The main members of each lobby are the relevant section of the armed forces, corporations which will get contracts and profits if the project goes ahead, and Members of Congress representing areas where those corporations will be operating. The system is so well known that it needs no further explication here.

Any R&D programme in the coming procurement 'bow wave' - and especially any of the extremely expensive ones - which is targeted for cancellation will involve intense battles. It is a process which could have been designed to make it hard to reduce military spending and to dampen any

⁵⁹ Gordon Adams & Stephen Alexis Cain, *The Legacies of the Military Buildup: Choices for the 1990s* [Washington, DC, Defense Budget Project, August 1988] p8.

⁶⁰ *Ibid*, pp 11-12.

⁶¹ *Ibid*, pp 18-20.

enthusiasm for cuts with which a Defense Secretary might start out. Cheney has already run into this problem: his plan to stop further production of F-14 fighters was defeated in the House of Representatives, while both House and Senate re-inserted funding for the V-22 Osprey tilt-rotor aircraft which he had been cut out.⁶²

The difficulty of eliminating weapons programmes inevitably makes a different approach more attractive - eliminating waste in the Pentagon. That there is waste is not disputed, although its scale is. One view sees it as exaggerated by the press, and as resulting from management problems which are real but eminently solvable.⁶³ A more caustic view sees the press coverage as superficial; it argues that, as a result of wholesale failures in the system of calculating costs, waste is on a much greater scale than press reports reveal and is endemic to the Pentagon.⁶⁴

Whatever the scale of waste, the view that it can be eradicated through managerial reforms seems hopelessly optimistic. A publication by the House Armed Services Committee reprints the reports of six major commissions established by US administrations to examine the procurement system and propose reforms. As the foreword points out, the two most striking aspects are 'the regularity with which the same procurement problems reappear time after time', and 'the Defense Department's unflagging resistance to institutional change'.⁶⁵ Its resistance, of course, has not only been unflagging - it has also been successful.

While weapons programmes are hard to cut and waste even harder to eliminate, the savings from cutting anything else are perhaps surprisingly limited. Supporting a plan to close unneeded bases, former Defense Secretary Frank Carlucci produced an illustrative list of 20 closings saving \$450 million a year. Congress is now seeing through a plan to close 86 bases and consolidate 54 more which will eventually save \$693.6 million a year⁶⁶ - proportionately far less than expected and a mere drop in the ocean of military spending.

⁶² 'Senators, At Odds With House, Pass Military Measure', *New York Times*, 5 August 1989.

⁶³ See, for example, Jaques S Gansler, *Affording Defense* [Cambridge, Ma, MIT Press 1989].

⁶⁴ The most caustic and well-documented version of this view is by A Ernest Fitzgerald, the cost-accountant the Pentagon must wish it did not still employ: *The Pentagonists*, [Boston, Houghton Mifflin, 1989].

⁶⁵ *Defense Acquisition: Major US Commission Reports (1949-1988)*, Committee on Armed Services, House of Representatives [Washington, DC, US Government Printing Office, November 1988] v. The reports date from 1949, 1955, 1970, 1972, 1983 and 1986.

⁶⁶ Richard Halloran, 'Pentagon Fights for Budget Cuts (Yes)', *New York Times*, 30 April 1989.

Savings from conventional arms control are also less than might be anticipated. A Congressional Budget Office study suggests that removing 30,000 troops from Europe, as envisaged in the Bush proposals at the NATO summit, would save about \$1.5 billion⁶⁷ - about 0.5 per cent of the current military budget. Another study states that the total reductions of US forces envisaged in NATO's arms control negotiating position would produce savings of 2 to 3 per cent of current spending at most.⁶⁸

A Strategic Arms Reduction Treaty could yield much larger savings, but their impact would be felt slowly. The initial savings from START would be rather small because of the costs of implementing it. It is also likely that savings would be nibbled away in a few years as new programmes of Research and Development come through the system. Hitherto, each generation of weaponry has been more sophisticated and thus more expensive than its predecessor and, unless the Pentagon's 'unflagging resistance to institutional change' is conquered, there is no reason to suppose that pattern will change. In any case, there may be no START agreement for some while despite the progress registered in the talks between Baker and Soviet Foreign Secretary Eduard Shevardnadze in Wyoming in September.⁶⁹ While the talks proceed, the Pentagon has begun to return to old habits, arguing the same case which was made during earlier strategic arms control negotiations in the 1970s - that the USA's negotiating position would be undermined if major strategic weapons programmes were cut.⁷⁰

For the moment then, the benefits of détente will not include easy opportunities to cut spending. There is a 'disarmament dividend' to be collected, but in the next five years it is unlikely to lead to large reductions in military spending or the Federal budget deficit. The need to make hard choices about cutting the military budget remains.

⁶⁷ Cited by Alex Brummer, 'Bush opts for risky strategy on troops', *The Guardian*, 29 May 1989. The savings would only be made if the troops were demobilised; simply redeploying them would cause increased expenditure because of the need to construct new bases.

⁶⁸ Randall Forsberg *et al*, *Cutting Conventional Forces* [Brookline, Ma, Institute for Defense and Disarmament Studies, July 1989] p25.

⁶⁹ 'Hitch in START Viewed as No Barrier to Summit', *International Herald Tribune*, 18 September 1989 and 'US-Soviet delight as mountain talks smooth path to arms treaty', *The Observer*, 24 September 1989.

⁷⁰ 'Stealth Bomber Is Key to Arms Talks, Administration Warns', *New York Times*, 22 July 1989, and Donald Atwood [Deputy Secretary of Defense], 'Why Stealth Makes Sense', *New York Times*, 27 July 1989.

The military budget and Congress

The scale of military spending for Fiscal Year 1990 was not finally decided at the time of writing. The administration sought a budget of \$305 billion and a spending programme in FY 1990 of \$291.2 billion, \$2.6 billion less than requested by the outgoing Reagan administration.⁷¹ The House of Representatives, while not disputing the budget request, voted to cut the spending programme by \$4.8 billion - 1.6 per cent.⁷² The Senate voted for a spending programme barely different from the administration's. The final programme will be decided by a conference between the House and Senate.

The difference seems minimal. Yet Senator Sam Nunn, Chairman of the Senate Armed Services Committee, described the divergence between his chamber and House as 'more profound differences than we've had in a long, long time.'⁷³ Defense Secretary Cheney, attacking the House in language tougher than was used by Weinberger or Carlucci during the Reagan era, accused it of wrongly thinking that the Soviet threat had evaporated when, he said, it had actually increased.⁷⁴

This apparently exaggerated language is explained by three factors. The first is that ground was being staked out for the House/ Senate conference which will produce the final version of the FY 1990 spending programme. Talking tough is a necessary part of that, just as, at an earlier stage of the budgetary process, it is necessary for the Pentagon to wax lyrically sombre about the Soviet threat.

The second factor is that the small overall difference masks proportionately bigger differences on key programmes. Table 2 shows some of the figures. The House cut funds for the Stealth bomber - which is in deep trouble because of technical problems and a cost officially estimated at \$532 million per plane and \$70.2 billion for the whole programme⁷⁵ - by 20 per cent and the Strategic Defense Initiative by over 35 per cent. It cut funds for the new basing system for the MX inter-continental missile by 45 per cent and struck the Midgetman missile out of the programme, while re-installing a couple of programmes the Pentagon had decided to do without.

⁷¹ *New York Times*, 10 February 1989. The difference between the budget figure and the spending figure is due to the distinction between budget authority and outlays. Money which is appropriated [budget authority] is not always spent [outlays] in the same Fiscal Year.

⁷² 'House Cuts Funds For The Military', *New York Times*, 5 August 1989.

⁷³ 'Senators, At Odds With House, Pass Military Measure', *New York Times*, 3 August 1989.

⁷⁴ 'Cheney Criticizes Cuts in Military', *New York Times*, 24 August 1989.

⁷⁵ Fred Kaplan, 'High-priced Stealth: a challenge for its promoters', *Boston Globe*, 19 July 1989.

**TABLE 2: ITEMS IN THE FY 1990 MILITARY SPENDING PROGRAMME:
THREE VERSIONS⁷⁶**

[figures in billions of US dollars]

	<u>Administration request</u>	<u>Senate decision</u>	<u>House decision</u>
Stealth	4.7	4.4	3.8
SDI	4.9	4.5	3.1
MX missile basing system	1.1	1.1	0.6
Midgetman missile.	0.1	0.1	0
F-14 fighter	0	0	0.2
Y-22 Osprey	0	0.3	0.5

But the reason for the amount of heat generated by a 1.6 per cent difference cannot be fully grasped unless the third factor is brought into focus. The real issue is not just what the House vote means for the FY 1990 programme, but what it betokens for the future. Although the Bush administration reduced the military budget request from the figure set by the outgoing Reagan administration, the signs were that the Joint Chiefs of Staff were still planning on increasing military spending after FY 1990. The rises, after allowing for inflation, would be small - 1 per cent in each of FY 1991 and FY 1992, and 2 per cent in each of FY 1993 and 1994.

In this, the trend set in the Reagan years of over-estimating the future availability of military resources is continued for there is little chance that Congress will approve such increases. The range of views within which consensus or compromise will be found lies between zero real growth [i.e., permitting increases in the budget for inflation only] and zero nominal growth [i.e., permitting no increases even for inflation].

Table 3 shows the implications of this. Apparently small differences accumulate over time. Zero nominal growth from the level set by the House vote in August leads to a shortfall over five years of \$150 billion [about 10 per cent] against likely Pentagon preferences. Even zero real growth from that level gives a budget in FY 1994 nearly 7.5 per cent lower than what the Pentagon would like.

⁷⁶ 'Senators, At Odds With House, Pass Military Measure', *New York Times*, 3 August 1989

NB: Figures are rounded

TABLE 3: POSSIBLE TRENDS IN MILITARY SPENDING, FY 1990-94⁷⁷
 [rounded figures in billions of US dollars]

	Modest growth, adjusted for inflation	Zero real growth, from House decision of August 1989	Zero nominal growth from House decision of August 1989
FY 1990	291	286	286
FY 1991	303	295	286
FY 1992	315	303	286
FY 1993	331	313	286
FY 1994	346	322	286
TOTAL [Current \$]	1588	1519	1430

What matters is the symbolism. The House vote in August included severe blows at major programmes - Stealth, SDI, the MX basing system, Midgetman [which is important strategically if not yet a major consumer of funds]. Hitting these programmes suggests, at least symbolically, a greater willingness in the House to take radical measures on military spending than is to be found in the Senate or, so far, the administration. It might therefore signal the start of real pressure for more severe budgetary cuts than have yet been seen. That, at least is the fear in the Pentagon.

Prospects

Which of the three columns in Table 3 most closely approximates military spending in Fiscal Years 1990-94 will depend on a variety of factors. Progress or lack of it in détente and arms control will have a part to play. Economic trends will also play a part, though they are not likely to come decisively to the rescue.

Paying off the interest on loans made necessary by the deficit, as we have seen, now constitutes a significant economic burden and restricts the room for manoeuvre in the budget. But the most serious problems created by the Federal deficit, like those associated with the trade deficit, are visible only in a long-term perspective or in the event of a world recession.

⁷⁷ 'Modest growth' = two years of 1 per cent increases and 2 of 2 per cent, after adjusting for inflation. The figures in the second column assume of 3 per cent inflation each year in the cost of military goods and services, which is more than charitable. The normal calculation of the relative price effect [the extra inflation in costs of military goods and services compared to civilian] is 2 per cent.

It is the long-term and conditional nature of the most serious problems which makes it difficult to adopt spending policies which would seriously reduce the Federal deficit. Politics in the USA are even more notorious than in most other countries for a tendency to prefer the short-term view to the long-term. In a typical characterisation of the problem, one Democrat senator commented of Washington, 'In this town, at this time, thinking six months ahead is vision.'⁷⁸ Amply confirming that judgement, a 'top Bush adviser' was quoted as responding to scepticism about how long the administration could avoid raising taxes by saying, 'That's all right. We'll take it a year at a time.'⁷⁹

Debate is beginning to swing towards the tax issue, but most observers of Congress agree that the Democrats do not want to become associated with tax increases. They believe them to be necessary, but will almost certainly contemplate them only in one of two circumstances: either public opinion must swing in favour of higher taxes, or President Bush must. The latter prospect seems to be viewed in a strange light - as unlikely yet inevitable. Bush currently shows no signs of walking away from his pledge against new taxes, and an administration proposal to cut capital gains tax is now before Congress. Yet without increasing taxes, even with creative forecasting by the Office of Management and Budget each 1 October, the figures simply do not add up. Among the possibilities are increasing indirect taxation. For example, the tax on beer and wine has not been changed since 1951; bringing it in line with the tax on spirits would raise about \$5 billion. The tax on a pack of cigarettes is 16 cents; doubling it would raise about \$3 billion.⁸⁰ Going by the Congressional Budget Office forecast that, unless remedial action is taken, Federal deficits will average \$140 billion for the next several years, it appears that much stronger action is required than that.

If tax increases cannot be brought in, or can only be introduced slowly, reducing the deficit must be done by cutting expenditure. To bring the deficit down in accordance with the Gramm-Rudman-Hollings law would probably require cutting expenditure by about \$45 billion to \$50 billion in Fiscal Year 1990, allowing for extra spending associated with the bail-out of the Savings and Loan banks and other steps. How the axe would fall would be decided by the political strength of the groups protecting each sector of spending. If it fell on 'relatively controllable' spending in proportion to the

⁷⁸ Elizabeth Drew, 'Letter from Washington', *The New Yorker*, 26 June 1989.

⁷⁹ 'Bush Bids Congress Join Him In Mission Of U.S. "Greatness"', *New York Times*, 10 February 1989.

⁸⁰ David E Rosenbaum, 'No New Taxes, But Plenty Of New Plans', *New York Times*, 10 September 1989.

present composition of that category [see Chart 6], then military spending would have to come down by in the region of \$30 billion - about 10 per cent of the likely FY 1990 military spending programme. In succeeding years further reductions would still be needed though could be somewhat smaller.

Reducing military spending on that scale could not be accomplished by arms control, which in any case will have no effect on the FY 1990 programme. To do it would require three things:

- demobilisations - not just withdrawing forces from Europe, nor simply switching large portions of the armed forces from active to reserve status as former US Navy Secretary John Lehman has suggested;⁸¹
- a slow-down in the procurement programme, including cancellation of some major projects;
- proportional cuts in the infrastructure.

If this action were to be taken, several observers believe the US Army may be the most likely candidate for cuts, partly because so much of its spending is on personnel rather than on major weapons procurement. In that event, further reductions in US forces in Europe would be unavoidable.

The alternative is a continued lack of solution to the deficit, combined with whatever relatively small cuts Congress makes in each year's administration budget and spending programme for the military. Given the powerful lobbies which defend procurement projects, the most likely outcome then is for readiness to be reduced. US forces would still be large, their deployment worldwide, their equipment sophisticated and expensive - but their ability to fight would be nibbled away from within.

As ever, politicians will pick their ways through these issues with as much focus on public opinion and their re-election prospects as on anything else. Since about the middle of 1988 public opinion polls have consistently identified the Federal deficit as a major problem; if that continues, politicians may do something about it. Whether that something will be enough is currently impossible to predict but, given the forces which protect military spending, it seems unlikely.

⁸¹ John Lehman, 'A New Blueprint For U.S. Forces', *New York Times*, 26 March 1989.

PART IV

THE USA IN A CHANGING WORLD

The basic challenge for the Bush administration in foreign and security policy is how to meet the realities of a changing world, including those of a changing USA. Equally, for the USA's allies and adversaries, the challenge is how to respond either to new policies as they develop or to the strains created by the failure to revise policy.

As with the military budget, so with grand strategy, at one level world political conditions would seem propitious for change. If straitened economic circumstances create the need, détente creates the opportunity. It could make possible cuts in US forces both in Europe and strategic nuclear weapons, and perhaps also in northeast Asia. Were they to go beyond the range currently envisaged in arms control talks, they might permit an overall decrease in military spending combined with actually increasing US forces available for other contingencies in other parts of the world. Essentially, as the East-West axis of conflict becomes less central, new axes could become more important. Withdrawals from Europe would mean redeployment elsewhere.

This could permit an increased orientation towards the Pacific, a theme which has long been popular in some circles in the USA, and/or towards the Third World more generally. Several observers appear to believe that one or both of these shifts are not only in prospect but also underlie the policy of the Bush administration towards Europe. In this perspective, what is happening at the moment is effectively a settling of accounts in Europe. As the Soviet threat diminishes and the USSR's control in eastern Europe weakens, a much smaller US military presence will be required.

The evidence about these potential shifts is mixed. Bush's arms control policy is not ambitious enough to release the scale of resources needed for major reductions in the Federal deficit, let alone a combination of those with more spending on other items in the military budget. On the basis of the current arms control talks, with a Democratic majority in Congress, the likelihood of resources released by arms control being used for anything except marginally reducing the Federal deficit is low. A shift in focus towards the Pacific or, at least, towards Japan seemed to be signalled when Bush attended Hirohito's funeral, but it is unlikely that this will be reflected in grand strategy. Similarly, the Bush administration is using armed forces in the Third World, but this is not associated with a major redirection of resources within the military budget.

'Low Intensity Conflict'

The authors of *Discriminate Deterrence* argued that US strategy had for too long focused on two extreme Soviet threats - an offensive in Europe and a nuclear strike on the USA - at the expense of other priorities, primarily in the Third World.⁸² In this they went some way towards agreeing with advocates of so-called 'Low Intensity Conflict' - 'so-called' because the intensity of LIC can be extremely high for people who live where it occurs. The view of the most outspoken LIC enthusiasts is that, by concentrating on Europe, the US Army is 'preparing for the wrong war'.⁸³

That strategic 'rejection' of the European theatre was not reflected at the highest levels in the Reagan administration. Weinberger, for example, speaking in May 1987, said, 'The United States has exactly the same deep and vital stake in the defense of Europe that it has had since World War II.'⁸⁴ But the importance of LIC was affirmed. For Weinberger, it was 'one of this administration's highest priorities', and 'the threat we are most likely to encounter throughout the end of this century.'⁸⁵ For Frank Carlucci, it was 'one of the most serious challenges to our security that we face today.'⁸⁶ Increased funding reflected this. The sum for SOF alone rose from \$441 million in 1981 to \$2.5 billion in 1988.⁸⁷

The authors of *Discriminate Deterrence* did not reject the European theatre either, nor the strategic nuclear arsenal, nor strategic defence. The need they saw to focus more on military contingencies in the Third World was not balanced by a case for focusing less on other contingencies. Consistent with the approach of the Reagan administration and the Weinberger Pentagon, they recommended more of everything through being unable to recommend less of anything.⁸⁸

The LIC debate within the US foreign and security policy establishment, however, is exactly the sort of debate which might lead to major shifts in the USA's strategic focus. LIC theory - the new version of

82 *Discriminate Deterrence*, pp 33-7.

83 JD Woghelstein, 'Post-Vietnam Counterinsurgency Warfare', *Military Review*, May 1985.

84 Speech at the Belgian Centre for Defence Studies, 25 May 1987 [USIS text, 26 May 1987].

85 CW Weinberger, *Annual Report to the Congress: Fiscal Year 1985* [Washington, DC, US Department of Defense, 1984] p276.

86 F Carlucci, *Annual Report to the Congress: Fiscal Year 1989* [Washington, DC, US Department of Defense, 1988] p63.

87 Stephen Goose, 'Low Intensity Warfare: The Warriors and Their Weapons', in Michael Klare and Peter Kornbluh, eds, *Low Intensity Warfare* [New York, Pantheon, 1987] p83.

88 *Discriminate Deterrence*, pp 64-8.