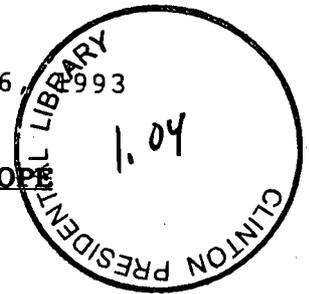

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PRD 36: U.S. POLICY TOWARD CENTRAL AND EASTERN EUROPE

Summary

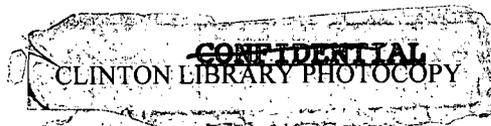
The new and aspiring democracies of Central and Eastern Europe (CEE) are a key test of this Administration's concept of enlarging the world's free community of market democracies as a major organizing principle of American foreign policy. The goal may be more attainable in this region than anywhere else in the world. Moreover, success in at least part of the region is a crucial precedent and possibly a prerequisite for success anywhere in the Newly Independent States (NIS) of the former Soviet Union. Success also can help create substantial new economic opportunities for Americans.

But success is far from assured. Notwithstanding substantial progress in northern CEE countries, economic and political stresses remain high and in some countries are mounting. Failure would be a blow to Western -- including American -- values. And the resulting turmoil could produce refugee flows that strain the democratic and open societies of our traditional allies. Growing "reform fatigue" in much of the region is compounded by a widespread sense of Western disengagement.

PRD 36 directed a comprehensive review of all instruments available to the USG to support the democratic transition in Central and Eastern Europe. No single, dramatic new American initiative is feasible or indeed desirable. But we can and should be more imaginative in focusing existing resources to deepen our engagement across the broad spectrum of political, economic and security issues that contribute to democratic stability. Specifically, this paper recommends:

Conceptual shifts in our engagement in the region:

- **Increasing the emphasis in our assistance programs on democratization and social safety-net areas.** (Although programs for private-sector development will still receive the greatest share of our assistance resources, recent experience indicates that this is a necessary, but not sufficient, condition to ensure the consolidation of reform.)
- **Matching NATO Summit (and corresponding bilateral) initiatives that deepen cooperation with CEE militaries with more attention to the non-military aspects of security, in particular the human rights oversight and other conflict-prevention tools of the Conference on Security and Cooperation in Europe (CSCE).**
- **An across-the-board effort to encourage intra-regional economic, political, and military cooperation.**



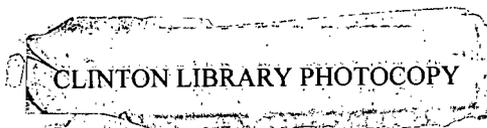
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In addition to these conceptual shifts, the paper recommends procedural changes to improve timeliness and flexibility in our assistance programs while reducing overhead and middleman costs.

The paper also recommends:

- Improving our ability to combine resources with non-governmental organizations (NGOs) as well as other governments and the international financial institutions, in support of democratization and market reforms. The paper includes recommendations that will enable all Western governments and NGOs to get a better fix on who now is doing what, both in individual CEE states and region-wide, as well as one controversial idea for a creation of a quasi-governmental Democracy Institute that would raise some funds from private sources.
- On market access, pressing to open Western markets for CEE countries' exports, primarily those of the European Union and EFTA countries, which are the CEE countries' most important trading partners. The U.S. has already lowered most, although not all, of its own barriers to CEE exports. We should use the July 1994 G-7 Summit as a forcing event, just as we used this past year's to forge an assistance effort for Russia.
- Extending increased support to American exporters and investors, in order to stimulate increased trade with and investment in Central and East European countries. This can provide vitally important help to CEE economies in the near term, as they struggle with challenge of market reform, and it can help American businessmen establish a position in what one day may be a booming new market and source of investment opportunity.
- More visible USG engagement. This is not just public relations. Central and Eastern Europe is one area in which the perception of American engagement can itself make a major contribution to stability and to the political courage, and possibly the political fortunes, of democratic leaders.
- Sustainability. There have been setbacks to the reform process in Central and Eastern Europe and there will be more. This Administration already has demonstrated its willingness to work with any democratically elected government, judging it by its actions rather than political coloration. The paper recommends some programs that enhance the flexibility that SEED programs have shown in the past, allowing us to maintain certain assistance activities even when a government's actions require that we distance ourselves from it.



- A better follow-up mechanism. The paper proposes a wide range of concrete and discrete actions. On many important points, however, it recommends a broad change of direction that will require sustained attention and, in some case, further work on the details of implementation. The paper therefore recommends a means of ensuring regular follow-up.

* * *

Attachment A lists specific recommendations that all Interagency Working Group (IWG) members hope Deputies will approve. While for the sake of convenience they are grouped under the three familiar headings of Democracy and Human Rights, Market Economy, and Security, recommendations under each heading serve the broad goals sketched above. Indeed, several of the specific recommendations serve more than one of our goals.

Attachment A also lists, under the relevant heading, issues on which IWG members disagree. These are:

- Whether to establish a quasi-governmental Democracy Institute that works through field offices in CEE states.
- Whether to set targets (not firm requirements) for directing a certain portion of U.S. economic and democracy-building assistance to programs involving more than one state or more than one ethnic group within a state.
- Whether to announce, in time for the Presidential trip in January, the initiation (or, if possible, the completion) of an accelerated review to promote CEE countries from non-market to market economy status for purposes of our anti-dumping laws; **or alternatively**, whether to study the issue only if an anti-dumping suit is brought against a CEE state.

PRD 36: U.S. POLICY TOWARD CENTRAL AND EASTERN EUROPE

Introduction

Four decades of U.S. policy in Central and Eastern Europe (CEE) bore fruit in the revolutions of 1989, which attained the ultimate aim set forth in NSC-58, the policy directive of 1949:

"the appearance in Eastern Europe of non-totalitarian administrations willing to accommodate themselves to, and participate in, the free world community."

From 1989 onward, the U.S. made great strides toward putting political and trade relations with Central and Eastern Europe on a normal footing. We launched high-profile diplomatic initiatives and programs of assistance to support democratic and market institutions there. But the collapse and fragmentation of Yugoslavia and the USSR have forced us to react to emergencies at the expense of long-range aims. The dynamics of Central and Eastern Europe's own revolutionary development put the countries of the region inherently at risk of domestic chaos; regression to statism, authoritarianism, or both; or regional war -- all of which can damage U.S. interests outright or shrink the horizons of our historic opportunities.

Goals and Interests

Our principal post-Cold War foreign policy goal is the "enlargement" of the community of free-market democracies. Few countries in the world offer as promising a prospect for successful democratic transition as those of Central and Eastern Europe that are the focus of this review, i.e. the non-combatants in the ex-Yugoslav Bosnia conflict -- Estonia, Latvia, Lithuania, Poland, Czech Republic, Slovakia, Hungary, Slovenia, Romania, Bulgaria, Macedonia and Albania). Their success would hand us a significant victory, validating the fundamental premise of U.S. foreign policy: that democratic systems are the best means for averting internal and external conflict, securing human rights, and promoting long-term economic prosperity.

The interests of the United States in Central and Eastern Europe are substantial because of Americans' historic ties to the region and because of the direct impact on our two highest foreign policy priorities: the former Soviet Union; and Western Europe/NATO. Our interests in the region follow directly from the U.S. strategic priorities outlined by Secretary Christopher before the Senate in November, of

supporting "political and economic reform in Russia and the other states of the former Soviet Union" and of preserving our "political, military, economic, and cultural link to Europe".

This does not make our interests in Central and Eastern Europe secondary or derivative. On the contrary, those interests gain weight and urgency as we come to perceive the strategic linkages between the CEE countries and their neighbors to the east and west. What happens in Central and Eastern Europe has a direct bearing on the fate of the Newly Independent States (NIS). Without the successful expansion of the democratic community to the CEE region, we likely will have insurmountably great difficulty in projecting our values and model of civil society successfully into Russia and the NIS.

Most fundamentally -- in terms of national interests -- the fate of Central and Eastern Europe will affect profoundly the security of the continent, and thus ourselves. We consider the security of Europe to be interconnected. Rampant ultra-nationalism, ethnic conflict, chaos, war or massive flows of refugees anywhere can threaten stability everywhere, including in the most advanced Western European democracies. (In this regard, we need to deal with the less expansive view of European security on the part of many of our own allies, who would prefer to seal off Western Europe from the turbulence in the East or, at most, focus on integrating the more stable Visegrad states.)

The region also has its own inherent value to the U.S. A pro-American Central and Eastern Europe broadens the geographic basis of our influence in Europe and in the international community. Active partnership with the CEE countries can help position us to deal with conflicts on the periphery of the former Soviet Union. The region's 100 million-plus people can increase the economic potential of the world trade community, and thus our own prosperity -- a prospect which American investors and exporters are starting to help realize.

These interests, however, are at risk. Despite enormous progress, economic reform and political democracy are still vulnerable throughout the region, though nowhere beyond hope. The four years since 1989 have witnessed some regional cooperation among the CEE countries, but also tensions (e.g., Hungary-Slovakia, Hungary-Romania, Lithuania-Poland). At their current level, these tensions constitute a distraction from the more important processes of reform, retard natural intra-CEE cooperation, and tend to allow nationalist forces greater scope to set their country's political agenda. Concern over intra-regional conflict has a chilling effect on CEE efforts to enter NATO. At their most extreme, these conflicts could lead to political instability in the region and even to anachronistic power politics as CEE states seek outside allies against their neighbors.

Meanwhile, for well over a year, our policy has been running largely on automatic. Our action programs were mostly launched under the previous administration. While these programs have been successful in many respects (and in many cases require only fine-tuning), more needs to be done to enhance our engagement as pressures in the region mount.

- Much of our current diplomatic engagement in the region is perceived as single-issue and negative (e.g., tariffs, intellectual property rights protection, opposition to arms sales, pressure to maintain Serbian sanctions) without a compensating positive dialogue.
- If our policy cannot be rooted in our long-term objectives, our relations with CEE countries will decline into ad hoc hockery. Without clear, long-term Western engagement with strategic purpose, the states of the region are not secure enough in their reforms or their relations with one another to manage. And without U.S. leadership, the West Europeans may persist in acting on the basis of narrow short-term interests.

On the positive side, however, our objectives in the region and the deepest aspirations of the CEE countries are still fundamentally compatible. A credible prospect of integration into the West -- the dream of becoming "normal" -- has been the most powerful stimulus to democratic and market reform and regional stability. Our operating philosophy since 1989, therefore, has been to hold open a credible Western democratic and market option for these nations. We are working to wipe the slate clean of all Cold War barriers for all CEE countries and to raise our relations with them to the same plane as our ties with West European countries -- a **strategy of integration** in practical and institutional terms.

- Full integration of the CEE states will not be attainable overnight (and, as we have already decided with respect to NATO, can only be the end of an evolutionary process that potentially embraces Russia, Ukraine, and other NIS).
- But orienting our policy -- in deeds as well as words -- toward the complete normalization of our relations with the CEE countries and their integration into the Western community can give additional encouragement to embattled reformers and entrepreneurs throughout the region. It will, at the same time, leave us free to reimpose such barriers as may prove necessary by their subsequent (mis)behavior.

Our reactivated engagement toward these objectives can ensure that we can set the framework for relations, according to our criteria.



Differentiation and the Russia Factor

Our interests and principles as outlined above should resolve the issue of differentiation and the balance between CEE and Russia. If we are consistent, we will not draw new lines between the NIS and CEE (or among CEE countries) that may not be valid for the longer term, since our goals of normalization and integration apply equally to Russia and the NIS as well as to Central and Eastern Europe. By the same token, we should not fall into the trap of thinking in terms of a choice between our strategic interests with Russia and our interests in Central and Eastern Europe. We will neither seek to use CEE against Russia nor give Russia a veto power over our CEE policy. Rather, against our democratic and market standards, we should apply policies based on each country's performance in living up to these standards. Differentiation should be a function of self-selection -- i.e. based on the success or lack thereof of the countries' own efforts -- and evolve over time.

Assistance Priorities

U.S. assistance objectives remain those established in the Support for East European Democracy (SEED) Act of 1989: developing a market economy; strengthening democratic institutions; and improving the basic quality of life in selected areas. Even in the countries that have made the most progress, market-oriented democracy is by no means assured and some assistance will be required for several more years, even as a phase-down of some programs has begun. The principal challenge is to tailor programs to meet specific needs of each country as it moves through the different stages of the transformation process. With tight constraints on the assistance budget, a phase-down of programs in the more successful countries has begun, and some resources will be shifted to those countries with more critical needs -- but only where they remain committed to political and economic reform. We will leverage wherever possible private sector and international financial institution (IFI) resources key to long-term economic development.

With respect to **assistance resources**, the elections in Lithuania and Poland demonstrate that the political and economic revolution in this region is not complete. While we must soon begin redeploying resources from the states farthest along in transition (generally the Northern Tier) to those less advanced, a substantial financial commitment to the region as a whole will be necessary to the end of the century. The collapse of reform would leave an unstable region on the doorstep of our European Allies and would be a serious blow to reformers in the NIS, who would be haunted by failure in countries that had much better prospects for success than their own.

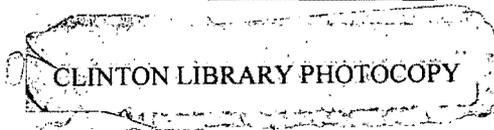
Assisting in the economic restructuring and support for reform in the region will continue to be a priority; however, we will shift greater emphasis to providing technical assistance for democratization and reform of the social safety net activities. The first phase of democratization and reform of social safety net activities has taken place throughout the region -- free elections, peaceful transfer of power, etc. -- though the roots of democracy have not taken hold deep in society. Our assistance will focus on strengthening governmental and non-governmental institutions in promoting democratic behavior, widespread participation in the process, and governmental responsiveness to public will. Likewise, the economic dislocation of the transition to a market economy has been severe for segments of the population. Our technical assistance programs will help governments develop short-term and long-term solutions to unemployment, job creation, and basic social services.

Dealing with Setbacks

We need a policy framework to guide responses to inevitable real or perceived setbacks. We should not retreat from good relations following legitimate electoral outcomes that give us pause (e.g. the victory of former communists in Poland). We should instead make decisions on the basis of policies these governments pursue. But we should respond to policy retreats on economic reform (e.g. a reversion to statism) by backing the international financial institutions' conditionality and, if necessary, by curtailing our economic support to governments. We can also respond to retreats in democracy or human rights behavior, or to unacceptable foreign policies, by curtailing some programs (e.g. government-to-government economic assistance; certain kinds of military, law enforcement, and intelligence cooperation) while maintaining others that are explicitly designed to promote democracy and independent social structures, including a free class of entrepreneurs.

Our Three-Part Agenda

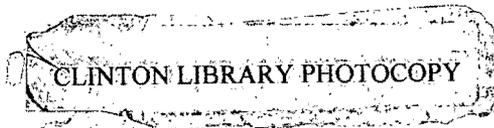
The bulk of the paper focuses on concrete near- and medium-range policy initiatives (and options) tied to our agenda, including shifts of emphasis to improve the effectiveness of U.S. programs and to respond to lessons of the past four years. We have defined our agenda as consisting of three major policy pillars: support for democracy; support for market economic transformation; and support for stable, NATO-compatible security policies to underpin reforms. To a degree this is arbitrary, and all three are mutually supporting, but the distinction eases handling the range of issues covered.



Resources

Our policy is taking shape against the background of tighter budgets. Since 1989, the SEED Act program mandate has expanded from three countries to thirteen, yet annual appropriations since 1990 have declined slightly. We assume the present level of funding (the SEED budget for FY-94 is \$390 million) will continue, at least for the next 2-3 fiscal years. Consequently, we are aware that many of the PRD's recommendations that entail resources must be accommodated within this budgetary constraint. We believe this can be done. The democracy and market economic transformation initiatives will draw upon redirected SEED resources as indicated in the text.

Recommendations in the security section are not so easily covered by redirecting present assistance resources. Indeed, we are in serious danger of not being able to afford the policies we are proposing at the NATO summit as well as in this paper. The nature of the security relationship with Central and Eastern Europe is about to be transformed -- with or without this PRD -- and we must address the resource issue to plan and program funds with existing appropriations adequate for the transformation.



ACTION PROGRAM: DEMOCRACY AND HUMAN RIGHTS

Problems

- How to promote the consolidation of democratic systems of government at all levels throughout Central and Eastern Europe.
- How to encourage the development of democratic political cultures.
- How to ensure that our (and Western) democracy-building initiatives are better delivered and effectively coordinated within a coherent assistance strategy for each country.

Premises

The peoples of Central and Eastern Europe want democratic forms of government and are willing to endure a surprising degree of material hardship, internal instability, and external vulnerability so long as they see hope of success. But the results of the elections in Poland and similar trends in Lithuania, Hungary, and Bulgaria make clear that public support for market reform is shaky at best; the lack of a substantial middle class throughout the region, continued severe economic and social stress, the immature state of political parties, and publics' susceptibility to nationalistic demagoguery exacerbate the situation further. Our challenge is to find ways to shore up support for democracy in the short and medium term, when the economic and social pressures will be greatest. Over the longer term, successful economic development will produce the middle class and the institutional pillars of civil society that are the mainstay of Western democratic systems. **Our policy must aim unwaveringly to sustain lasting democratic systems, not the ephemeral fortunes of specific individuals or parties.**

Although Western Europe serves as a practical model for the CEE countries, the United States is the main source of inspiration. We continue to command prestige and moral authority, which should be cultivated as our primary political assets in the region.

All of the post-communist countries are going through a two-phase process of democracy-building. In the initial phase, they started systems of free and fair multiparty elections. U.S. start-up assistance with electoral processes in the Southern Tier was a critical contribution to these efforts. At present, in the second phase, we are helping to foster acceptance of the rule of law, especially respect for diversity and human rights for minorities, private property rights, and independence of the media and the judiciary.

But this will not be enough. To support democratic governance, we will need to help define the proper role of government vis-à-vis the private sector and strengthen the indigenous institutions in the public and private sectors to fill these roles. Concurrently, we will need to help stabilize pluralist political structures by coalition-building at the national level, and support decentralization by strengthening local government's capabilities and its participatory responsiveness. In the private sector, we will need to help non-governmental groups become more effective advocates for pluralism and for national and local development needs and interests.

To the extent possible, U.S. initiatives in the field of democracy-building and promotion of political and ethnic tolerance should involve multilateral institutions which we have a strong interest in animating -- in the first place, the Conference on Security and Cooperation in Europe (CSCE).

In the bilateral sphere, operational decisions must place a premium on the strategic coherence of democracy activities. In pursuit of this objective, we must be mindful of the need for fast turnarounds of grant requests, especially small-scale requests, where timeliness is a major issue. Other operational objectives include private matching funds (where possible) and U.S. Embassy involvement. Some of our democracy efforts to date have been hampered by being too Washington-centered in their implementation, rather than getting to the local and grass-roots level in the CEE countries where democracy must first lay down roots.

Key Policy Recommendations

- Devote greater resources, including a greater portion of SEED funds, to democracy-building programs.
- Improve mechanisms for guiding and monitoring democracy-building programs.
- Foster development of the CSCE as the institution of first resort for human rights and democratic process issues.

Action Program

1. Greatly increase emphasis and resources for democracy programs in FY94, undertaking an initiative: "**Second Generation Democracy.**" This initiative, which is an expansion of current efforts, will be funded by redirecting SEED resources. We estimate that SEED funds devoted to democracy-building will be increased from \$30 million to \$47 million in FY94. The initiative should include:

- A large-scale, in-country program to train and reinforce democratic behavior in government administration. Public administration reforms will include: decentralization; transparency and accountability; responsiveness to public opinion, interest groups, and elected officials.
 - Strengthening the role of an independent judiciary through training, exchanges, provision of equipment, and political support.
2. **Promote democratization through non-governmental organizations (NGOs).** There is disagreement on how to implement this objective. Two options follow. See Attachment B, Annex 1, for details of the Democracy Institute proposal, plus pros and cons.
- OPTION I -- USG NGO Initiative**
- Establish a new SEED program to have U.S. non-governmental organizations help develop and strengthen CEE NGOs that can contribute to democracy-building (e.g. human rights organizations, advocacy and watchdog groups, and professional associations).
 - This program should allow for technical as well as modest transitional financial support to indigenous NGOs (i.e. small sub-grants).
- OPTION II -- Democracy Institute (NSC Staff proposes, but AID, OMB, USIA, Treasury and NEC oppose)**
- Establish an independent, non-profit foundation -- a "**Democracy Institute**" -- to promote democracy programs. The Democracy Institute, headquartered in Washington, would function through small field offices in CEE countries. Its mandate would be:
 - a) through the field offices, to give small grants in-country for worthwhile projects;
 - b) once established, to run its own programs; and
 - c) to work in concert with other NGOs and Western official organizations on a project-by-project basis, including by provision of matching funds.
3. Support regionally based professional associations and NGOs and regional projects designed to bring together citizens of more than one country and ethnic group.

4. Establish a U.S. Embassy-based "Democracy Commission" in each CEE country, chaired by the Ambassador and including all country team members involved in democracy-building activities, to ensure that our program is tailored to the particular needs of each country. Each Commission should be encouraged to seek out the views of other in-country sources, such as representatives of indigenous NGOs and the American business community.

- The Commission would be responsible for developing and monitoring a democracy strategy to be incorporated into the Mission Program Plan and the SEED Act Country Assistance Strategies.

- In addition, the Commission could recommend program changes and new initiatives to the President's CEE Assistance Coordinator in Washington and would have the right, to the extent practicable, to concur in U.S.-funded grants to the indigenous NGOs described above. (The President's CEE Assistance Coordinator would be supported in his or her democracy-coordinating role by the IWG on Democracy proposed by PRD 26 on human rights and the IWG on Central and Eastern Europe proposed by this paper.)

- To support the Democracy Commission, there would be a small grant program implemented at post with enhanced funding under the SEED Act to support in-country efforts.

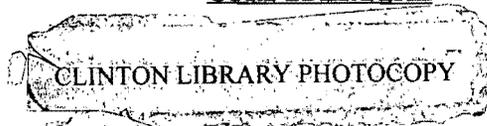
5. Through diplomatic engagement, **use the CSCE as the institution of first resort** for channeling U.S. action on problems of human rights or democratic process where a multilateral approach is preferable to a bilateral one.

- Support ongoing efforts to create additional positions in CSCE's Office of Democratic Initiatives and Human Rights (ODIHR) for information management and area expertise.

- Establish ODIHR as a clearinghouse (data bank) for information on bilateral, multilateral, and private democracy initiatives, in order to facilitate better coordination of all Western efforts in this area.

- Press CSCE member states to give greater emphasis to the role of the CSCE's High Commissioner for National Minorities and his or her active engagement in key disputes (e.g., Greece/Albania); use our Embassies to press disputants directly to seek resolution through the Commissioner's involvement.

- Actively support ongoing efforts in CSCE's Forum on Security Cooperation (FSC) to negotiate a "code of



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conduct" on military-security issues that expresses Western norms regarding civil-military relations and the role of the military in a democratic society.

6. Insert in our bilateral dialogues and in multilateral meetings and consultations the view that **CSCE should have primacy in disputes over the protection of rights of members of ethnic minorities**, invoking the principle that a nation (e.g., Hungary or Russia) has no business claiming specific rights in the protection of "its" ethnic minority in a neighboring state.

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ACTION PROGRAM: MARKET ECONOMY

Problems

- How to foster the development of thriving market economies while improving quality of life during the period of transition.
- How to promote the integration of CEE countries into the Western trade and economic system.
- How to broaden CEE countries' access to the markets of European Union (EU, formerly EC) and European Free Trade Area (EFTA) states as well as to U.S. markets, and how to increase U.S. firms' access to CEE markets.
- How to encourage healthy, stabilizing economic inter-dependencies among CEE countries themselves.
- How to harness the financial resources of international financial institutions (IFIs) to advance our agenda.
- How to promote market reform while minimizing side-effects which could undermine the political basis for it.
- How to direct our assistance program to advance our objectives and meet CEE countries' varied and rapidly evolving needs.

Premises

We and CEE countries share a vital stake in creating functioning market economies that would help consolidate democracy, increase regional stability, expand world markets, and provide models for each other and the NIS.

Political and economic reforms are inextricably linked. In Central and Eastern Europe, significant social and economic stresses have occurred during the transition phase of the transformation, creating substantial problems in maintaining the pace of political and economic reforms.

There are several overlapping economic stages through which CEE must pass. Western assistance, channeled both bilaterally and through the several international financial institutions (IFIs), must be tailored to meet the circumstances with which each must deal.

- **Liberalization and stabilization:** controls over prices and subsidies lifted; international trade and investment



liberalized; and individuals freed to engage in many kinds of economic activities. These steps are accompanied by stabilizing monetary and fiscal policies, with initial funding for program provided by IFIs.

- **Institutional reform:** a number of institutional, legal, and management reforms to permit a market economy to take root required. Finance Ministries and Central Banks need to be established, commercial codes and banking laws written, accounting standards set, and bankruptcy laws adopted.
- **Privatization and structural reform:** new private firms to be established and existing state-owned enterprises (SOEs) privatized.
- **Modernizing and strengthening social safety nets:** the rationalization of government programs to ensure protection of and services for the most vulnerable groups, consistent with overall fiscal constraints.

Where is the process of transition among CEE economies now?

There is a mixed pattern among the CEE countries. Progress has varied from dramatic (Poland, Czech Republic, and Hungary) to uneven (Romania, Bulgaria, Slovakia). Those countries which have implemented a program of liberalization-cum-stabilization are showing progress, the others less so.

- The Northern Tier countries of Poland, Czech Republic, and, to a lesser extent, Hungary have been the most successful in implementing reforms. After big declines in output during the first two to three years of the transformation, these countries are already achieving (in the case of Poland) or are approaching increases in real output.
- The Balkan States continue to trail, but their decline in output may bottom out in the next year.
- The Baltic States, especially Estonia, have made good progress in stabilizing their economies.

Apart from most of the former Yugoslavia, most states in the region (especially the Northern Tier) have reoriented their trade to the West and have begun the process of eventually joining the European Union.

Signs of Progress and Outstanding Issues

The pace of market reforms has decelerated in the last year or so, partly because the easiest reforms have been made and the tougher reforms still remain to be fully implemented.

With only some exceptions, **price controls** have been lifted by the reform governments. As supplies of goods have increased, queuing has disappeared. Laws on competition and monopoly will need to be developed or enforced.

The **private sector** already accounts for half of economic activity in Poland, a little less in Hungary and the Czech Republic, 20-30 percent in Slovakia and the Baltic states, and about 15 percent in Bulgaria and Romania. Privatization of large SOEs, industrial restructuring, banking and financial system reform, and agrarian reform are proving to be more difficult and more drawn out in even the most market-oriented of the former centrally planned economies. That has occurred because of the complexity of these tasks along with political hesitancy in the face of eroding popular support for reform.

Budget deficits in most countries far exceeded forecasts. Economic growth has fallen short of projections, and significant parts of national budget revenues from the growing private sector are not captured. Hungary, Bulgaria, Romania and Slovakia are still struggling to cut budget deficits so as to conform with IMF performance targets. The Baltic countries and Poland have implemented budgetary controls (though the election in Poland may bring some changes in budgetary policy). As the CEE governments tackle 1994 budgets, they will again feel pressured by the need to balance requirements of financial stabilization versus domestic pressure to increase social safety net spending.

Until growth in world economies picks up and the market in the former Soviet Union returns, CEE countries will be hard pressed to increase **exports** rapidly. In this case, and unless offset by rising domestic demand, CEE economies may continue to flounder, pushing unemployment rates higher and adding to social safety net spending. The Northern Tier states, especially, are frustrated by continued barriers to EU markets and full EU membership.

Slovakia and the Balkan countries are more likely than the other Northern Tier countries to deviate from the reform path. Reforms have stalled in Bulgaria and Romania under governments led by politically weak technocrats; the lack of fiscal discipline plagues both countries.

U.S. Trade and Assistance

After the Bush Administration's Trade Enhancement Initiative, few quantitative and tariff barriers now affect CEE exports to the U.S. The remaining barriers -- textiles and cheese quota -- are being addressed within the context of the Uruguay Round negotiations due to the significant political sensitivities involved. If a Uruguay Round solution is found, Central and Eastern Europe will be given a portion of the

cheese quota and all textile quotas will be phased out. However, CEE export successes in the future in the U.S. can be stymied by anti-dumping actions. Recommendations in this section address that problem.

Since 1989, overall trade flows in the region have shifted dramatically away from Cold War-era partners and toward the OECD countries. This reorientation is one result of normal economic forces and has led to the reestablishment of pre-World War II general trade patterns. This development of trade based on market forces augments and furthers the CEE countries' own dramatic economic reform programs.

EU and EFTA Trade Barriers

The EU has concluded Association Agreements with the Visegrad states, Romania and Bulgaria, and is negotiating an Association Agreement with Slovenia. The Association Agreements envisage the gradual integration of those CEE countries into a free trade zone with the EU by the end of the decade. Those agreements set long transitional periods for reducing barriers to imports in the "sensitive areas" of steel, agricultural products, coal, food, textiles, and clothes. These areas account for 35 to 45 percent of CEE countries' traditional exports to the EU. The EFTA countries have also reached trade agreements with the Visegrad countries, but they too retain significant barriers to imports in sensitive areas.

Despite the substantial trade concessions granted in the Association Agreements, the EU market is not opening as fast as the CEE states or we would like. A study by the OECD earlier this year found that the EU and EFTA markets were less open to the CEE countries than the U.S. market.

The Central and East Europeans also face EU and EFTA non-tariff barriers, which are almost as great a problem as formal restrictions. The EU has exercised its right to "contingent protection" against surges of cheap CEE goods to reimpose steel quotas, to set minimum prices on some agricultural goods, and to impose anti-dumping duties on fertilizer. In addition, the EU and EFTA countries protect their domestic markets by throwing up indirect trade barriers such as the ban on certain imports for health, quality, or environmental reasons.

Regional Cooperation

A number of post-1989 regional groups have sprung up in CEE. Some are comprised only of CEE countries (the Visegrad group of Poland, Czech Republic, Slovakia, and Hungary); others involve CEE and West European states (e.g. the Central European Initiative, including the Visegrad Four, Italy, Austria, and former Yugoslav states; the Black Sea Economic Cooperation

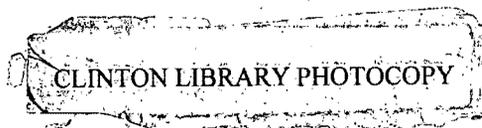
Organization, including non-Yugoslav Balkan States, Ukraine, Moldova, Russia, and the Caucasian states; the Council of Baltic Sea States, including the three Baltic states, Denmark, Finland, Germany, Norway, Poland, Russia and Sweden; and some of the EU's Euroregions, involving border areas of two or several states). These groups have been slow to develop or plan joint projects (though some steps, such as a Visegrad free trade agreement, have been taken). Some of the problem is lack of technical resources and some is lack of sustained political will -- CEE governments would prefer to deal with the West on their own and often in competition with their neighbors.

Yet the need for regional cooperation is considerable, on both political and economic grounds. Some problems require regional solutions -- transport and communications infrastructure, border crossing, and environmental projects among them. Political rivalries fueled by local competitions or ethnic problems can grow as economic stresses continue, and regional cooperation can be a countervailing factor. To get it moving, political support and some Western resources may be needed, and the recommendations below address this.

The U.S. and other Western countries are providing technical assistance in critical sectors: banking and bank regulation; budget and tax administration; commercial, banking, and accounting law and regulations; privatization and anti-trust, competition, and monopoly laws and enforcement; public service; and other areas. Based on needs of the individual countries and the stage of their economic transformation, resources can be redirected from support for private enterprise programs in the Northern Tier and from Northern to Southern Tier countries generally, guided by the President's CEE Assistance Coordinator.

Key Policy Recommendations

- Using high-level diplomatic efforts and public statements, press the EU and EFTA to provide greater market access for CEE countries. For our part, take steps to open our markets, including by recategorizing eligible CEE countries as having market vice non-market economies. (There are disagreements on how to proceed.)
- Direct greater emphasis on assistance programs which help CEE governments develop a responsive social safety net within their fiscal restraints.
- Devote greater effort to encourage Western and U.S. trade and investment in CEE.
- Encourage IFI projects on regional transportation and communications infrastructure.



- Initiate an effort to coordinate resources more effectively to assist privatized firms in their attempts to restructure. The World Bank would be encouraged to reprogram funds to help cushion the immediate adverse social impact.
- Emphasize bilaterally and through the IFIs other forms of transnational economic cooperation, possibly by setting a target portion of assistance and IFI funds for this purpose (this is a disputed issue).

Action Program

A. Integration

The most effective way to promote a successful transition to a market system over the long run is to bring the CEE countries straightaway into the community of market-based economies. We are already making considerable progress in constructing the legal and treaty underpinnings for full trade relations with all CEE countries (trade agreements, investment treaties, tax treaties, GATT membership, unconditional MFN status, export control systems, removal of Cold War-era restrictions, etc.). These efforts will continue. Integration can be further advanced by the following initiatives:

1. **Challenge EU and EFTA protectionism vis-à-vis CEE and the U.S.** (after completion of the Uruguay Round). We should use the July 1994 G-7 Summit as a forcing event, just as we used this past year's to forge an assistance effort for Russia. In the near term, we should:
 - Apply pressure on EU and EFTA countries through official channels and public diplomacy over their barriers to trade with CEE. We have several upcoming opportunities for high-visibility public diplomacy to push this theme, for example: the President's speech before the European Parliament January 9; and the U.S.-EU Summit on January 11. Additionally, we can use the U.S.-EU Subcabinet forum to push for greater market access; the next Subcabinet meeting should be at the end of January 1994.
 - Examine the EU Association Agreements and the EFTA free trade agreements with the CEE states for compatibility with the GATT and seek remedial action where warranted. (This aims to ensure that those agreements cover substantially all trade as required by the GATT and do not disadvantage the CEE countries by allowing Western Europe to open markets selectively in order to benefit their own interests. Our main target is the EU.)

-- Assist CEE countries in challenging EU and EFTA unfair trade practices, taking care not to damage legitimate CEE interests with the EU; supply technical assistance to support CEE activism.

2. Review the manner in which U.S. anti-dumping laws are applied to CEE countries. This is an issue of disagreement. The two options follow:

OPTION I

- The Secretary of Commerce, or his designee, should conduct an accelerated review of the countries in the region to determine whether to change their status from "non-market" to "market economies" -- the criterion for deciding how to calculate fair-market value for an anti-dumping action. The President could announce initiation of this review (or, if possible, its completion) during his January visit to Prague. (**USTR, Treasury, State and NSC Staff support this option; Commerce strongly opposes.**)

OPTION II

- Determine whether to change status on a case-by-case basis in the context of an anti-dumping case or administrative review. (**Commerce, the administering authority, supports this option.**)

Note: Under either option, there could be concerns in some quarters on Capitol Hill stemming from the potentially adverse impact on U.S. industry, although many in the Congress could well support this effort to help the CEE states; opinions differ as to whether Congressional concerns would be greater in the case of an across-the-board review under option 1, or a country-specific review keyed to a specific case affecting a particular U.S. firm under option 2. Commerce also notes that the task of compiling statutorily-mandated data on a region-wide basis under option 1 would be formidable, although other agencies believe the CEE countries would be eager to provide the necessary data given the benefits from this initiative.

3. Along the lines of their treatment of Russia and the NIS, Commerce should increase its efforts to **educate Non-Market Economy (NME) officials on the complexities of the anti-dumping law** to ensure their full cooperation in investigations and thus avoid resort to adverse inferences for failure to supply required data. In addition, Commerce should provide technical assistance to educate NME officials regarding competitive markets, pricing, and profit maximization, in general.

4. Commerce should, within its statutory authority, give serious consideration to establishing **quotas in accordance with the special suspension agreement provision for those CEE countries that remain designated as NMEs.** (This is a specialized category for NMEs we have used for Russian uranium.) The purpose of this approach is to, while protecting domestic industry from unfairly priced goods, allow CEE states access to the U.S. market.

B. Strengthen the U.S. commercial position

We are already active in encouraging U.S. commercial presence in CEE countries. Without requiring new policy decisions, relevant U.S. agencies will continue to expand the official U.S. commercial presence in the region and will be working to support and encourage activities of Chambers of Commerce, Business Councils, and other private-sector entities to facilitate ongoing trade and investment activity in each CEE state and to increase CEE market awareness among U.S. firms. We will also continue to use USG entities, including the Trade Promotion Coordinating Committee, to direct USG export promotion programs toward CEE. In addition, we propose the following new or expanded initiatives.

1. Organize **business development/promotion missions**, particularly in areas with good U.S. export potential, such as energy and power projects, telecommunications, franchising, environmental equipment and technology, transportation infrastructure, medical equipment, and electronics. Funding for such missions will be drawn primarily from private sector participants.
2. Organize a **high-profile conference, sponsored by the White House, to focus on the evolving investment climate in CEE and trade and investment opportunities.** The aim would be to catalyze increased U.S. investment in, and trade with, CEE states by helping CEE governments and entrepreneurs in eliminating remaining barriers. (Care must be taken to avoid any "job export" implications.)
3. **Target OPIC programs and services, furthering U.S. investment in the region, through the following:**
 - Elicit and accept sound proposals from private fund managers to establish privately managed investment funds in the region, similar to the Poland Partners Fund (an investment fund backed by OPIC guarantees that will provide capital for projects in Poland);

- Increase the per-project lending limit from \$50 million to \$200 million;
 - Seek legislative authority to enable OPIC to provide equity as part of a total project financing package.
4. Fully fund the U.S. commitment to the EBRD. Congress has cut funding to zero from the Administration's request for \$60 million for FY-94. An Administration initiative explaining why we believe the shake-up in the EBRD's leadership justifies continued U.S. support will be needed to restore it.

C. Regional Cooperation

1. Take specific steps to **encourage binational and multi-national cooperation among CEE nations**, making clear that such cooperation is a complement to, not a substitute for, integration into Western institutions:
- Seek regular dialogue with constructive emerging transnational groups -- such as Visegrad, the Central European Initiative, the Black Sea Economic Initiative, and Euroregions -- and with the front-line states facing Serbia (there is a precedent, e.g., we attend ASEAN post-ministerial conferences at Cabinet level.)
 - Provide technical assistance to design and implement joint projects of interest to regional or ad hoc groups from more than one nation and to encourage other Western countries, the EU, and other multilateral groups to do the same.
 - Based on the precedent of the Caribbean Basin Initiative, support economic cooperation among CEE firms by allowing duty-free (GSP) importation of products whose combined CEE domestic value-added portion reaches 35 percent, instead of the current 35 percent value-added in a single country. **This will require legislation, e.g., in the context of GSP in renewal in 1994.**
2. **NSC Staff proposes, but AID, State, Treasury, and OMB oppose, the following:** (See Attachment B, Annex 2 for details, pros and cons.)
- Announce that the U.S. will seek to use 20 percent of our assistance funds in support of viable initiatives designed by regional groups or involving more than one nation in the region. The 20-percent figure would be a

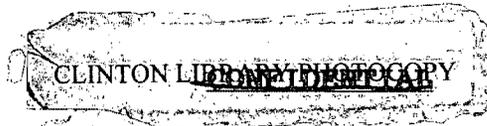
target for viable regional projects and **neither a ceiling nor a rigid earmark** -- totals could go higher. Urge that IFIs and the EU similarly designate a portion of their funds.

- Economic project categories from which we would seek to reach the 20-percent figure include: regional transportation and communication infrastructure projects (see below), environmental projects including the possible new Joint Japan-U.S. East European Environmental Initiative, projects designed by CEE Euroregions, tourism and cross-border small trade projects, and projects to upgrade border crossing facilities. We would also include democracy initiatives and viable projects involving more than one nation or more than one ethnic group within a single country.

Note: The President's CEE Assistance Coordinator believes there is no empirical basis for a 20-percent target. If Deputies believe a greater emphasis should be placed on regional activities, however, the Coordinator would report progress in his follow-up actions, allowing the Deputies to monitor progress without setting an arbitrary target figure.

D. Infrastructure

1. Through coordinating meetings with the EU and IFIs and dialogue with CEE states, encourage greater development of **regional transportation and communications infrastructure**. This will yield both economic and political dividends in the front-line states hard-pressed by the cost of enforcing the Serbian the sanctions regime. While front-line states have priority, efforts should also include the Northern Tier states, e.g. assistance in border crossings. (See Attachment B, Annex 3 for details.)
 - Use U.S. influence with IFIs to promote funding of regional projects.
 - Encourage CEE states to work together (perhaps through existing Black Sea, Central European Initiative, and Baltic groups) to translate project ideas into feasibility studies and funding proposals. Extend offer of U.S. good offices to help resolve disagreements. Where appropriate, provide technical assistance to help the CEE states craft project and funding proposals.
 - Urge IFIs to provide financing to sector-specific, cross-border funds, such as in telecommunications.
 - Establish appropriate USG programs (OPIC, Commerce programs, Trade and Development Agency, Exim) to support infrastructure projects.



E. Assistance for Reform

Although the reform process has made significant progress since 1989, success is far from assured. A substantial commitment to the region as a whole will be necessary at least until the end of the century. Given the limited assistance budget, in FY94 we will begin the phase-down of programs in certain sectors in those countries where reforms are progressing well, e.g. support for private enterprise in the Northern Tier countries. This should permit us to apply those saved resources to assistance programs in the Southern Tier countries. With these redirected resources in mind, we propose to continue assistance in macroeconomic, budget, tax, legal, and fiscal areas, which lay the groundwork for increased foreign investment. We also propose to:

1. Increase emphasis of **technical assistance on systemic responses to unemployment and other social safety net issues**, helping governments to develop a rational safety net, within their fiscal constraints.
2. Ensure that **minorities** are benefiting from ongoing assistance projects in an effort to enhance their integration into the emerging market economic system. This should include promoting programs in which more than one ethnic group participates.
3. Develop, possibly in coordination with the World Bank and other donor institutions, a new **"post-privatization" effort**, using existing funds, to coordinate assistance to enterprises, owners and managers restructuring firms after they have been privatized, and to selected regions or cities to help ease some of privatization's negative side effects. Reprogrammed IFI resources could be used to help cushion the short-term impact on social services that the newly privatized firms would shed. **This initiative will need to be developed further by the Interagency Working Group before it can be implemented.** (See Attachment B, Annex 4 for details.)

ACTION PROGRAM: SECURITY

Problems

- How to induce a stabilizing sense of security among CEE countries and build bridges to Russia and the NIS without drawing new, self-fulfilling barriers in Europe or compromising the operational effectiveness of NATO.
- How to integrate CEE countries into a broader, more stable Western security system -- with NATO as a key pillar -- that also can encompass Russia, Ukraine, and the other NIS.
- How to head off or bring to a satisfactory end armed conflicts that do arise in the region.
- How to prevent proliferation of weapons of mass destruction and their delivery systems from or into the region.
- How to strengthen CEE countries' ability and interest in eliminating or cutting back on arms and other dangerous or destabilizing sales to pariah regimes.
- How to promote development of military establishments that form an integral part of a democratic constitutional order.
- How to assist CEE countries with their legitimate defense needs.
- How to encourage intra-regional stability by fostering cooperation among CEE militaries.

Premises

Our short-term aims are both political and psychological: to reassure the new democracies that their present cooperation with NATO is the first stage of an evolutionary process that could lead to NATO membership; and to develop more effective mechanisms, through the CSCE and NACC, for conflict prevention and crisis management. Significant progress toward NATO admission would help reformist political leaders to make the case to their publics for the sacrifices necessary for a market economy by providing a sense of security to governments and societies.

Our long-term aim is broader: to integrate the CEE region as a whole -- including the NIS -- into a common Euro-Atlantic security system in which relationships among Eastern states are as stable and peaceful as among most NATO members. We should



promote intra-CEE cooperation as a complement to, not a substitute for, CEE cooperation with the West. While CEE states have an intense desire to develop their cooperation with the West, development of cooperation with one another may require outside leadership.

"Joining Europe" is still the basic aim of all the CEE countries except Serbia-Montenegro. It still imparts most of the momentum to CEE's domestic and foreign policies. The CEE countries have embraced the European model of constitutional parliamentary republics, they yearn for membership in the EU and NATO, and their leaders exhort their people to act in a manner befitting European civil society at the close of the 20th century.

Progress in "creating the basis for continent-wide security" should be made on three tracks: enhancing the effectiveness of the CSCE as the pan-European instrument of choice for conflict-prevention and crisis-management in situations not requiring military action; promoting a more dynamic role for NATO -- on its own and in concert with the "Partners for Peace" -- in peacekeeping and crisis-management; and "normalizing" our defense and security relations with the CEE countries through bilateral programs and through the North Atlantic Cooperation Council (NACC).

CSCE

CSCE's mandate covers military, economic, and political aspects of security, although its greatest area of relative advantage has been in minority and other human rights issues. CSCE is the only organization that includes (nearly) all European states and has an agreed legitimate interest in aspects of states' internal affairs, including how governments treat their own people.

Since ethnic and other internal tensions are among the most likely sources of conflict in today's Europe, enhancing CSCE's ability to deal with them is the heart of "preventive diplomacy" -- the lower end of security underpinnings in CEE. We recognize CSCE's limitations: when military capabilities are needed to manage European crisis situations, CSCE should turn to NATO, members of the NACC/Partnership for Peace (PFP), or the Western European Union (WEU). Enforcement of CSCE norms is not in the cards for the foreseeable future. But through sustained attention and effort, we can give CSCE the political backing it needs and improve its tools for oversight of compliance and for moral suasion, although steps toward this end will be incremental and individually undramatic.

NATO

NATO's potentially greater role in conflict prevention and crisis management is based on its offer to support on a case-by-case basis peacekeeping operations under the authority of the UN or CSCE. Peacekeeping by NATO -- with its robust capabilities and effective command and control -- will be seen by U.S. and Western publics as distinct from traditional UN peacekeeping operations, because NATO is an established military organization with well trained and integrated forces.

NATO's cooperation with the CEE countries through the NACC and its PFP will aim in part at promoting "NATO compatibility" for CEE militaries (civilian control, defensive doctrines, common training and information-security standards, and interoperable equipment) both as a basis for joint action and as a prerequisite for potential NATO membership.

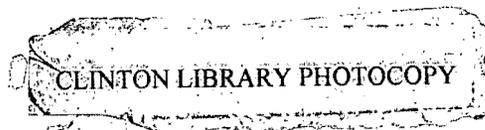
NATO outreach in the area of arms control implementation can also play a positive role in building concrete political and military relationships with CEE states. We must continue to signal the importance we attach to fulfillment of arms control commitments.

Bilateral Relations

Our bilateral cooperation programs with CEE states should reinforce and complement the PFP and other NACC programs -- in effect, grooming CEE military and defense establishments for possible NATO membership. The content of our bilateral cooperation as well as "differentiation" within the NACC and the PFP should proceed through self-selection, based in part on the interest and ability of cooperation partners to participate in cooperative activities, rather than on any explicit geostrategic or economic criteria.

Our bilateral programs should provide practical examples of the benefits of cooperation while contributing to the education of a recipient country's defense establishment. These new or expanded programs can lead to a qualitatively different relationship on security issues, supporting a second, post-NATO-Summit stage of military-to-military cooperation. Among a variety of tools, the U.S. European Command's Military Joint Contact Team Program (JCTP) has most effectively met the Central and East Europeans' critical needs -- obtaining NATO-compatible expertise and an understanding of Western concepts of civil-military relations -- at minimal cost.

With limited funding, we are in serious danger of not being able to afford the policy we are proposing at the NATO Summit as well as in this paper. This will become an acute problem



for our bilateral initiatives and our credibility post-Summit unless we address the security assistance issue immediately. We have yet to plan and program funds adequately for the transition from JCTP to normal security related cooperation (Foreign Military Sales (FMS), service programs, etc.).

Deputies have already agreed that NATO members should look for opportunities to provide excess military equipment to active Eastern participants in the PFP. The PFP initiative will lead us toward decisions and programs to provide CEE states with military equipment. Our release of military equipment should emphasize defensive systems and should promote interoperability of command, control and communications to facilitate joint exercises and peacekeeping operations, contingent upon continued social and political progress by the partnership nation. Budgetary constraints will continue to limit CEE modernization efforts, however.

Arms Controls/Export Controls

Under severe economic and social pressure, CEE countries have been unable to resist the temptation to make lucrative but sometimes harmful sales of military and other equipment to traditional Cold War-era customers (Syria, North Korea) and to other pariah countries (Iran, Burma). When challenged, CEE states sometimes back off sales; at other times they go ahead. When they do go ahead, they sometimes cite real or alleged Western or Russian sales of similar equipment (e.g. U.S. helicopters to Burma, Russian submarines to Iran). However, U.S. sales are subject to a strict system of export controls (prohibition on retransfers, etc.) designed to restrict destabilizing arms transfers.

Our policy should strongly discourage the CEE states from undertaking technology transfers related to weapons of mass destruction, and arms sales to Iran, Libya and other countries that threaten international stability. We must also recognize the need for consistency in our arms transfer policy: we will not be credible in asking CEE states to refrain from arms transfers unless we press for parallel restraint from Russia, our allies, and ourselves. Overall policies for conventional arms transfers are being developed pursuant to PDD-13.

Production cooperation, either through sharing of technology or arrangements for licensed production of U.S. equipment, can help CEE countries address procurement problems. More extensive application of dual-use technologies can ease the conversion of defense to civilian production. Solid export control regimes and responsible export policies should remain a precondition for close cooperation in technology transfers and invitation into international control fora, as well as enhanced cooperation and trade in military areas.

Key Policy Recommendations:

Decisions taken by Deputies and Principals as part of NATO Summit preparations have begun the process of moving beyond the introductory phase of military-to-military relations. We are beginning efforts to encourage CEE states to engage meaningfully in the PFP; to expand and deepen bilateral cooperation on security issues; to integrate our bilateral initiatives into NATO and PFP efforts to support CEE countries; and to strengthen CSCE's ability to handle low-level, incipient conflicts between and within CEE states. Most of the following action program builds upon these processes. Key new elements, however, are:

- Assist in organizing, training, and to a degree equipping CEE units to promote compatibility with U.S. and NATO forces.
- Incrementally enhance CSCE's operational and conflict-prevention capabilities.
- End remaining Cold War-era prohibitions and restrictions on U.S. arms sales and transfers to CEE states, relying instead on established laws and policy on sensitive transfers and case-by-case adjudications.
- Launch an initiative to establish a region-wide airspace management and air sovereignty regime.

Action Program

A. NATO/NACC/Partnership for Peace

1. Assist, both bilaterally and through NACC and PFP programs, in organizing and training, and equipping where possible, CEE units to NATO standards. The aim is to facilitate joint operations by CEE militaries with the Alliance.
 - Encourage CEE countries to maintain or create units capable of and earmarked for possible joint peacekeeping operations with NATO.
 - Work with allies and CEE partners to identify available excess, second generation, NATO-compatible equipment for potential transfer or sale or that can be purchased commercially at relatively low cost.
 - Seek funding for assistance to CEE countries to modernize the equipment and improve the interoperability of their militaries.
2. Encourage active participation by CEE states in other aspects of the PFP.

3. Boost NATO's capacity to serve as a clearinghouse for coordination of allies' bilateral military-to-military programs of assistance to the East, as a means of ensuring a more rational division of labor and avoiding duplication.

-- To set an example for the Allies, we should channel as much as possible of our bilateral effort through NATO, NACC, PFP, and Group on Defense Matters programs, and ensure that our bilateral programs do not get too far out in front of those of our allies politically or financially.

B. CSCE

Conflict Prevention. CSCE's evolution should remain incremental, a matter of responding to concrete problems rather than an attempt to impose some grand design on Europe's fluid security situation. That said, there are practical steps that should be taken now to improve the effectiveness of CSCE's oversight/mediation role on minority and other internal issues that could lead to conflict. In addition to the Deputies' agreement that the **PFP coordinate responses to CSCE missions' resource needs**, the CSCE Ministerial in Rome agreed in principle to U.S. initiatives to establish a **"rapid reaction roster"** of personnel and a **revolving fund** that will enable CSCE missions to be deployed on short notice. In addition, we should propose or support proposals to:

1. **Give CSCE a small stock of its own equipment.** For example, we should actively explore the possibility of providing communications expertise to CSCE's Missions Support Unit in Vienna. This could be a unilateral offer or one through NATO, which would fulfill NATO's promise at the Oslo Ministerial actively to support CSCE's conflict-prevention work.
2. **Require countries to report to CSCE on implementation of recommendations from CSCE missions.** The reports could explain what steps were being taken as alternatives to CSCE recommendations. Implementation reports would be discussed by the Permanent Committee or the Committee of Senior Officials.

Dispute Settlement mechanisms. We also will continue to urge states to use CSCE's existing dispute settlement mechanisms. We propose to strengthen those by:

3. **Closing the "Valletta loophole",** whereby states are not obligated to accept any third-party involvement in disputes between them that involve territory or sovereignty.

Institutional Reform. While preserving the institutional and procedural flexibility that are important to CSCE's effectiveness, we also should look for opportunities to streamline and better coordinate overlapping functions and procedures that have mushroomed. Here, too, the best course probably will be to look for incremental and evolutionary opportunities rather than proposing sweeping reform. Progress was made in this regard at the Rome Ministerial where CSCE members endorsed U.S. proposals to **strengthen the role of the Vienna Group**, renamed the Permanent Committee. Looking ahead:

4. By mid-1994, our CSCE Ambassador should make other specific proposals on the institutional direction in which we want to urge CSCE to go as opportunities arise.

CSCE Long-Duration Missions.

5. We should propose that CSCE missions of long duration routinely include military personnel, and be willing -- on a case-by-case basis -- to name U.S. military personnel to serve on CEE missions. (This would not change the policy of not putting American military personnel on the ground in the NIS.)

C. Nonproliferation/Export Controls

We are already working with CEE countries on establishing and maintaining effective arms and export control regimes that comport with COCOM (and its successor) and other regimes such as the Missile Technology Control Regime, Nuclear Suppliers Group, and Australia Group. We must continue to emphasize the importance of full implementation of existing arms control agreements and nonproliferation regimes (e.g., the Nuclear Nonproliferation Treaty, Chemical Warfare Convention, Biological Warfare Convention). At the same time, we continue to press CEE states not to sell arms to pariah states.

Our action plan in this area is a continuation of these current, active policies, keeping in mind the need for consistency between what we ask of CEE countries and what we ask of our allies, Russia, and other countries.

D. Other Bilateral Cooperation and Assistance

We will continue to work to expand and improve several on-going programs, including the EUCOM Joint Contact Team Program (JCTP) and programs for the exchange of information, intelligence, and expertise. We will transform the JCTP into a long-term sustained effort relying over time on Defense Attache Offices and the establishment of Offices of Defense Cooperation as security assistance programs begin to grow. Although not new initiatives, these proposals are newly relevant as we seek

to enhance future interoperability of CEE militaries with NATO and ensure their civilian oversight. At the same time, we face new challenges to secure funding for these programs. In addition to making these current programs sustainable and more relevant to future needs, we propose that:

1. OSD should continue development of programs of **civilian defense cooperation with CEE ministries of defense** under the auspices of the **Bilateral Working Groups**. This would parallel the ongoing cooperation with uniformed militaries and promote "civilianization" of security policies. Special attention should go to help relevant Congressional staff develop **cooperative exchanges with CEE parliaments** to promote democratic defense and security institutions.
2. **End Cold War-era prohibitions and restrictions on U.S. arms sales and arms transfers that bar assistance that could help CEE countries in meeting legitimate defense needs and in developing NATO-compatible military capabilities.**

-- Complete security assistance Presidential Determinations (PDs) for all CEE states. This would allow the USG to transfer U.S. defense articles and services to CEE governments. **Sensitive arms transfers would still be appropriately constrained by existing laws and established policy that, inter alia, prohibit retransfer without U.S. consent, and by case-by-case adjudications of each transfer.** (Only Poland and Hungary now benefit from PDs.)

- PDs should be completed for all countries in the region (except those under arms embargoes) and should avoid drawing distinctions. Such discrimination can be managed by the case-by-case reviews of each transfer. **(Note: All agencies support this recommendation for PDs on a region-wide basis. State/PM notes that a country-specific review would be necessary for each CEE state before judging that it qualifies for a PD.)**

-- The Secretary of State should **remove all CEE states (except those under arms embargoes) from the list of proscribed countries in the International Traffic in Arms Regulations (ITAR)** to permit CEE private and governmental entities to purchase defense articles and technology from U.S. commercial sources. (Only Poland, Hungary, the Czech Republic, and Slovakia have been removed from the ITAR list to date.)

-- **The President should announce these steps during his January 1994 visit to Prague.**

3. Intensify programs of U.S. Navy ship visits to CEE ports.

E. Regional Security Cooperation

Using NACC, CSCE, Partnership for Peace and bilateral instruments, we should support and encourage regional security cooperation among groups of CEE states when it is not directed against third parties. In so doing, we should make clear to the CEE states that this is not a substitute for integration into NATO structures through the NACC and PFP, but a means of reinforcing that process. The IWG has identified one specific area where a regional approach would be beneficial:

1. DOD and other agencies should launch an initiative to help establish a **region-wide civil-military airspace management and air sovereignty system**, using bilateral technical assistance and NATO/NACC mechanisms. Finding adequate resources to finance such an initiative is the chief impediment (the first stage, for Visegrad countries, would cost roughly \$500,000); a NACC approach could provide for greater burden-sharing, but it would be extremely difficult to gain allied agreement. (See Attachment B, Annex 5 for details.)

ACTION PROGRAM: FOLLOW UP

Sustained, high-level engagement

Our efforts to realize the objectives and initiatives set forth above will be more effective if they are coordinated, monitored, and accompanied by visible, frequent high-level attention to the region. Toward this end, we propose:

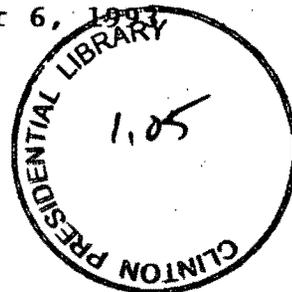
- **The President should enunciate our new policy** in his European speech just before the January 1994 NATO Summit, and in his Prague meeting with the Visegrad leaders just after.
- This should be followed by **Cabinet-level visits to all CEE capitals during 1994**, with special attention to non-Visegrad states.
- **Intensified regular consultations** should be established with CEE countries and with regional groups and **ad hoc** groups of more than one country -- at the Assistant Secretary or Deputy Assistant Secretary level -- on political issues, economic policies, and transnational problems such as counter-terrorism, narcotics, and the environment.
- This should be accompanied by the continuation of **Bilateral Working Groups on defense and security issues** or the establishment of such groups with those states in the region with whom we have not yet done so.

Funding Issues

Although the democracy and market reform initiatives covered in this PRD can be absorbed within existing -- albeit modestly redirected -- SEED resources, some of the security recommendations will require new initiatives to identify resources within DOD and elsewhere. This will occur as the PFP program acquires specificity and substance.

Sustained Follow-up within the USG

To ensure effective implementation of our policy, State should establish an Interagency Working Group on Central and Eastern Europe chaired at the Deputy Assistant Secretary level to meet every two months to review and task follow-through on PRD recommendations, working in coordination with existing IWGs on CEE assistance and military-to-military relations, and with the IWG established by PRD-26 for promoting democracy.



ATTACHMENT A

PRD 36: SUMMARY OF POLICY RECOMMENDATIONS

Democracy and Human Rights:

See Text Page:

-- Points of Agreement

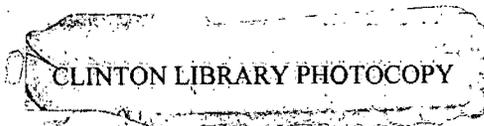
- o Devote greater resources for democracy programs. 11
- o Support regional or inter-ethnic democracy programs. 12
- o Establish Embassy-based "Democracy Commissions" to coordinate in-country democracy programs. 13
 - Commissions would administer a small grant program.
- o Use CSCE as institution of first resort for multilateral approaches to human rights/democracy problems. 13
 - Establish a data bank for public and private democracy initiatives at CSCE's Warsaw Office of Democratic Initiatives and Human Rights (ODIHR); add ODIHR positions.
 - Increase diplomatic support for CSCE's High Commissioner for National Minorities.
- o Assert principle that CSCE, not particular states, has primacy in disputes over human rights/ethnic minorities. 14

-- Points of Disagreement

- o Whether to establish a quasi-governmental Democracy Institute working through CEE field offices. 12

(Annex 1)

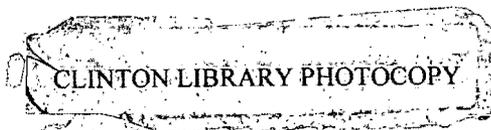
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Market Economy

-- Points of Agreement

- o Challenge EU and EFTA protectionism through diplomatic and public efforts, using July G-7 Summit as forcing event. Assist CEE countries in challenging unfair EU trade practices. 20
- o Commerce to increase efforts to educate CEE on anti-dumping laws. 21
- o Commerce, within statutory authority, to consider establishing quotas in accordance with special suspension agreement authority for remaining CEE non-market economies. 22
- o Strengthen the U.S. commercial position. 22
 - Organize business promotion missions.
 - Organize a White House-sponsored conference on CEE investment and trade.
- o Target OPIC programs in CEE. 22
 - Consider proposals from private fund managers to establish privately managed investment funds.
 - Increase the per-project lending limit to as much as \$200 million.
 - Seek legislative authority for OPIC to provide equity as part of total project financing package.
- o Continue efforts to fund U.S. commitment to the EBRD. 23
- o Encourage regional/sub-regional cooperation. 23
 - Seek dialogue with regional/subregional groups.
 - Provide technical assistance to regional/subregional groups.
 - Change duty schedule to benefit regionally produced products.



- o Initiate regional transport/communications infrastructure projects. 24
(Annex 3)
 - Use influence with IFIs; bilateral tools.
 - Encourage development of a regional planning authority for joint projects.
- o Increase technical assistance to reform public sector/social safety net. 25
- o Ensure minorities benefit from assistance projects. 25
- o Develop initiative for post-privatization assistance to firms and communities, possibly working with World Bank. 25
(Annex 4)

-- **Points of Disagreement**

- o Whether, in time for the President's January trip, to announce the initiation (or, if possible, the completion) of an accelerated review aimed at recategorizing eligible CEEs from non-market to market economy status under current anti-dumping laws, or alternatively, whether to study the issue only in the context of an anti-dumping suit. 21
- o Whether to establish targets for directing 20 percent of USG economic and democracy assistance toward regional programs involving more than one state or ethnic group. 23
(Annex 2)

Security:

-- **Points of Agreement**

- o Assist in organizing and training CEE units to NATO standards. 30
 - Encourage CEE countries to create peacekeeping units for joint operations with NATO.
 - Identify NATO-compatible equipment for grant or sale.

- Seek funding for military assistance for CEE.
- o Boost NATO's capacity to serve as clearinghouse for NATO members' bilateral mil-mil programs. 31
- o Increase CSCE's effectiveness in conflict prevention. 31
- Give CSCE a small stock of its own equipment.
- Require countries to report on implementation of CSCE recommendations.
- CSCE Ambassador to make institutional proposals by mid-1994.
- Close the "Valletta loophole."
- Propose that CSCE long-duration missions include military personnel, and be willing to name U.S. military personnel on a case-by-case basis to serve on missions in CEE. 32
- o Develop civilian defense cooperation. 33
- o End Cold War-era prohibitions and restrictions on U.S arms sales and transfers. 33
- Complete Presidential Determinations for all CEE states.
- Remove CEE states from ITAR list.
- o Increase Navy ship visits. 33
- o Launch initiative to develop regional civil/military airspace regime, pending identification of funding. 34 (Annex 5)

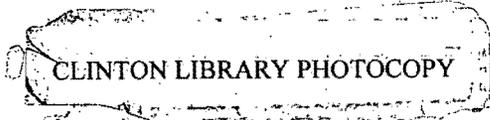
Sustained High-Level Engagement:

- o Recommend the President enunciate our CEE policy during the European trip. 35
- o Cabinet-level visits to all CEE capitals in 1994. 35
- o Intensified regular consultations with all CEE countries at A/S or DAS level. 35

- o Establish IWG chaired by State at DAS level to follow through on PRD recommendations. 35

Resources:

- o SEED resources should be maintained at about current level (just under \$400 million). 35
- o Resources for military-to-military programs should be increased. 35



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December 6, 1993



ATTACHMENT B

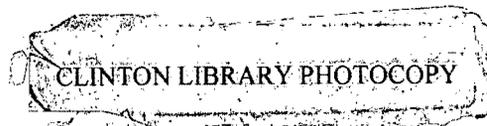
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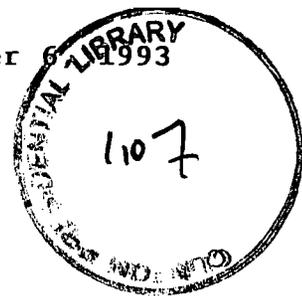
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PRD 36: ANNEX 1

"DEMOCRACY INSTITUTE" PROPOSAL

Option: To establish an independent, non-profit foundation (the "Central and Eastern European Institute for Democracy," or Democracy Institute) modeled on other regionally based foundations such as the Eurasia Foundation, headquartered in Washington with small field offices in CEE countries. It would have a mandate to: a) give small grants in-country for projects in support of democracy; b) as it establishes itself, run its own programs directly where this makes sense in terms of need and other available programs; and c) work in concert with other NGOs and Western official organizations on a project-by-project basis, including matching funds. The heads of field offices would participate in Embassy Democracy Commissions.

Background: IWG members agree that more resources need to be devoted to support for democracy, broadly defined to include support for grass roots and other citizens and professional groups. The USG presently is planning to address this with a large (\$5.5 million per year starting in CY 94) project working through U.S.-based NGOs to support the development of private and non-profit organizations in CEE.

The Democracy Institute concept is an alternative to the USG's planned program to respond to significant unmet needs that inhibit the effectiveness of traditional programs. These needs include more field-based decision-making; an ability to make small grants; an ability to support indigenous NGOs more directly; greater flexibility in working with local, U.S., and other organizations on specific programs; and a mandate to leverage funds from sources other than the USG.

The concept draws on the Eurasia Foundation, established by the USG and operating in the NIS under a contract with AID. The President's NIS Assistance Coordinator has had positive initial experience with the Eurasia Foundation. No new legislation would be required: the mechanism for USG funding could be a contract between the Institute and AID. Congress would be notified via the standard AID congressional notification procedures.

The Democracy Institute's field offices would work in coordination with local U.S. Embassies and would accept Embassy guidance and input. The headquarters office in Washington would also accept guidance and input. Neither the Washington office nor the field offices of the Democracy Institute would be formal USG bodies under direct USG supervision, but the contract with the USG would stipulate procedures for formal reports and audits.

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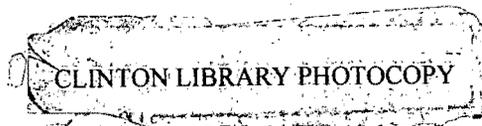
The Democracy Institute's activities would embrace three categories:

- o Giving small grants to local groups (e.g., NGOs, non-partisan citizens groups). Turnaround time would be fast (the Eurasia Foundation turns around grant requests within a few weeks). The field offices would coordinate with local Embassies and receive approval from the Washington office. Grants would be a major activity in more developed CEE countries where local NGOs are relatively skilled.
- o Initiating and running programs directly. In a second phase as they became established, the field offices would be able to bring in long-term experts to carry out programs. This would be a more prevalent activity in less-developed CEE countries (e.g., Albania).
- o Working jointly with other organizations -- USG, U.S. NGOs, corporations, third country, and multilateral -- to raise funds and conduct programs. The Asia Foundation works with the National Democratic and Republican Institutes, and the Eurasia Foundation is working on cooperative programs with the German Marshall Fund. These involve pooling of resources for joint projects. A minority portion of the Asia Foundation's budget is covered by non-USG sources.

Staffing of each field office would be light, perhaps consisting of a U.S. citizen and local co-director, and, possibly, additional local staff. When possible, office space could be shared with other USG-affiliated bodies (Citizens Democracy Corps) or even with other Western organizations working to support democracy. Headquarters staffing would also be very light. For comparative purposes, the Eurasia Foundation has a Washington staff of about 15 plus five field offices in the NIS and has targeted its overhead for about 15% of budget (its first year start-up overhead was 22% of budget), a very low figure by NGO (and USG) standards.

Substantive activities would vary in each country, depending on local needs and programs (USG or otherwise) already running. The Democracy Institute would have more flexibility than the NGOs under contract to AID, though it would seek, through coordination with the local U.S. Embassy, to complement ongoing programs. Activities would have a grass roots, regional or provincial focus; programs that brought together different ethnic or national communities would have a priority. Possible areas of activity include: strengthening the independent judiciary and legal profession; promoting ethnic tolerance, especially through work with local organizations; and

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education, including especially civics. In these sensitive cases, relative distance from the USG could be a decided asset.

Funding would have to be identified within the existing SEED budget. (For comparative purposes, the Eurasia Foundation budget is about \$15 million per year and AID is planning to fund new public administration programs for CEE in FY94 at \$30 million.) The \$5.5 million targeted by AID for its U.S. NGO democracy programs would be one source for the Democracy Institute. Another would be found in resources made available as the Enterprise Funds in the Northern Tier countries reach full capitalization, expected in FY94.

In addition, following the precedent of the Asia Foundation, Embassy AID offices could provide funding in the field for designated Democracy Institute projects; as noted above, the Democracy Institute would elicit a portion of its funds from other NGOs and organizations for particular projects.

PROS

The Political Message. The Democracy Institute would pay political dividends. Unlike traditional programs, it is intended to be seen in CEE countries as evidence of sustained U.S. commitment to long-term democracy-building there. A sense that America is "with them" for the long haul can reassure and bolster democratic forces, especially as the reform process encounters setbacks (as it already is); that sense is now lacking. Political forces that resented the Democracy Institute as paternalistic might well resent any USG democracy program.

We would present the Democracy Institute as an example of government/private partnership representing broad U.S. values and objectives, not the USG; we would be clear that the Democracy Institute was not a USG organization. Ample precedent exists for this ambiguous situation: the Asia Foundation, the Eurasia Foundation, and other similar bodies exemplify the quasi-official/independent model we seek; the Asia Foundation has been a success for many years. Experience shows that such organizations can have a significant, positive impact, especially over the medium and longer term, as they establish themselves and gain local experience and credibility. In the event of a reversal of democracy in a given country, an independent body operating in country can play an especially important role.

While a long-term commitment is a positive signal, the Democracy Institute would not be a permanent fixture. In countries where democracy was clearly entrenched at all levels and irreversible, Democracy Institute programs could be slowly phased out.

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- o **A new institution -- a dedicated, regional NGO as a carrier of the U.S. democracy agenda in CEE -- arguably brings advantages that cannot fully be duplicated using traditional USG programs: speed in turning around indigenous grant requests; breadth; flexibility in designing programs and cooperating with other organizations; a long-term, field-based presence that brings credibility and knowledge of the area; and sustainability through access to non-USG funds (the precedent of the Asia Foundation is relevant in this respect). Relying solely on contracted American NGOs will result in short-term presence; the USG should have its own, informally affiliated democracy flagship to demonstrate commitment and to get more of our modest assistance funds directly to indigenous groups rather than having to work through American contractors and NGOs.**

- o **The NIS Coordinator's office has found the Eurasia Foundation, in some ways a precedent for this proposal, to be a responsible, cooperative partner. Past experience with similar regional, quasi-USG foundations (e.g., the Asia Foundation) suggests the overhead they bring is neither large nor onerous, and certainly no greater than that of the existing NGOs to which AID would turn.**

- o **Start-up time and costs could be mitigated by transitional use of existing infrastructure in Washington (e.g., by asking the Eurasia Foundation to take on CEE during a transitional period) and in the field (use of existing offices, such as the Citizens Democracy Corps). Proponents believe that start-up time would be no greater than, and possibly less than, the NGO approach suggested by AID.**

- o **Coordination with the Embassy would be informal but extensive, working through the Embassy's Democracy Commissions suggested in this PRD. The long experience of the Asia Foundation suggests that the working relationship between the Embassy and local field office can be very productive and that problems can be avoided, even in authoritarian host country environments. A requirement to consult could be written into the Democracy Institute contract with AID.**

- o **Embassies would still have a role in democracy programs. However, as the experience of the Asia and Eurasia Foundations suggests, there are advantages in establishing an institution with some distance from the Embassy. The experience of the Asia Foundation suggests that such quasi-official bodies can function without being regarded as USG instruments.**

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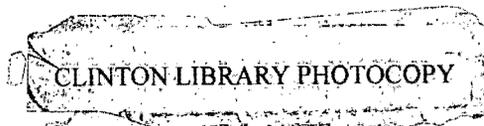
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- o Sustainability and a long-term presence are advantages. **The issue of performance and unwanted "entitlement" can be addressed in the initial contract** (e.g., by setting term limits on the Institute's leadership and providing a sunset clause).
- o Empowering Embassy Democracy Commissions to make their own small grants has merit, but does not eliminate the need for a long-standing, independent source of funding and activity for democracy programs. The independence and distance from the Embassy of a Democracy Institute could be advantages in the event of significant setbacks in a given country, and the greater flexibility an independent foundation would have in raising funds and cooperating with other local and third country bodies is a plus in any event.

CONS

- o The President's CEE Assistance Coordinator believes **there is no need for a new institution**. Areas of weakness identified in the political structures of the CEE states are being addressed by ongoing and planned assistance programs. The "Second Generation" initiatives on developing NGOs and Public Administration -- programs developed over the past year -- as well as a small grant capacity in the Embassy's Democracy Commission address all of the target areas of the Democracy Institute.
- o We already have institutions in each country that can focus U.S. attention and resources on democracy programs; they are the U.S. Embassies. **A bifurcation of responsibility between Embassies and Democracy Institute might undermine policy**. U.S. policies promoting democratization need to come from the Administration and be implemented at its direction. Particularly in countries where democratic institutions are fragile, we need to take a systematic, coherent approach to making them stronger, not abdicate that responsibility to a government-funded but independent organization. Governments in this part of the world will simply not believe that an institute funded by the USG is not representing U.S. policy. We cannot afford confusion about who speaks for us on issues that are so potentially explosive.
- o **CEE governments are likely to react negatively to the Institute field offices**, viewing them as a paternalistic gesture that implies that the U.S. does not believe they will ever be able to handle democracy on their own. Most of these countries do have a democratic tradition and all of them are committed to joining the West. What we need to do is help strengthen indigenous institutions (NGOs and the



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like) to take care of their own democracy -- something our planned NGO program will accomplish -- not give them a U.S. watchdog institution.

- o **Start-up time would be considerable** before projects actually got underway (at least 18 months in the case of the Eurasia Foundation, although this was largely due to the change in Administration). It may be suggested that the Eurasia Foundation could provide bridging help, operating in CEE while infrastructure for a separate entity is put in place. Whether or not it is capable of this, from a political standpoint, the idea that Central and East Europeans would welcome such activities by an institution set up to promote democratization in the FSU is not credible.
- o **Long-term funding would be a problem.** The Institute's finances will inevitably be dependent on SEED. There is no basis for concluding that they could survive after the phasing out of SEED over the next 5-7 years. This calls into question the economic efficacy of the high start-up costs of the operation, if it will be shut down after such a short period.
- o **The Eurasia Foundation is not a precedent** that relieves us of responsibility for making an independent judgment about this proposal. The Eurasia Foundation has a budget of approximately \$17 million per year (our "democratization" programs are funded at \$42.5 million for FY 94) and seems mainly engaged in providing short-term training grants. It is far too early to judge whether it will provide added value in the FSU.

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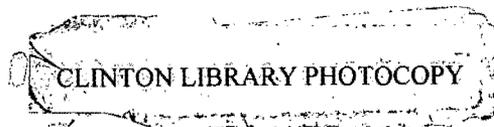
TARGET FUNDING LEVEL FOR
REGIONAL ASSISTANCE PROJECTS

PROS

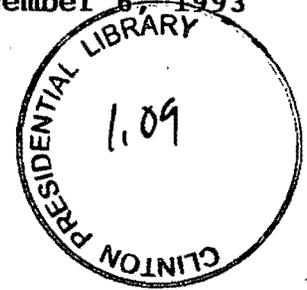
- o Establishing a target figure for USG assistance in support of regional projects would focus U.S. efforts far more than purely hortatory language.
- o A USG target figure would be a strong political signal to the IFIs of our interest in regional cooperation, encouraging them either to set their own target figure or to make greater efforts in that direction. Our modest budget could leverage significant resources.
- o Especially if followed by comparable steps by IFIs, a target figure for regional programs would be an incentive to countries in the area to intensify their own cooperative efforts. In post-World War II Western Europe we took even stronger steps (though with greater resources) to encourage reluctant countries to cooperate.
- o A target figure would not be a straitjacket or act of micro-management, but a strong statement of purpose; if we could not mount sound regional programs to make the designated target, the money would not be lost. A designation of a target figure for an objective we agree is sound is hardly an example of "central planning." Grants for multi-state projects are no more examples of central planning than single-state grants.

CONS

- o There is no empirical basis for arriving at the 20 percent figure. After we have persuaded the CEE states to abandon central planning, we would now be imposing it on ourselves.
- o While we have historically been in favor of regional projects, the CEE governments have shown little enthusiasm for them.
- o Our assistance budget is not large enough to give us effective leverage, i.e. to force the CEE states to do regional programs.
- o Deputies may wish to direct that greater emphasis be placed on regional programs. The President's CEE Assistance Coordinator would then report progress in his follow-up actions. This would allow Deputies to monitor the evolution of regional programs without setting an arbitrary target that cannot be justified in budget or program terms.



PRD 36: ANNEX 3



REGIONAL INFRASTRUCTURE

I. PARAMETERS OF THE PROBLEM

Transport and telecommunications links in CEE countries have not developed at the pace seen in Western Europe. At a time when this situation was beginning to change, the region suffered a major setback. The collapse of Yugoslavia -- and the imposition of UN sanctions on Serbia-Montenegro -- have shattered regional trade in the Southern Tier. Traditional transit routes between the Balkans and Central and Western Europe have been cut off, with almost all of Bulgarian, Macedonian, Greek, and Turkish freight traffic routed through one aging Danube bridge and a lone ferry port in Romania. Albania, emerging from decades of isolation, found its most direct surface route to Europe and major markets in the Balkans cut off by UN sanctions. The West has threatened to retain these sanctions for years -- to turn Serbia into a pariah state -- while ignoring the need for some kind of compensation for trade losses.

Compensation for Sanctions Losses: It has been clear for some time that the USG would not have the resources needed to resolve the issue of direct compensation to the front-line states (Hungary, Romania, Bulgaria, Macedonia, and Albania) for the significant costs of sanctions-related trade losses to their economies. While the impact of the sanctions is not assessed at the present time to be regime-threatening, we must consider the long-term loss of 2-4 percent of GDP a threat to continued political and economic reform efforts in the front-line states.

Infrastructure Assistance: The primary alternative of interest to the countries of the Southern Tier is assistance in funding regional infrastructure projects. Some in the Balkans categorize this assistance as "indirect compensation." These projects are largely in the region's long-term developmental interest and should improve access to primary markets; they are not simple stop-gap measures aimed at completing a bypass of Serbia-Montenegro. Such projects might possibly include:

- o A "rolling highway" for rapid piggyback rail (Ro-Ro) transport of trucks from the Hungarian/Romanian border to Bulgaria, possibly onward to Greece/Turkey. The system would connect into the system being built connecting Hungary with Germany.
- o The construction of new Danube bridges linking Bulgaria to Romania providing access to upgraded Romanian highways to Europe.



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- o An east-west road-rail corridor linking Durres, Albania with Macedonia and Bulgaria.
- o An east-west telecommunications corridor linking the countries in the above item via fiber-optic cable.
- o In the Northern Tier countries, projects would include upgrading those border crossings identified as bottlenecks to regional trade from Lithuania down to Slovenia.

Political Messages: Within the context of the Yugoslav crisis, regional infrastructure projects send a political message to Belgrade. That message is simple: Serbia's monopoly on the Balkan transportation net will be broken, making it possible for the international community to deliver on the threat of turning Serbia-Montenegro into a Balkan backwater as the rest of the region integrates into the greater European economy. Beyond this, such infrastructure projects also signal our support for CEE economic integration and provide for a measure of trade facilitation.

II. REGIONAL TRANSPORTATION INITIATIVE; KEY ELEMENTS

Resource Commitments: Launching an initiative in the regional transportation field will not require large commitments for new assistance funds. Available tools are limited, but a significant initiative can be managed through improved coordination with organizations already working on the transport front and relatively small disbursements of assistance resources to move projects forward.

Working with the IFIs: Northern Tier infrastructure projects appear to be moving through IFI reviews smoothly. However, the front-line states have not submitted project proposals for new routes around Serbia to the IFIs and have asked for help on this front. The IBRD, in particular, shows little enthusiasm for funding routes around Serbia based on what it views as short-term political criteria. We can potentially help accelerate the process by calling for the formation of a multi-donor technical assistance fund to assist front-line states to finalize funding proposals. The IBRD or the EBRD would be logical candidates to operate the fund. Once a project proposal has been submitted, we intend to use our influence to get proposals approved in the shortest feasible time, consistent with economic development criteria, bank procedures to meet environmental concerns, and procurement regulations.

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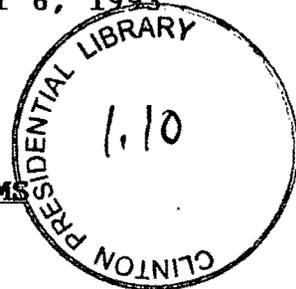
Expanded EU Role: We would expect the EU to take on some responsibility for regional projects, as Brussels now has Association Agreements with the Visegrad countries as well as Romania and Bulgaria. The G-24 Transport Committee is an appropriate vehicle for coordinating our efforts, and more emphasis on this Committee's work will probably pay off.

Tools: We have had few readily available tools to move regional infrastructure projects forward or to help jump-start the process. Our contributions to the process on the diplomatic front have been limited, with the primary intent of bolstering the political will of the front-line states to enforce sanctions. Moving beyond the sanctions phase has proven difficult because we have not identified appropriate funding vehicles other than a short-term injection of sanctions enforcement funds (SEED funds cannot be used for infrastructure construction, although technical assistance is possible). We expect that Trade and Development Agency (TDA) funding of small feasibility studies will begin to attract U.S. business to the opportunities contained in these infrastructure projects.

- o Improving customs procedures throughout the region is an area that could yield a significant change in a short time, without the need for much construction.
- o The U.S. can make a significant contribution here, but in view of the Association Agreements, it would be more efficient if the EU were to accelerate its own plans for customs assistance to the region.

Progress to Date: Crossing the Danube is the main barrier to north-south traffic through the region; the Romanians have issued a tender for construction of a new bridge at Bechet. The Bulgarians and Romanians have just issued a joint tender for a Calafat-Vidin bridge. We have already transferred \$850,000 in sanctions enforcement funds (the biggest contribution to-date from any donor) to the UNDP in FY93 for a combined project intended to alleviate road congestion at the Friendship Bridge crossing between Bulgaria and Romania (Giurgiu-Ruse). This project will yield minor infrastructure improvements, but these should go a long way toward eliminating one of the major bottlenecks on the north-south route.

PRD 36: ANNEX 4



COORDINATING ASSISTANCE FOR NEWLY PRIVATIZED FIRMS

OVERVIEW

The purpose of this paper is to set forth a USG effort to better coordinate existing resources and information about their availability to newly privatized firms seeking to restructure. By targeting newly privatized firms and encouraging the World Bank to help cushion the immediate adverse social impact, we hope to provide incentive to other firms to press on with privatization.

WHY THIS PROGRAM IS NECESSARY

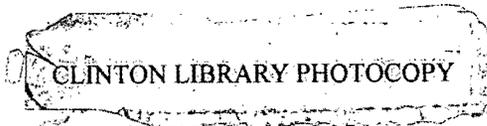
There are several reasons to consider a new initiative:

First, results to date to privatize enterprises in CEE countries are mixed. Although there has been significant success in privatizing smaller and medium-sized enterprises, there has been far less progress in privatizing the larger state-owned enterprises, which still account for a large share of output and employment in most countries.

Second, coordination of resources for newly privatized firms can be improved. Often newly privatized firms seeking to restructure are not aware of the full range of resources available to them, and donor agencies may not be fully aware of the needs of individual firms. As a result, firms may not be able to obtain the mix of assistance they require to restructure: debt and equity capital, financing for critical imports, insurance and guarantees to help attract foreign investors, technical assistance to draw up business plans, etc.

Third, a comprehensive program and adequate resources to deal with the "social consequences" of restructuring are often lacking. This deficiency reinforces a go-slow attitude. Governments may delay privatization if they believe they are expected to accept the responsibility of providing the services (education, health, pensions, etc.) provided by the enterprises.

State and AID share the desire to better coordinate resources available to newly privatized enterprises. However, they are not convinced that the program described below is the most appropriate way to address "post-privatization" needs. Moreover, they question both the mechanism as described by Treasury below and the resource implications of the initiative. State and AID recommend that the initiative be remanded for further discussion in the IWG.



WHAT THE NEW PROGRAM WOULD DO

A new initiative would encourage the speeding of privatization, improve resource availability for restructuring through improved coordination, and enhance the transition to a market economy. Bringing World Bank resources to the initiative to help cushion the impact on the social safety net will enhance the attractiveness of the initiative.

HOW WOULD IT WORK?

Several steps are necessary:

First, we need to reach agreement with the G-7 and the donor institutions that we can enhance the privatization process and transition to a market economy in CEE by coordinating more effectively resources available to newly privatized firms.

Second, we need to obtain G-7 agreement, and that of senior policy officials of the World Bank, that the Bank would be the "coordinator" or executing entity. We believe the Bank is best placed to do this, given its presence in CEE countries and its experience in project finance.

Third, the Bank would meet with resource providers, both at the national level (Exim, OPIC, and their foreign counterparts) and international level (EBRD, IFC, MIGA) to insure that resources are available for restructuring newly privatized firms. In its dialogue with these institutions, the Bank would seek to determine what problems they may be experiencing in disbursing their resources and to work with them (and as appropriate the host government) in trying to overcome these difficulties.

Note: this is not a World Bank "one-stop shopping" exercise. We want to avoid substituting control by the World Bank for control by government ministries. Rather, the emphasis is on coordination of resource availability and problem solving to marshal resources in an integrated fashion.

Fourth, the coordination effort should be publicized in CEE countries, through appropriate media which have contact with newly privatized enterprises. It is the prospect of access to capital and other resources which will leverage the desired behavior. Therefore the program should be publicized as widely as possible.

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ANNEX 4

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WHERE WOULD THE RESOURCES COME FROM?

Our objective is to catalyze existing resources. The program would be conducted by pulling together resources from a number of bilateral and multilateral entities into a comprehensive and integrated design for accelerating reform and privatization.

Potentially, equity and debt funds could be provided from a combination of our Enterprise Funds, EBRD, IFC, OPIC leveraged funds, Exim, and private capital, both foreign and domestic.

DEALING WITH THE SOCIAL CONSEQUENCES

A major and central issue is the need to deal with the social "consequences" of privatization. To this end, IFI resources programmed for Enterprise and Financial Restructuring loans (EFSAL) could be designed to help cushion the short term impact on social services that newly privatized firms would shed. Conditionality would be attached to speed the pace of market reform and insure appropriate expenditure of funds allocated for the social safety net. This element of the program could contribute to removing a key obstacle holding back quicker and broader privatization.

OTHER FACTORS

All the diverse elements in the program would be pulled together in an initiative which would require the endorsement and support of various participants. Details would need to be worked out, including, for example, the length of such a program be in effect, exit strategies, and other operational concerns.

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PRD 36: ANNEX 5

REGIONAL AIRSPACE INITIATIVE

OBJECTIVE: To launch an initiative to establish a region-wide civil/military airspace management and air sovereignty system in CEE using bilateral and multilateral mechanisms to provide, respectively, technical assistance and policy-level coordination.

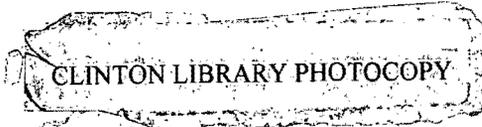
PURPOSES: This initiative would serve several objectives at once: 1) increase civilian control of national airspace and civil-military cooperation within CEE countries; 2) increase cooperation among CEE countries in air traffic control (ATC) and in issues of air sovereignty, thus serving our objective of enhancing intra-regional habits of cooperation and reducing the likelihood or fear of war among participating states; 3) improve commercial ties with the West through a more efficient air traffic infrastructure; 4) produce cost savings for CEE defense budgets by combining civil and military systems as is done in the U.S.; 5) support a modernized CEE regional air sovereignty system that could be integrated into NATO systems, if desired in the future.

BACKGROUND: With the dissolution of the Warsaw Pact, CEE countries were left with antiquated civilian ATC systems, Soviet-style air defense systems, air forces that were not equipped with International Civil Aviation Organization-compatible transponders, and a policy situation in which all decisions concerning the use and control of national airspace were left to the military. These countries regard modernization of their air sovereignty systems as a major national security priority. Limited bilateral and NACC cooperation in this area has begun, but has yet to gain the momentum we envision.

Bilaterally, we have encouraged these countries to consider civilian airspace control and discussed with them the value of adopting a unified civil-military ATC system as in the U.S. In addition, we have discussed with them the economic advantages of leveraging any ATC investments into a united civil-military ATC/air sovereignty system (we pursued this topic at a EUCOM-sponsored meeting -- "Airspace Management Seminar" -- in Oberammergau in May 1992, and through the military-to-military contact program and our bilateral working groups).

In NATO, we have pursued the topic of civil-military cooperation in ATC and airspace management using the NATO Committee for European Airspace Coordination (CEAC) as a forum. After two years of slow work, primarily to overcome French objections, we succeeded in opening the NATO CEAC meetings to NACC members. To date, two formal meetings have

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been held, and Visegrad countries have participated with both civil and military representatives.

The CEE countries have expressed interest in the subject and acknowledged the need for a modern air sovereignty system and an improved ATC capability; however, none has yet made the political decision to transfer ultimate authority for airspace matters from the military to civilian control. Nevertheless, while such a transfer of authority must prevail as a cornerstone of future airspace management developments, the groundwork has been prepared for more serious efforts to support CEE countries in establishing integrated, civil-military ATC/air sovereignty systems.

AN INITIATIVE: We suggest a two-stage approach.

Stage I: Architecture Development.

The U.S. would offer to prepare a comprehensive plan to develop architectures for modern digital ATC/air sovereignty systems. While continually encouraging the CEE countries to adopt a regional perspective with respect to their airspace management decisions, we would, nonetheless, develop architecture on a bilateral basis. So doing would ensure that the equipment, procedures, and training provided were technically compatible and suitable for future integration when relations among the regional neighbors had progressed to the point that a shared system was politically feasible.

We should initially offer this to the Visegrad countries as a pilot project, but a view toward expanding it to Bulgaria, Romania and Albania. (Our policy emphasis to date has reinforced the perception among Southern Tier states that they are behind the Visegrad countries in terms of economic and/or political "Westernization," resulting in less attention from the West. By including them in this initiative, we offer an incentive to develop the same regional outlook we are trying to instill among the Visegrad states.)

The architectures would be structured to provide easy connectivity to NATO systems, if desired in the future, and would be predicated on very close operational cooperation between the militaries and civil ATC systems of the participating countries. The plan would be prepared with the complete participation of host governments and the Federal Aviation Administration. Conducting a thorough study via NATO or NACC would be too lengthy and might not reach the detail, and thus utility, of what we have in mind; but, we should keep NATO and NACC informed of our efforts and ensure the design would be compatible with Western Europe's new ATC program ("EATCHIP").

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Resources: Design of a comprehensive system for the Visegrad countries would cost about \$0.5 million. We would ask host governments to make symbolic contributions and provide the bulk of the funding ourselves. The architecture plan would take about 6 months to complete.

Stage II: Establishing the System

Bilateral Activities: Assuming the architecture plan was accepted by the countries, the U.S. would offer to provide technical assistance throughout the process of implementation (the U.S. has, in the past, supported establishment of such systems in other countries, e.g. Colombia, using anti-narcotics funds). This would include short- and long-term training and assistance, active support for U.S. commercial involvement in the civilian elements of the project, provision of short- or medium-term military and civilian technical advisors (possibly through the military-to-military contact or follow-on program), active use of FMS, licensing support when necessary, and other forms of bilateral assistance (e.g. EDA, TDA, AID when feasible). At the same time, we would make special efforts to enlist support of NATO countries with a special ability to be helpful in our bilateral work, e.g., Germany; we could work with Germany in a 2 + 4 (Visegrad) + 3 (Bulgaria, Romania, Albania).

Multilateral Activities: In parallel, the U.S. would undertake to engage NATO/NACC involvement in this project. We would press NACC to establish a special ad hoc subgroup on airspace cooperation to act as a clearinghouse for NACC multilateral efforts and bilateral efforts among NACC nations. We would press the North Atlantic Council (NAC) to task the NATO CEAC and the NATO Air Defense Committee (NADC) to form a special joint working group to coordinate both NATO sponsored multilateral work and NATO member-initiated bilateral initiatives in the area.

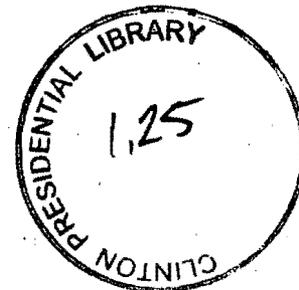
In addition, the joint CEAC/NADC working group would develop and propose a work plan for NATO/NACC to pursue. CEAC, as the senior committee, would report periodically to the NAC a recapitulation of individual states' bilateral work to assure such activity by member countries was consistent with NATO goals and policies. We would seek to link these efforts with Partnership For Peace activities through a series of exercises and, finally, full field training exercises, such as a trans-national hijacking scenario, civil emergency, or natural disaster relief, and a massive peacekeeping exercise. These exercises, planned as part of Partnership For Peace exercises that will go beyond airspace issues, could involve familiarization of CEE militaries with AWACS operations and short-term assets. But they would also be designed to test a regionally coordinated system with militaries of various CEE countries working together.

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UNITED STATES ARMS CONTROL AND DISARMAMENT AGENCY

Washington, D.C. 20451



OFFICE OF
THE DIRECTOR

DEC 21 1993

MEMORANDUM FOR WILLIAM H. ITOH
EXECUTIVE SECRETARY, NATIONAL SECURITY COUNCIL

SUBJECT: U.S. Policy Toward Central and Eastern Europe
(PRD 36) (C)

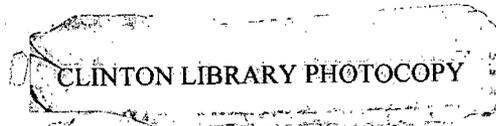
The Deputies Committee met December 14, 1993 to consider the report of the Interagency Working Group (IWG) on PRD-36. Although representatives of the U.S. Arms Control and Disarmament Agency (ACDA) participated throughout the review by the State-led IWG, ACDA was not invited to this Deputies Committee meeting. I would appreciate receiving a copy of the current version of the PRD-36 report as it emerged from the Deputies' meeting and an opportunity for ACDA to provide comments. I also would appreciate your assurance that ACDA representatives will be invited to attend any further meetings at the Deputies Committee level and above on this PRD. (C)

Barbara Starr
Barbara Starr
Executive Secretary

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