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August 12,2005

TO: Stephen J. Hadley

cc: The Honorable Dr. J.D. Crouch

FROM: Donald Rumsfeld D.R.

SUBJECT: Funds to help transform NATO

Van Galbraith has come up with an idea that is described in the attached paper. I believe J.D. Crouch is familiar with it. Van has been talking to key people about it -- some at Treasury and elsewhere.

My suggestion is that you folks take a look at it, and possibly have the PCC or the Deputies' Committee take a look at it. It might be something that would be good to broach at an early NAC meeting at the ambassador level, or in a discussion, for example, at the informal NATO Defense Ministerial meetings in Berlin that are upcoming next month.

I would appreciate it if you would take a look at it, and give me some guidance as to how you think we ought to proceed.

Thanks.

Attach: 4/29/05 Paper: "Money Needed to Transform NATO

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Money Needed to Transform NATO

NATO is building an expeditionary capability. It has entered the War on Terrorism and sent forces to Afghanistan - the intention is to reduce the U.S. Forces in Afghanistan and merge them into a NATO Command. A NATO training center is being stood up in Iraq. NATO ships are interdicting suspect maritime traffic in the Mediterranean. NATO has 17,000 troops in Kosovo and retains an office in Bosnia.

The original purpose of NATO, to defend Europe, remains, but the War on Terrorism requires NATO to be capable of projecting force and assistance outside of Europe. To this end, NATO has created a NATO Response Force (NRF) to send up to 20,000 war fighters rapidly into a hostile foreign environment. NATO's expeditionary experience, albeit limited, confirms the NRF's mission, and the value of a NATO capability to the United States is manifest. However, the cold reality is that NATO Allies now know modern expeditionary warfare is expensive. The cost to France of its 45 day peace-keeping mission to the Congo (est. $500 million) and of containing the revolution in the Cote d'Ivoire ($675 million per year) has caused France to hollow out forces and cut back on procurement. The UK's operational tempo in Iraq, Afghanistan, and the Balkans has caused delays in force modernization, e.g. aircraft carriers.

This reality of increased costs could soon render NATO impotent. Our Allies are reluctant to respond to SACEUR's force generations. Shortfalls of men and equipment are the rule, not the exception, even though both are available to Allies. Moreover, the United States often has to supply expensive enablers - airlift, logistics, combat services and support, force protection, special forces, intelligence, etc. The United States has spent $2.5 billion per year to building an Afghan National Army (ANA), a prerequisite to the U.S. and NATO reducing their forces in Afghanistan. The Allies spend relatively little for an ANA capability. The Italians were willing to send 5,000 troops to provide security for the Afghan elections in September 2004, but the United States had to provide airlift and logistical support at an estimated cost to the U.S. of $6 million. Under a MOU with CENTCOM, NATO is spared millions in force protection for the NATO Provincial Reconstruction Teams (PRTs) and the NATO forces in Kabul. A similar story is developing in Iraq. Allies would not be able to stand up the 350 trainers for a NATO training center without the perimeter protection and logistical support supplied by the United States at a large cost of troops and money.

The chances for meaningful increases in the defense budgets of our Allies are nil. Most have large budget deficits and several are in violation of the EU 3% GDP limitation. And time will not heal the wound. The macro economic outlook in Europe is poor and it will take years before the U.S. economic locomotive overcomes the built-in obstacles to European growth.

The defense funds which were hoped to have been recouped by Allies cutting Soviet oriented defense costs have proved illusory. Transformation has not and will not generate sufficient resources to pull the Allies up above the defense poverty level.

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The Secretary General of NATO, Jaap de Hoop Scheffer and SACEUR, General Jones, both call for common funding of operational expenses by Allies. They feel the NRF may otherwise fail. If so, NATO would give way to ad hoc Coalitions of the Willing with each nation paying its own troop costs and the U.S. paying for the enablers and logistics. Coalitions have worked, e.g., twice in Iraq, but if NATO had its own capital a NATO coalition would be broader and deeper. Allies would be more inclined to send troops and materiel if NATO assumed the cost. Moreover, the United States which has the largest share of the NATO military budget (22%) would benefit the most by not having to pay the usual outsized portion of operational expenses. Thus, the United States could save hundreds of millions or more by the Allies using NATO's capital and not that of the U.S. As significant, the reduction in the use of U.S. forces and equipment would be substantial.

The U.S. is severely cutting its defense budgets to pay for operations in Iraq and Afghanistan. U.S. procurement will continue to slip until these operations run down, causing force modernization and transformation to be adversely affected. Any reduction in our outlays in support of NATO would be welcome elsewhere in our defense budget.

Capitalizing NATO

Today, using only the several guarantees of the Allies (not the joint guarantees), NATO could raise several billion euros or dollars of long term financing. Presently, nations can walk away from their commitments to the NATO budgets. With a bond issue the nations' commitments will run to the bond holders. Taking the U.S. (22%) and Allies at their present share of the NATO military budget, an example of the terms could be:

Amount: 1-3 billion, dollars or euros.

Maturity: 30 year single, bullet payment. Acceleration in the event of default.

Issuer: Special purpose financing subsidiary of NATO.

Guarantors: NATO, and each member severally liable up to its percentage of the military budget.

Form and Denominations: Bearer bonds of e.g., $1,000,000, $100,000 or $50,000.

Prepayment: Prepayment penalty.

Interest rate: 4.5% - 5%. Payable every six months.

Offering and Listing: Offered internationally and listed on the Luxembourg stock exchange.

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Legal Opinions: (a) NATO's legal authority for it and its subsidiary to issue the bonds (b) Verifying the guarantees to be the binding full faith and credit of the guarantors.

Underwriting: The issue of the bonds would be underwritten and sold by an international syndicate of financial institutions.

Bond Rating: AAA or AA+

The Case against Capitalizing NATO

A. A Congressional appropriation would probably be necessary to allow the U.S. Treasury to guarantee the U.S. portion of bonds issued by NATO and this may be difficult. After the receipt of my letter (March 16, 2005) the Undersecretary of the Treasury accepted in a long telephone conversation (March 31, 2005) that the proposal should generate significant savings to the United States and he opined that Treasury would be "supportive" in seeking Congressional approval to help the US. to save money and reduce casualties.

B. The fact that the Treasury could borrow at a cheaper rate than NATO creates an argument that it would be cheaper for the US. to supply cash to NATO instead of its guarantee. This argument fails for two reasons. One, the amount saved by the reduction in the U.S.'s paying for the operating expenses of other Allies dwarfs the differential in interest rates between NATO bonds and Treasuries. Second, while the U.S. might be willing to supply NATO with 22% of an expanded military budget in cash, other nations will not, and as the nations do not pay their share, the amount paid by the US. would increase. For most nations it will be politically easier to issue a guarantee and if the U.S. were not to participate, the joint project would fall apart.

C. It has been said the U.S. should not be a party to an effort by Allies to circumvent their parliaments. Our reply is that the U.S. does what it must do, but it should not try to judge how other democracies conduct their financing.

D. Some question how NATO will pay the interest and repay the principal on the bonds; it has no taxing power. The investors will be looking to the guarantees and to avoid the embarrassment of having to make good on such guarantees, nations will pay into NATO according to an agreed schedule. The funds raised will not be spent immediately and will be put to work to earn interest and if interest rates rise, to buy back bonds trading below the issue price. Sometime before 30 years NATO will do what governments usually do, refinance debt with another issue of bonds. For every $1 billion of bonds an annual interest cost of $45 to 50 million will be paid, diminished by interest earned and repurchase profit for a total cost of say $25 million per year, i.e. only $5.5 million for the U.S.

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The Way Forward

It is often said in Washington, by both political parties, that the U.S. should do more with NATO. Unless NATO is capitalized, there may soon be very little it can do.

E. G. Galbraith
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