MEDITERRANEAN PAPER SERIES **2012**

SOUTHERN EUROPE IN TROUBLE

DOMESTIC AND FOREIGN POLICY CHALLENGES OF THE FINANCIAL CRISIS

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Cover photo: February 22, 2012: Student demonstration in Valencia streets, against the cuts in the public education and against the police violence. The banner slogan reads "We are the people."

Southern Europe in Trouble

Domestic and Foreign Policy Challenges of the Financial Crisis

Mediterranean Paper Series

December 2012

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Foreword

Andrea Dessì and Ettore Greco

The financial crisis that originated in the United States in 2008 sparked a global crisis, which quickly spread across the Atlantic and shook the very foundations of the eurozone project. The ensuing sovereign debt crisis has called into question the principles and institutional mechanisms of the EU's economic governance, especially those of the Economic and Monetary Union (EMU), causing divisions between and within individual member states and deep popular discontent across the continent. The political setting in the most troubled countries has become more unstable, with growing tensions emerging both at the institutional level and between the central and local governments. The crisis has highlighted the inherent contradictions of a project that has failed to progress from the creation of a common currency into a genuine fiscal and political union.

Southern European countries have been the hardest hit by the crisis, as mounting public debt, combined with slow or inexistent economic growth, pushed nation after nation closer to the precipice of bankruptcy. The climate of resentment and mistrust that has taken root between northern and southern Europe is one of the biggest obstacles for the adoption of an effective crisis management strategy.

European countries that have submitted to bailout programs have in effect been forced to outsource economic policy to Brussels, and this in turn has stirred resentment against EU institutions. For Southern European countries, there is a high risk of remaining trapped in a vicious circle of stringent austerity measures, growing indebtedness, and economic stagnation. Populist parties and groups are benefitting from rising popular frustration and may be able to obstruct fiscal adjustment and reform efforts. While important steps have been made at the EU level to mitigate the effects of the financial crisis — especially since mid-2012 — much more has to be done in order to restore confidence in the euro's survival.

For the United States, developments across the Atlantic are of a primary concern, not least because the economic recovery of that country is in no small part contingent on Europe's economic revival (and vice-versa). Moreover, for the United States, Europe still represents the major source of moral, economic, and political support. In a time when the United States is increasingly perceived as struggling on the world stage, the transatlantic relationship remains a fundamental asset for the United States' capacity to project its interests abroad. Notwithstanding the United States' increased focus on Asia, the European dimension will continue to represent a central tenant of U.S. foreign policy.

This installment of the *Mediterranean Paper Series* focuses on four financially volatile Southern European countries: Italy, Spain, Greece, and Portugal. The authors — all from leading European research centers — examine the effects of the crisis on the domestic and foreign policies of the above mentioned countries. Each author also discusses the repercussions of the crisis on the social and institutional fabric as well as on the European project as a whole. Each country report further analyzes the impact of the current financial predicament on relations with the United States and advances a series of proposals and policy recommendations on how to develop common responses to the crisis while avoiding a negative fall-out on the transatlantic relationship.

1 Damage Control
Italy and the European Financial Crisis
Andrea Dessì and Ettore Greco

Italy's financial standing worsened considerably in the second half of 2011 as the country became the target of violent speculative attacks, which exponentially increased its borrowing costs. The prospect of Italy, the eurozone's third largest economy, defaulting on its debt sent ripples across the continent, as this could precipitate a collapse of the EU's Economic and Monetary Union (EMU) as a whole. The need to reassure allies, investors, and bond markets of Italy's capacity to weather the financial crisis became the government's top priority in both the domestic and foreign policy realms. The center-right coalition government headed by Prime Minister Silvio Berlusconi struggled to project a reassuring image abroad of Italy's finances and the deeply polarized political setting. This, combined with Berlusconi's declining majority in parliament, led to growing skepticism within Europe as to whether his government would be able to implement the reforms needed to curtail the country's mounting sovereign debt. Italy's financial troubles and Berlusconi's declining ability to reassure allies of his capacity to balance the budget brought on successive downgrades of Italy's bond ratings by major international agencies. This in turn fuelled international mistrust in his government's ability to comply with the fiscal commitments and related reform program it had agreed to under pressure from the EU. Reflecting Italy's central importance for the survival of the eurozone, EU institutions and major European states such as France and Germany began pressing Italian authorities to implement those economic and structural reforms needed to pull Italy back from the precipice of insolvency.

A turning point was reached in early November 2011, when the spread between Italian and German government bonds reached unsustainable levels, raising the specter of an Italian default. Faced with growing domestic and international pressure, Berlusconi eventually resigned. His center-right government was replaced by a technocratic one headed by an internationally respected and European-minded economist, Mario Monti. The new government, composed entirely of independents, was sworn in on November 16 and was well-received by Italy's international partners. Monti's appointment was widely perceived as a sign of the country's commitment to fiscal reform and deeper European integration thanks to Monti's record as an effective European Commissioner and his reputation as a principled free-marketeer. These credentials facilitated an immediate rapprochement with Italy's European partners, notably Germany and France, as well as an improvement in relations with U.S. President Barak Obama.

Strengths and Weaknesses of the Monti Government

Strongly sponsored by Giorgio Napolitano, Italy's Head of State and another highly respected figure in Italian politics, Mario Monti concentrated his efforts on reassuring international partners of Italy's commitment to fiscal discipline and structural reform. Drawing on his international experience as European Commissioner for the Internal Market between 1994 and 1999 and then as Commissioner for Competition until 2004, Monti and his government marked a clear break from the previous cabinet's troubled relations with major eurozone countries. His appointment to the dual post of prime minister and finance minister opened a new chapter in Italy's relations with Europe, helping to restore Italy's tarnished diplomatic role in the EU.

A distinctive feature of the Monti government, one that is widely appreciated by the public, is its independent, non-partisan profile, a rare trait in a political scene that for years has been dominated by harmful partisan politics and deep-seated antagonism between center-left and center-right parties. Working relations between individual ministers have also been far smoother than in previous cabinets, an aspect that has greatly facilitated the decision-making process within the cabinet.

However, the Monti government has also suffered from inherent weaknesses. Chief among these is the fact that it took office late in a crisis, of which the root causes are decades of poor policies pursued by successive governments from both sides of the political spectrum. Thus, while Monti was no doubt aware of the daunting challenges facing his government, the fact that he was only appointed in late 2011 and that his mandate was set to expire in spring 2013 are factors that in themselves were bound to constrain his scope for action.

The Monti government also lacks a political base of its own, which means that it relies on support from Italy's established political parties, which have indeed resisted or watered down several reform measures. While a vast parliamentary majority composed of the center-left Democratic Party (PD), the center-right People of Freedom Party (PDL), and the smaller Union of the Center party (UDC) supports the government, the parties themselves pursue largely divergent political agendas and are therefore at odds on a number of social and economic issues. This has considerably complicated the government's consensus-building efforts. So, while the Monti government has shown a remarkable degree of internal cohesion, the draft legislation it has approved has often had to navigate through stormy waters in Parliament.

Moreover, the Monti government has understandably chosen to concentrate on economic policy, leaving the task of dealing with badly needed political and institutional reforms to the parliamentary coalition. Of deep interest to the Italian public, these reforms include that of the judiciary, the constitutional system, and the electoral law. The failure of the parliamentary majority to enact these reforms has given additional impetus to populist and anti-establishment movements, but also contributed to eroding popular support for the Monti government.

Thanks to the resolute action immediately undertaken by Monti to bring public finances under control, the risk of a financial meltdown, which was widely perceived as substantial upon his taking office, was averted. At the time of writing, the austerity measures enacted by the Monti government — chief among them a fiscal adjustment package amounting to 5.2 percent of GDP - has also spared Italy the humiliation of having to submit to a bailout program. Such a request would weaken Italy's standing vis-à-vis its European partners, limit Monti's maneuverability on economic policy and, more generally, deal a serious blow to the country's international reputation.

Dragging Italy out of the financial abyss was without doubt the biggest achievement of the Monti government. In particular, despite strong opposition from trade unions, the government enacted a bold overhaul of the pension system which will greatly contribute to its long-term sustainability. The mounting costs of Italy's pension system due to generous benefits for older workers and a rapidly aging population had long been a ticking time bomb that risked undermining the country's public finances. Defusing this danger was key to reassuring financial markets.

The effects of other reforms introduced by the Monti government are however more uncertain. This was the case with a liberalization package aimed at increasing competition among professions and in the services market which has been widely criticized for being too timid. The government's parliamentary majority forced it to water down its original reform proposals, making a number of concessions to taxi drivers, lawyers, chemists, etc. The choice to accommodate the interests of such groups has contributed to eroding the consensus of the government among the wider public. Rules regulating the labor market were also reformed with the goal of reducing the huge disparities in the rights granted to the various categories of workers, but most analysts estimate that very little has been done to increase the flexibility of the system. In spring 2012, the government also embarked on an ambitious plan to cut public expenditures, which will affect various social groups, especially public employees. However, the plan has met with fierce resistance from both the public administration and the concerned social groups, which gives rise to serious doubts about the government's capacity to implement this reform before the end of the legislature.

The Populist Backlash

Given Monti's independent and non-partisan credentials and the significant support for his appointment from European and international partners, Italy's technocratic government initially enjoyed high domestic approval ratings. This honeymoon, however, proved short-lived, and public excitement soon gave way to growing worries about the social impact of Monti's reform package. Declining household income and, more generally, the effects austerity was having on an already sluggish economic growth soon came to top popular fears.

As Monti's austerity program began to be implemented, public spending was cut in sectors ranging from education to public health, leading to growing opposition from major trade unions and some of the smaller parties on both sides of the political spectrum. Approval ratings for the government declined from 71 percent in November 2011, to 47 percent in April 2012, and reached a minimum of 33 percent in June before increasing to 42 percent in September. Other factors also played a role in Monti's declining domestic support. The financial outlook in Italy (and Europe) did not improve, and as it became clear that the government's reforms were hostage to the parliamentary majority, Italians grew increasingly frustrated by the lack of a visible prospect of economic recovery. Moreover, important reforms of Italy's political and constitutional system were not in sight, thus further increasing popular disillusionment.

While Monti's declining support is significant, opinion surveys must be put into context. In fact, polls have also shown deep and growing popular mistrust toward parliament and public institutions in general (with the notable exception of the President of the Republic) as well as toward mainstream political parties. Moreover, recent developments in Italy and Europe have also created conditions for the rising popularity of parties that expound a populist platform, are critical of the European project, and oppose the granting of new political and economic powers to Brussels. While support for the Northern League, a devolutionist/secessionist and anti-immigrant party, has suffered as a result of a series of corruption scandals involving its highest ranks, a populist and anti-establishment group, the Five-Star Movement led by comedian Beppe Grillo, which promises a clean break with the past, has exponentially increased its following. The Five-Star Movement is expected to win a substantial share of the votes in the upcoming general election, thereby increasing the difficulty of forming a stable ruling coalition. Monti himself has repeatedly warned European partners of the risks posed by the growing tide of populist, anti-European, and anti-German sentiments across Europe, emphasizing that strict austerity measures without a parallel commitment to growth and employment would only favor the rise of such radical groups across the continent.

Like elsewhere in Southern Europe, the rise of populist tendencies and anti-EU sentiments is closely correlated to the social impact of the harsh austerity measures requested by EU authorities as a condition to help countries redress fiscal imbalances and avert the specter of a default. In Italy, increased support for such movements is also a result of growing popular disillusionment toward the established political parties, which are widely blamed for the country's current predicament.[1] Moreover, while austerity is causing widespread social hardship, Italy's economic outlook has shown little or no improvement, leading many to question whether such measures are indeed the correct response to Europe's financial troubles.

Italy's economic indicators have indeed worsened since 2011. While Italy's GDP grew by a modest 0.4 percent last year, the Italian economy recorded four successive quarters of negative growth in the period July 2011-June 2012.[2] Moreover, forecasts by the Italian National Institute of Statistics (ISTAT) for 2012 and 2013 put GDP growth at -2.3 percent and -0.5 percent, respectively. The country is now projected to remain in recession at least until mid-2013.[3] Such a prolonged slump is having a huge social impact. Unemployment statistics are particularly worrying, and the number of unemployed youth has increased sharply, raising the specter of a "lost generation." The overall unemployment figure rose from 8.8 percent in September 2011 to 10.8 percent a year later and is expected to increase further, reaching 11.4 percent in 2013.[4] In comparison, between September 2011 and September 2012, youth unemployment increased by 4.7 percentage points, reaching 35.1 percent.[5] This dismal situation has fuelled popular discontent about the government's wave of tax increases and spending cuts. At the same time, there is a widespread perception that such measures have in effect been dictated from Brussels, which in turn has also stirred anti-European feelings. Rising euroscepticism in Italy is documented by the 2012 edition of the annual *Transatlantic Trends* survey in which 40 percent of Italian respondents believed that membership in the EU had been bad for Italy's economy, a significant increase from the 23 percent figure registered the previous year.[6]

Italy's Foreign Policy in the Shadow of the Sovereign Debt Crisis

Over the last few years, economic policy and Italy's role within the EU has dominated the country's foreign policy agenda, but this has not prevented Italy from actively taking part in numerous international foreign policy initiatives. Italy has made a major effort to establish working relations with the new governments installed in the wake of the Arab Spring, while reaffirming its commitment to the NATO mission in Afghanistan and backing increased sanctions on Iran and Syria. Moreover, after some initial hesitation, Italy also actively took part in the NATO campaign in Libya.

[1] When asked who is to blame for the current Economic problems, 84 percent of Italian respondents said the national government, 58 percent said banks and financial institutions, and 15 percent the EU. See Pew Research Center, "European Unity on the Rocks," *Pew Research Center's Global Attitudes Project*, May 29, 2012, http://www.pewglobal.org/2012/05/29/chapter-1-national-conditions-and-economic-ratings.

[2] "Italy recession deeper than first estimated," *BBC News*, September 10, 2012, http://www.bbc.co.uk/news/business-19543214.

[3] ISTAT, *Italy's Economic Outlook*, November 5, 2012, http://www.istat.it/en/archive/73838.

[4] Eurostat, "euro area unemployment rate at 11.6 percent," *Euroindicators News release*, No. 155/2012, October 31, 2012, http://europa.eu/rapid/press-release_STAT-12-155_en.htm. ISTAT estimates Italy's unemployment rates to reach 11.4 percent in 2013.

[5] Eurostat, "euro area unemployment rate at 11.6%," *cit.*

[6] German Marshall Fund, *Transatlantic Trends 2012*, pg.17. http://trends.gmfus.org/files/2012/09/TT-2012-Key-Findings-Report.pdf; A 2012 survey by the Pew Research Center also showed growing disillusionment toward the European Union as a whole, with favorability ratings in Italy declining from 78 percent in 2007 to 59 percent in May 2012. Pew Research Center, "European Unity on the Rocks," *cit.*

Italy's change of government and the appointment of Mario Monti to the dual post of prime minister and finance minister reflected the urgent need to repair Italy's tarnished standing and reassure transatlantic partners of its commitment to far-reaching economic reforms. Given Monti's lack of a popular mandate and his fairly limited time horizon, Italy's new executive was not expected — and indeed did not aspire — to introduce significant changes to the country's foreign relations. A degree of continuity is in fact present between the two governments' foreign policy priorities. This is especially visible in such areas as Italy's Mediterranean and Middle Eastern policy, where energy, immigration, and security interests, combined with continued support for U.S. and Western initiatives toward the region, have continued to guide the country's foreign policy. Changes introduced by the Monti government were overwhelmingly related to Italy's role within Europe, notably a more active Italian support for the goal of achieving a full fiscal and political union among eurozone countries. The Monti government also managed to improve ties with the Obama administration.

Italian Budget Cuts and International Commitments

Italy's soaring public debt and the government's commitment to achieving a balanced budget by 2013 led to substantial cuts across various sectors, fueling concerns that reduced resources would limit Italy's ability to promote its interests abroad. Defense spending was scaled back by 2.9 percent in 2012 as compared to the previous year, bringing the total Italian spending on defense down to pre-2007 levels.[7] Italy has however confirmed its commitment to numerous international operations, most significantly to the NATO mission in Afghanistan, where Italy has deployed about 4,000 troops and has pledged to maintain a presence in the country for training and support operations even after the official withdrawal date set for 2014. In other theaters, such as the UN mission in Lebanon, where Italy assumed the command of UNIFIL forces in late January 2012, or in NATO's *Joint Enterprise* mission in Kosovo, the government has introduced substantial personnel cuts while reassuring its allies that this will not infringe on Italy's ability to carry out its operational commitments. Italian armed forces have also been deployed in support of EU and NATO anti-piracy operations in the Indian Ocean, a further example of Italy's commitment to transatlantic initiatives not least as a means to ensure a continued Italian presence on the international scene.

Italy's foreign aid spending, which had already witnessed huge cutbacks over the past years, was another area hit heavily by the government's austerity cuts. Foreign aid decreased by 38 percent in 2011, leaving only €158 million earmarked for such programs, the lowest figure in the past 20 years.[8] Moreover, according to a 2012 report published by the international development organization *AidWatch*, less than 50 percent of the funds Italy pledged for EU-led aid programs in 2011 were actually disbursed.[9] The same report estimates further cuts of up to 38 percent in 2012. Numerous national and international NGOs have warned that Italy's declining commitment to development aid will damage the country's international standing for years to come.

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[7] Italian Ministry of Defense, *Nota Aggiuntiva allo stato di previsione per la Difesa per l'anno 2012, April 2012*, http://www.difesa.it/Approfondimenti/Nota-aggiuntiva/Documents/Nota%20Aggiuntiva%202012.pdf.

[8] ActionAid, *Out of Bounds. Italy and the Fight against World Poverty*, September 2011, p. 16, http://www.actionaid.it/filemanager/cms_actionaid/images/DOWNLOAD/Rapporti_GOVERNANCE/ILAP2011_eng.pdf.

[9] Together with Italy, six other EU member states (Austria, Bulgaria, Greece, Latvia, Romania, and the Slovak Republic) contributed less than 50 percent of their pledges. See CONCORD, *Aid We Can, Invest More in Global Development. AidWatch Report 2012*, p. 9, http://aidwatch.concordeurope.org/static/files/assets/3f200cc4/report.pdf.

Italy and the EU

European and transatlantic relations have traditionally been the primary focus of Rome's foreign policy, but the country's declining credibility in both areas was perceived as seriously undermining its international standing. As Europe's third largest economy, a founding member of the EU, and a strong NATO partner, Italy's place at the decision-making table should have been a given, but because of its increasingly dysfunctional internal politics and Berlusconi's shaky parliamentary majority, it became ever harder for Italy to voice its priorities on the international stage. Its growing isolation within Europe combined with the markedly cooler relations with the United States after the election of President Obama led to growing fears that the country was gradually losing its ability to project its interests internationally.

Berlusconi's controversial reputation became an increasingly worrying liability. European leaders were growing wary of being too closely associated with Berlusconi, whose endless international gaffes, numerous legal and conflict-of-interest problems, and taste for extravagant late-night parties seriously damaged his government's ability to command respect abroad. Italy was increasingly finding itself excluded from important high-level meetings of European leaders and while this cannot be explained solely by Berlusconi's troubled image, the declining credibility of his government surely played a major role.

Italy's fear of being relegated to the position of a second-tier power within Europe re-emerged in domestic discourse as EU countries. France and Germany especially seemed intent on guiding the eurozone's response to the financial crisis while neglecting Italian views.[10] Moreover, increased cooperation between France and the U.K. in military and defense matters was viewed with concern in Italy, as it could harm prospects for stronger EU defense integration and damage the interests of Italy's military industry. When, France and the U.K. signed a wide-ranging defense cooperation deal in November 2011, Italian politicians described it as an "unsustainable threat to Italian industry" and Italy later banded with Germany and other European countries in an attempt to create "parallel initiatives" aimed at promoting Italy's military industry in other markets.[11]

Italian fears of being sidelined within Europe emerged again in the wake of the Libyan crisis. The Italian government did little to conceal its fears that its privileged economic relations with Gaddafi's Libya would be damaged by a military intervention. Italy also insisted that command of the operation be given to NATO and not to individual European countries, most notably France and the U.K., and even threatened to refuse the use of its airbases' in the event that NATO was not given full control. However, even after promising its full support for the NATO mission, Italy was excluded from a high-level conference call between France, the U.K., Germany, and the United States to discuss plans for the NATO campaign. This exclusion, which was widely reported in the domestic media, fuelled fears that Italy could be increasingly marginalized not only within Europe and NATO but also in Libya.

Italy's hesitant reaction to the Libyan crisis did little to improve Rome's international reputation. Berlusconi's statement that he would not "disturb" Gadaffi while the Libyan leader was escalating his repression of the Libyan people not only damaged Italy's credibility as a European power but also effectively prevented Rome from being able to cast

[10] Alessandro Colombo and Ettore Greco (eds.), *La politica estera dell'Italia. Edizione 2012*, Bologna, Il Mulino, 2012, pp. 17-20.

[11] Tom Kington, "Anglo-French Deal Upsets Neighbors," *Defense News*, June 13, 2011, http://www.defensenews.com/article/20110613/DEFFEAT04/106130301/Anglo-French-Deal-Upsets-Neighbors.

itself as a credible mediator in the crisis, a role the government had initially hoped to play. Italy's feelings of isolation within Europe were further increased as events in the southern Mediterranean prompted new tensions and disagreements between Rome, Brussels, and other European capitals. In the wake of the Arab Spring protests, waves of migrants from North Africa began reaching Italy's shores. The Italian government was unprepared to deal with the quantity of new arrivals and, increasingly, members of Berlusconi's coalition began blaming the EU for not coming to Italy's aid. Almost 50,000 migrants arrived in Italy during the first seven months of 2011, and Italy, together with five EU Mediterranean states, called on the EU to help share the burden of these arrivals by parceling out refugees to the other European states. This request encountered the firm resistance of France, Germany, and the U.K., among others, all of whom reminded the Italian government that their respective immigrant populations' far outstripped that of Italy. Eventually, by mid-April, the Berlusconi government approved the granting of temporary six-month residency permits to immigrants from North Africa, a decision that in effect gave the holders of these permits the right to travel anywhere within the Schengen area. Given that many were known to want to travel and settle in France, this decision led to tensions between Rome and Paris, pushing French authorities to momentarily seal part of its border with Italy in order to stop migrants from reaching French territory. These disagreements were eventually overcome during a bilateral summit in Rome held in late April 2011, in which Berlusconi backtracked from his previous stance and formally recognized that France's immigration burden was "five times that of Italy," while pledging a more rigorous Italian response to deal with the immigration crisis.

Italy's standing within Europe continued to falter under pressure from the economic crisis and the country's mounting public debt. A degree of consolation came in late June when European leaders voted in favor of appointing Mario Draghi, governor of the Bank of Italy, as the new president of the European Central Bank (ECB). Draghi, who replaced Jean-Claude Trichet, officially took over his post in November and was welcomed by international leaders for his support for greater fiscal unity across the eurozone. At that very time, however, Berlusconi's declining majority in parliament was gradually undermining his government's credibility in the eyes of Italy's European allies and this led to constant speculation as to whether Italy would be able to overcome its current fiscal troubles without outside help.[12]

The Monti Government: Damage Control in Europe

The appointment of former European Commissioner and internationally respected economist Mario Monti to the dual post of Italy's prime minister and finance minister in mid-November 2011 was welcomed within the transatlantic community as a sign of Italy's commitment to fiscal discipline and economic reform. When presenting the new government's foreign policy priorities to the Italian parliament, Italy's new foreign minister, Giulio Terzi di Sant'Agata, stated that his government would work to "strengthen Italy's international credibility" while ensuring that his country would be an active "protagonist in promoting the consolidation" of the European project.[13] Italy's foreign minister further reminded his audience that during these times of economic crisis, "domestic and foreign policy" are

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[12] See for instance, Barry Moody, "Smile or Smirk? Germans deny apologizing to Berlusconi," *Reuters*, October 27, 2011, http://www.reuters.com/article/2011/10/27/italy-berlusconi-smirk-idUSL5E7LR4B620111027.

[13] Italian Chamber of Deputies, *Audizione del Ministro degli affari esteri, Giulio Terzi di Sant'Agata, sulle linee programmatiche del suo Dicastero*, November 30, 2011, http://www.camera.it/_dati/leg16/lavori/stencomm/03c03/audiz2/2011/1130/INTERO.pdf.

"closely interrelated,"[14] thus hinting that Italy's top priority would be to overcome its current financial predicament while strengthening its role in the EU.

Relations between Italy and other EU member states improved considerably following the unveiling of Monti's reform package. In the months that followed, Italy's new PM held bilateral meetings with almost every European leader as well as trilateral summits with the French president and German chancellor. Monti did not limit himself to following EU guidelines emphasizing the need for fiscal austerity and spending cuts, but strove to make sure that Italy's opinion on how to overcome Europe's economic troubles was also taken into account. Monti warned Germany that its uncompromising focus on fiscal austerity would deepen the divide between Northern and Southern Europe while risk creating a dangerous populist backlash that could threaten the very foundations of the European project.[15]

Italy was soon to find a solid partner in France's new Socialist president, Francois Hollande, who shared Italy's emphasis on stimulating growth and employment rather than concentrating solely on austerity measures and spending cuts. The positions of Monti and Hollande prevailed during a four-way summit held in Rome on June 22, 2012, between the leaders of Italy, Spain, France, and Germany, convincing a hesitant German chancellor of the necessity to strike a balance between austerity at the national level and stronger solidarity at the European one. At the following EU council meeting held on June 28, Italy banded with Spain to secure an EU commitment to implement a bond-buying mechanism aimed at limiting the growing gap between German and Italian (or Spanish) ten-year government bonds. During the meeting, which lasted for over 14 hours, the Italian and Spanish prime ministers went as far as threatening to veto any EU declaration that did not contain a specific EU commitment to implement such anti-spread measures. While Monti had lobbied for such mechanisms to be activated automatically, the German position eventually prevailed. The agreed-upon arrangement foresees that financially troubled European countries should enter into a formal agreement with EU institutions as a precondition for being able to benefit from this bond-buying scheme.

By mid-2012, Italy's reputation and credibility had improved. Monti's activism on the European front and his ability to command respect in Brussels have been important aspects of the county's renewed self-confidence on the international scene. Monti's mandate is however set to expire in early 2013 and given the persistent political polarization, many in Italy and abroad lack confidence in the capacity of the country's major political parties to continue on the path of far reaching reforms, which would undoubtedly encounter fierce resistance from large segments of their electorates.

Italy's Mediterranean Policy in the Wake of the Arab Spring

As a vital conduit for Italy's energy supplies, an important market for Italian investments, and a key area of shared security interests between Italy, Europe, and the United States, the Middle East and North African region has long occupied a central position (second only to Europe and the United States) in Italy's foreign policy priorities. Italy, like most international powers, was caught off-guard by the momentous events that swept across the region in 2011. The toppling of long standing regimes in Tunisia, Egypt, and Libya forced Rome to dedicate a lot of time and resources to the goal of establishing working relations with the newly installed governments in the southern Mediterranean.

[14] *Ibid.*

[15] Peter Spiegel, Guy Dinmore, and Giulia Segreti, "Monti warns of political backlash," *Financial Times*, January 16, 2012.

On the whole, the need to safeguard Italy's economic interests coupled with fears that a prolonged period of instability in these countries would lead to renewed waves of immigration guided much of Italy's reaction to the Arab Spring. The change of government did not bring any significant change to Italy's foreign policy priorities. Continuity is especially visible in close relationship with Israel, support for Turkey's stalled EU membership bid, and convergence with European and U.S. policies toward Iran, Syria, and Afghanistan.

The Berlusconi government routinely described Italy as Israel's "best friend in Europe," and relations between the two countries were consolidated through regular bilateral meetings and numerous trade and business agreements. Moreover, the Berlusconi government consistently supported Israel in international forums, especially with regard to the Palestinian plan to request full-statehood status at the United Nations in September 2011. The Berlusconi government also decided to boycott an informal gathering to commemorate the tenth anniversary of the UN meeting on racism (Durban III), which Israel had long criticized as biased against it, and abstained during a vote in UNESCO on a Palestinian request to join the organization. With regard to the peace process with the Palestinians, Italy has aligned its position to those of the United States and the EU, maintaining that both parties must renew direct negotiations, without preconditions, as the only way to salvage the prospect of a two-state solution to the conflict. Italy's change of government did not change this attitude, and Italy's new foreign minister reiterated that Italy would remain Israel's "privileged partner"[16] in Europe, while continuing to press both parties to renew direct negotiations.

[16] Italian Chamber of Deputies, *Audizione del Ministro degli affari esteri, Giulio Terzi …, cit.*

With regard to North Africa, Italy was quick to begin talks with the new transition governments installed in the wake of the Arab uprisings in order to secure new commitments and bilateral agreements on border controls and the repatriation of newly arrived migrants. Following the outbreak of hostilities in Libya, Italy was among the first European powers to send humanitarian aid to the border with Tunisia where thousands of refugees were seeking refuge from the fighting. A motivation behind this swift response to Tunisia's call for aid can be found in Italy's concern that many of these refugees would make their way across the Mediterranean. In this context, Italy's interior minister, Roberto Maroni, took the lead in negotiating a new agreement with Tunisia, signed after months of tough negotiations on April 5, 2011. The agreement calls for security and border coordination between the two countries and gives Italy a legal framework within which to repatriate Tunisian migrants who reach Italy's shores. A similar agreement was then reached with Libya and signed by the Monti government in April 2012. Reflecting provisions similar to those of the 2008 Treaty of Friendship signed by Berlusconi and Gadaffi, the new agreement allows for the repatriation of migrants from Italy to the North African state, causing Amnesty International to issue a tough reprimand against Italy's government for not doing enough to safeguard the rights of refugees repatriated to Libya.[17]

In the wake of the popular uprisings that swept across the region since early 2011, Italy's economic interests in the Arab world suffered considerably. The conflict in Libya led to significant trade losses for Italy, with imports from the North African state declining by 67.6 percent and exports by 77.3 percent in 2011 as compared with 2010. The

[17] Amnesty International Italia, *L'accordo Italia-Libia in materia di immigrazione mette a rischio i diritti umani*, June 18, 2012, http://www.amnesty.it/accordo-italia-libia-in-materia-di-immigrazione-mette-a-rischio-i-diritti-umani.

trend improved in the first eight months of 2012, however, with imports increasing by 172.4 percent compared to the same period in 2011 and exports growing by 268.8 percent. With regard to Egypt, another important Italian trading partner in the region, Italian exports declined by 11.9 percent in 2011 as compared to the previous year, while imports increased by 32.9 percent. In the case of Syria, where an oil embargo and commercial sanctions have been imposed by Europe and the United States with Italian support, trade relations have diminished considerably, with exports declining by 22.6 percent and imports decreasing by 15.3 percent in 2011 compared to 2010. As a result of the sanctions, Italian exports to Syria decreased by a further 70 percent during the first eight months of 2012, while imports declined by 94.7 percent.[18]

Italy and the United States

While Berlusconi had continued Italy's traditional support for U.S. foreign policy priorities — from Afghanistan to Iran — NATO's missile defense program, anti-piracy operations in the Indian Ocean, and international sanctions against the Syrian regime, by 2011 it became increasingly apparent that the Obama administration was keeping the Berlusconi government at arm's length. Instead, the United States preferred to foster a close working relationship with Italy's head of state, Giorgio Napolitano, who had increasingly taken upon himself the task of coordinating Italy's relations with the United States during Berlusconi's domestic troubles.

Berlusconi had for years championed a foreign policy based primarily on his personal ties with world leaders, most notably Vladimir Putin, Colonel Gadaffi, and former U.S. President George W. Bush, but successive efforts by Berlusconi to cast himself as a mediator between the transatlantic community on one hand and Russia or Libya on the other were ill-received in EU capitals and Washington. Instead, as revealed by a series of U.S. diplomatic cables released by the whistle-blowing website *Wikileaks*, Berlusconi's ties to Putin and Gadaffi caused some apprehension on both sides of the Atlantic. According to one such cable, a senior U.S. diplomat in Rome characterized Berlusconi as acting as Putin's "mouthpiece" in Europe, while a second described Italy's PM as "feckless, vain, and ineffective as a modern European leader."[19] Notwithstanding these concerns, Italy was still regarded as a "key ally" by the United States, especially given that Berlusconi was known for being "vocally pro-American" as one U.S. diplomatic cable put it in 2010.[20] This trait was reflected by Berlusconi's support for almost every U.S. policy initiative since he first returned to the post of prime minister in 2001.

Like Italy's European allies, the United States was also growing increasingly concerned about Italy's financial troubles especially given Italy's vital role for the survival of the eurozone on which the United States' own economic recovery also depended. U.S. President Barak Obama had issued numerous calls reaffirming Washington's commitment to Italy's economic recovery while also exhorting Italian leaders to redouble their efforts aimed at achieving fiscal sustainability.

With the appointment of Mario Monti's new technocratic government, relations with the United

[18] ISTAT and ICE, *Commercio estero e attività internazionali delle imprese - 2011*. Vol.. 2. Paesi, settori, regioni, July 2012, http://www.ice.it/statistiche/pdf/Annuario_2_vol_2012.pdf; ISTAT and ICE, *Interscambio commerciale dell'Italia per settori*, gennaio-agosto 2012 - Libya; Syria, http://actea.ice.it/tavole_paesi/T1_608.pdf; http://actea.ice.it/tavole_paesi/T1_216.pdf.

[19] James Mackenzie, "Update 1: Wikileaks shows U.S. concern at Berlusconi-Putin tie," *Reuters*, December 2, 2011, http://www.reuters.com/article/2010/12/02/wikileaks-italy-russia-idAFLDE6B12AC20101202.

[20] "U.S. embassy cables: Barak Obama privately told of Berlusconi's secret business deals," *The Guardian*, December 2, 2011, http://www.guardian.co.uk/world/us-embassy-cables-documents/210920.

States improved considerably, as mentioned above. The choice of Giulio Terzi as Italy's new foreign minister also reflected the importance given to restoring good relations with the United States. Terzi had previously served as Italy's ambassador to the United States (and before that to NATO and Israel) and was known as a strong supporter of strengthening Europe's commitment to NATO. He has also repeatedly sided with the United States on such issues as increasing economic and diplomatic sanctions against the Iranian and Syrian regimes, while pushing for serious negotiations aimed at reviving Turkey's EU accession bid, a stance strongly shared by Washington. However, much concern remains in Washington regarding the risk of growing political fragmentation and instability once Monti's mandate expires in 2013.[21]

On the whole, therefore, the change of government has not modified the substance of the transatlantic relationship — which has always remained strong — but it has led to a more visible reaffirmation of the interests that tie the two nations. A further example of the degree to which the United States still considers Italy a valued and important ally is given by the Obama administration's decision to arm Italy's fleet of U.S.-built Reaper drones with missiles and laser-guided bombs, making Italy the first foreign country after Britain to be supplied with such advanced U.S. weaponry.[22]

Future Prospects and Implications for the Transatlantic Relationship

As Monti's mandate draws to a close, his government will continue to face an uphill battle to keep Italy's finances under control, a challenge that will also have to be picked up by the next government. Popular discontent is likely to persist and even increase, given Italy's need to implement more austerity cuts in order to balance its budget by 2013. Pressure will likely grow as a result of mounting unemployment, sluggish or inexistent macro-economic growth, and a growing disillusionment toward austerity and the seemingly far off prospect of recovery. Fresh economic data now indicates that economic recovery in the eurozone will not begin before mid-2013. This will no doubt increase popular frustration and resentment, given the sacrifices many Italians have already had to endure and may, in turn, give further impetus to anti-EU populist groups. Italy's political scene will probably become more fragmented as mainstream parties seem set to lose a substantial number of seats in parliament.

There is great uncertainty surrounding Italy's upcoming elections, and Italy's European and transatlantic partners are closely following political developments in Italy for fear that the country's new government will backtrack on the reform pledges made by Monti. The formation of a stable and cohesive majority government will not be an easy task and the prospect of Italy forming another technocratic government supported by a coalition alliance composed of the mainstream parties cannot be ruled out. The increased representation of anti-European parties in parliament could further increase the polarization of Italy's political setting, as mainstream parties who espouse a pro-EU stance will no doubt come under increased pressure from populist voices in parliament.

Ultimately, the prospect of Italy eventually having to request an emergency bailout in order to stabilize the country's finances cannot be ruled out. Such a request, coming on the back of similar bailouts for other Southern European countries, would add further uncertainty to Europe's hesitant recovery, potentially derailing confidence in the survival of the eurozone as a whole.

[21] Mark Gilbert, "Mario Monti and Italy's Generational Crisis," *Foreign Affairs Snapshots*, February 14, 2012, http://www.foreignaffairs.com/articles/137200/mark-gilbert/mario-monti-and-italys-generational-crisis.

[22] Adam Entous, "U.S. Plans to Arm Italy's Drones," *The Wall Street Journal*, May 29, 2012, http://online.wsj.com/article/SB10001424052702303395604577432323658176792.html.

Within Europe, Italy is likely to continue pressing leaders to work toward an increased financial and political union across the eurozone as the best means to limit the adverse effects of the crisis and to promote a stronger and more confident Europe on the world stage. Moreover, Italy will also strive to limit divisions between Northern and Southern Europe and attempt to create a more cohesive Union based on solidarity and a common vision for the future.

Given Europe's fiscal troubles and mounting social challenges, it is unlikely that the EU will embark on bold new initiatives toward the southern Mediterranean and the Arab world. Relations across the Mediterranean are indeed likely to continue along established norms, and the consolidation of bilateral ties between individual countries will likely increase. Thus Italy is expected to deepen its economic and energy relations with such traditional partners as Libya, Tunisia, and Algeria while focusing primarily on sectors such as immigration, trade, and security. One area where certain European countries are taking an increased interest is the Sahel region, but again this focus is dictated primarily by immigration, terrorism, and economic fears, given the destabilizing potential of the Sahel for the region as a whole and particularly for such countries as Algeria, Libya, and Morocco, where European economic and energy interests are most pronounced. A second area of potential EU action is Nigeria, but given the limited European interests in that country, it is unlikely to receive the same degree of attention as the Sahel, for which the UN has recently appointed former Italian Prime Minister Romano Prodi as special envoy.

By favoring bilateral relations between individual European and North African states, Europe risks undermining its ability to speak with a single voice and this, in turn, will likely result in a relative loss of European influence over the Maghreb and Arab world in general. One way to limit such a development would be to strengthen such tools as the 5+5 dialogue, which creates a positive framework for cooperation between five Southern European countries (Portugal, Spain, France, Italy, and Malta) and five North African countries (Algeria, Libya, Mauritania, Morocco, and Tunisia).

Moving to the transatlantic dimension, Italy's financial troubles and the government's limited resources will no doubt risk limiting Italy's room for action on the international front. In turn, this could create possible areas of contention with the United States and other European countries on such aspects as defense spending and burden sharing. At the EU level, limited resources also risk weakening Europe's role internationally and this could lead certain European countries to increase their trade and economic relations with third countries, such as China, a further aspect that risks creating tensions across the Atlantic. Italy's close ties with Washington are unlikely to undergo substantial changes, however, and indeed Italy will likely continue to back U.S. initiatives on the world stage, especially with regard to Iran, Syria, Turkey, Afghanistan, and such issues as NATO's missile defense program.

Italy's close relations with Israel could grow cooler as Italy attempts to strike a balance between its relations with Tel Aviv and those it is building with the new regimes installed in the wake of the Arab uprisings. The Italian-Israeli relationship is not set to undergo significant upheavals however and will continue to be grounded in mutually beneficial trade and business relations, as Italy remains Israel's fourth major trade supplier after the United States, China, and Germany.

Ultimately, one action that could help limit the potentially damaging effects of the crisis on the transatlantic relationship as a whole is the creation of a Transatlantic Free Trade Area (TAFTA), an idea that has gradually been gaining support on both sides of the Atlantic. Such a free trade area would not only increase and consolidate the transatlantic alliance during a time of increased political and financial uncertainty, but also help the economic recovery of both Europe and the United States and thus prove beneficial for all parties involved.

2 The Pain in Spain
Madrid and the European Financial Crisis

Charles Powell

Major Economic Problems and Outlook for 2012-13

The global financial and economic crisis has exposed serious weaknesses in the performance of the Spanish economy. From 1995 to 2007, Spain recorded a long period of strong growth, which was partly based on a credit-driven domestic demand boom resulting from the creation of the euro. Very low real interest rates triggered the accumulation of high domestic and external imbalances as well as an unprecedented real estate bubble.[23] The 2008 sharp correction of that boom in the context of the international financial crisis has led to a deep recession and a spectacular increase in unemployment, which has tripled in five years (from 8 percent in 2007 to 25 percent in 2012). Youth unemployment (those aged 16 to 24) reached a staggering 51 percent in mid-2012. In turn, this has led to an enormous increase in unemployment benefit payments, which partly explains why Spain's public debt has risen from 69 percent of GDP in 2011 to an expected 89 percent of GDP by the end of 2012.

The unwinding of these economic imbalances is weighing heavily on Spain's growth outlook. Private sector deleveraging implies subdued domestic demand in the medium term. Furthermore, sizeable external financing needs have increased the vulnerability of the Spanish economy. A shift to durable current account surpluses will be required to reduce external debt to a sustainable level. Public debt is increasing rapidly due to persistently high general government deficits since the beginning of the crisis, combined with the shift to a much less tax-rich growth pattern.

The challenges facing large segments of the banking sector continue to bear negatively on the economy as the credit flow remains constrained. In particular, unhealthy exposure to the real estate and construction sectors have eroded investor and consumer confidence. As the linkages between the banking sector and the sovereign have increased, a negative feedback loop has emerged. Consequently, the restructuring and recapitalization of banks is key to mitigating these linkages, increasing confidence, and spurring economic growth.

The new Spanish government, which came into office in December 2011, has initiated numerous reforms in an attempt to deal with the crisis. With regard to the banking system, provisions and capital requirements have been raised, independent valuations have been commissioned, and the country's fourth largest bank (Bankia) is being restructured. In order to implement these measures, in June 2012 the government finally requested a bailout loan for vulnerable banks, and the EU subsequently agreed to make a maximum of €100 billion available to the Spanish authorities.

On the fiscal front, two major reform packages were announced by the Spanish government, in December 2011 and July 2012. Tax increases (above all, VAT) and spending cuts amounting to €80 billion (over the period 2012-13) were adopted to reduce the budget deficit, and new budget stability and transparency laws seeking to ensure greater accountability and control over regional finances are being implemented.

The most controversial measure adopted by the new government was undoubtedly its February 2012 labor reform, which made it easier and cheaper to fire workers, including those employed in the public sector. The government is also seeking to restrict access to early and partial retirement, and to accelerate the raising of the legal retirement age from 65 to 67, already contemplated in the 2011 pension reform adopted by its Socialist predecessor. Furthermore, the executive has introduced a number of liberalizing measures aimed at stimulating domestic consumption; for

[23] At its peak in 2007, the construction sector accounted for 16 percent of GDP and 12 percent of Spanish jobs.

example, supermarkets will be free to determine their opening hours. Plans are also underway for further, potentially far-reaching reforms such as the liberalization of railway transport.

Overall, these reforms could lead to a significantly better medium-term outlook. In the meantime, however, the Spanish economy is still in the midst of an unprecedented double-dip recession, the deleveraging process will be slow, and it will take time to digest the implosion of the biggest real estate bubble in the country's history. After growing a very modest 0.4 percent of GDP in 2011, the current IMF estimate is that the Spanish economy will shrink by 1.7 percent of GDP in 2012 and by a further 1.2 percent in 2013. This will make it very difficult for the government, which inherited a budget deficit of 8.9 percent of GDP in late 2011, to meet its current deficit targets of 6.3 percent in 2012, 4.5 percent in 2013, and 2.8 percent in 2014.

Spain's economic outlook remains highly uncertain. On July 25, 2012, ten-year government bond yields reached a record 7.75 percent, prompting frenzied speculation of an EU bailout. The European Central Bank responded in early September by announcing that it would buy unlimited amounts of Spanish bonds if the government applied for help from the eurozone rescue fund, bringing yields down well below 6 percent. The Spanish authorities, however, are in no hurry to submit an application. One reason for this is the widely held view that it is virtually impossible for a government to survive a full bailout. Additionally, there is serious concern about the impact this would have on Spain's long-term reputation and credibility. To complicate matters further, early elections are now due on October 21 in the Basque Country and Galicia, where the Popular Party (PP) could lose its majority. Most importantly, there is fear that a bailout would entail additional austerity measures requiring painful budget cuts. Spain would probably prefer to apply for a bailout in tandem with Italy rather than go it alone so as to dilute the political fallout, but this would cause Mario Monti serious difficulties at home. In spite of Mariano Rajoy's delaying tactics, it is increasingly likely that he will be forced to request the European Central Bank (ECB) to start buying Spanish debt in the secondary market well before the end of 2012.

In the longer term, a determined effort at the European level, aimed at improving the incomplete governance structure of the euro, will be essential to ensure that the reforms and adjustments implemented in Spain (and in other Southern European countries) are effective. This effort should include a full banking union, a more dynamic European Central Bank (capable of acting consistently as a lender of last resort), and some form of limited debt mutualization.

The Political and Social Consequences of the Crisis

The financial and economic crisis starting in 2008 was largely responsible for Prime Minister José Luis Rodríguez Zapatero's decision to bring forward the general election due in March 2012, to November 2011. This did not prevent the incumbent Socialist Party (PSOE) from being soundly defeated by its major national rival, the center-right PP, led by Rajoy. Zapatero's decision not to lead his party into a third election, and his replacement by his deputy, Alfredo Pérez Rubalcaba, did not have much impact on the final result.

With only 28 percent of the vote and 110 out of 350 seats in the Congress of Deputies, this was the PSOE's worst result since democracy was restored in 1977. The PP, on the other hand, won 44 percent of the vote and 186 seats, ten more than it needed to secure an absolute majority (176) in the Spanish lower house, its best result ever. Other than the PP, the main beneficiaries of the PSOE's poor performance were Izquierda Unida (IU), a left-wing coalition, which attracted 7 percent of the vote and won 11 seats (up from 2 seats in 2008); the major Catalan nationalist party, Convergencia i Uniò (CiU), which won 4 percent of the vote and 16 seats; and a relatively new centrist party, Unión Progreso y Democracia (UPyD), which received 5 percent of the vote and 5 seats (four more than in 2008). At 71 percent, voter turn-out was relatively low by Spanish standards, an outcome that is largely attributable to the attitude of many former PSOE supporters, who expressed their dissatisfaction with Zapatero's economic policy by staying at home.

In short, Prime Minister Rajoy came to office in December 2011 with considerable popular support. Whether or not he also enjoyed a clear mandate from the Spanish people is debatable, particularly given his reluctance to provide details as to his economic program during the election campaign.

The government's comfortable parliamentary majority has made it reluctant to seek the support of other parties, most notably the PSOE, even when it comes to approving highly controversial measures and implementing structural reforms. Some analysts have claimed that, given the magnitude of the economic crisis, the two major parties (which jointly account for 72 percent of the vote and 290 out of 350 parliamentary seats) should try to reach a broad consensus on major policies, and in particular, on the major reforms that the EU expects Spain to implement in order to meet its obligations as a eurozone member. Others, however, believe it preferable for a recently elected government that enjoys a comfortable parliamentary majority not to seek to share responsibility with other parties, since this would deprive the electorate of a viable alternative should its policies prove unsuccessful.

To complicate matters further, the major opposition party is experiencing significant difficulties of its own. This is not entirely surprising given the magnitude of the defeat it suffered in the recent elections. Inevitably, Rubalcaba, who was elected party leader in February 2012, is tainted by his former association with Zapatero, whom many voters hold at least partly responsible for the depth of the current crisis. In spite of these difficulties, the PSOE did surprisingly well in the March 2012 regional elections in Andalusia; although it narrowly lost them for the first time in 30 years (with 39 percent of the votes, as opposed to the PP's 40 percent), it was able to remain in office thanks to the parliamentary support provided by IU. In the regional elections held in Asturias on the same day, both the PSOE and IU did significantly better than they had done in the 2011 general election.

As one would expect, the government's popularity has suffered considerably in the course of 2012 as a result of the tough measures it has been forced to adopt. Surprisingly, however, the PSOE's standing in the polls has also declined during these months. Although popular confidence in politicians' ability to deal with the crisis is at an all-time low, there is no serious discussion in Spain of the need for a technocratic government — such as that of Monti in Italy — to replace the existing one.[24]

Overall, the economic crisis has further undermined public trust in Spain's major political institutions, which were already facing considerable

[24] According to a major poll carried out by the state-funded Centro de Investigaciones Sociológicas (CIS) in July 2012, the PP enjoyed the support of 36 percent of the electorate, still comfortably ahead of the PSOE's 30 percent. Although 56 percent of those polled judged the government's performance to be poor or very poor, a slightly higher proportion, 57 percent, claimed the same could said of the PSOE's role in opposition. See CIS, "Barómetro de julio," *Estudios*, No. 2951, July 2012, http://www.cis.es/cis/opencm/ES/1_encuestas/estudios/ver.jsp?estudio=12944.

criticism before 2008.[25] What is new about the current situation is that, for the first time in recent democratic history, numerous opinion polls suggest that it is the political elites themselves who are bringing the system into disrepute.[26]

It is not only politicians who are increasingly out of favor with the general public, however. The untoward behavior of the president of the Supreme Court, who was forced to resign in June 2012 after a month-long scandal concerning his use of public funds, brought public support for the judiciary, which was never very strong to begin with, down to an all-time low.[27] Furthermore, this incident served to highlight the lack of transparency and accountability with which the governing council of the judiciary (Consejo General del Poder Judicial) has traditionally conducted its business, raising fresh doubts about its political independence and overall credibility.

The crisis has also affected the monarchy. In the past, the popularity of the king and the institution he embodies increased in times of crisis, presumably because they were perceived as being above the political fray.[28] The current economic crisis, however, has led to unprecedented levels of public and private criticism of the royal family and its lifestyle. This became a serious political issue as a result of the accident suffered by King Juan Carlos during a hunting trip to Botswana in April 2012, which later resulted in a hip operation. Although the king publicly apologized for his recklessness, many Spaniards obviously disapproved of him going on expensive holidays at a time when his countrymen were suffering the consequences of recession and unemployment. Furthermore, this came at a time when his son-in-law was under investigation for tax fraud and embezzlement of public funds.

Politicians, however, have attracted the lion's share of the blame for the current crisis. Citizens blame them (whatever their ideology) for their poor handling of the crisis, for not having regulated the financial sector adequately, for undermining the credibility of hitherto highly-respected institutions such as the Bank of Spain, and for politicizing the management of savings banks (cajas de ahorro), which were traditionally held in high esteem by the population at large.

Partly due to the central government's difficulties in curbing public spending, some citizens are also increasingly blaming the crisis on the unexpected (and unwanted) consequences of political devolution. In some quarters, the existence of 17 autonomous communities is increasingly being seen as an expensive luxury that Spain can no

[25] The Fundación Alternativas produces an annual report in which the quality of Spanish democracy is graded on a scale from one to ten; in recent years, this has dropped from 6.2 in 2008 to 5.8 in 2011. For the latest report, see Fundación Alternativas, Report of Democracy in Spain 2012, http://www.falternativas.org/laboratorio/libros-e-informes/ide/report-on-democracy-in-spain-2012-english-version. However, in its 2011 report, the Global Democracy Association, which aims to compare the quality of democracy worldwide, ranked Spain in 16th place, ahead of France (17th), Portugal (18th), Italy (27th) and Greece (32nd). See *Global Democracy Ranking 2011*, http://www.democracyranking.org/en/Democracy-Ranking_2011-Scores+Dimensions.htm.

[26] According to the CIS study quoted above, 11 percent of respondents spontaneously mentioned politicians and political parties as their first answer to the question: "What, in your opinion, is the major problem currently facing Spain?" If those mentioning politicians and political parties as their second or third answer are added, some 25 percent of respondents may be said to share this concern.

[27] According to a poll published in July 2012, 69 percent of Spaniards believe the justice system functions poorly or very poorly. See José Juan Toharia, "El desprestigio viene de arriba," *El País*, August 12, 2012, http://politica.elpais.com/politica/2012/08/11/actualidad/1344684017_186742.html.

[28] Nevertheless, support for the monarchy has declined significantly in recent years. In 2007, Spaniards favoring the monarchy (69 percent) easily outnumbered those who preferred a republic (22 percent); by 2011, the figures were 49 percent and 37 percent, respectively. According to the CIS, which has measured the public standing of major Spanish institutions since 1994, in October 2011 trust in the Crown dropped to an all-time low of 4.89 out of 10. See CIS, "Barómetro de octubre," *Estudios*, No. 2914, October 2011, http://www.cis.es/cis/opencm/ES/1_encuestas/estudios/ver.jsp?estudio=11904.

longer afford (assuming it ever could). It has thus become commonplace to accuse politicians at the regional and municipal levels of spending well beyond their means in their never-ending efforts to curry favor with voters. This type of criticism, which naturally feeds on the numerous corruption scandals involving local and regional politicians that have dominated the headlines in recent years, is of course most widespread in those regions and sectors of society in which support for political devolution was never particularly strong in the first place. The novelty, however, is that serious analysts and practitioners are increasingly concerned about the seemingly dysfunctional nature of Spain's semi-federal system of government.

Predictably, the crisis has also fuelled center-periphery tensions, which were already quite significant to begin with. The fact that the PP is currently in office in 12 out of Spain's 17 autonomous communities means the central government is in a reasonably good position to enforce its austerity program in these regions, though unpopular reforms have sometimes caused friction amongst leaders of the same party. The main challenge, however, resides in Catalonia, where the CiU (conservative nationalist) government is seeking a new "fiscal pact" with Madrid in order to catch up with the two regions that enjoy the highest levels of fiscal autonomy, namely the Basque Country and Navarre. Although the CiU government's overall economic philosophy is actually quite similar to that of the central government, this has not hindered it from accusing Madrid of placing an intolerable burden on its finances, a complaint that resonates well with many Catalan voters. With an economy the size of Portugal's, Catalonia has the largest debt burden of any Spanish region (€41.8 billion), but the regional government claims this is largely because it receives €18 billion less per annum than it pays back into the central government's coffers. The Catalan government was finally forced to seek a €5 billion bailout from Madrid in August 2012. A month later, Rajoy's refusal to negotiate a new fiscal pact prompted it to call early elections for November 25, adding further political uncertainty to an already complex scenario. As it turned out, the election did not hand the CiU a majority in the local parliament and instead the party will have to form an alliance in order to govern.

In the Basque Country and above all Catalonia, the economic crisis has also fuelled separatist sympathies. Those in favor of independence are blaming Spanish governments for undermining their regional economies — which are generally more developed and diverse than those of some other parts of Spain — on account of their poor handling of state finances. They also like to point out that, given that Madrid has effectively transferred all economic sovereignty to Brussels, Berlin, and Frankfurt, it no longer has the right to attempt to enforce its economic program on them.

As was to be expected, the government's austerity measures have also placed it on a collision course with the major Spanish trade union organizations, UGT and CCOO. In March 2012, these and other labor organizations staged a 24-hour general strike in protest against the executive's austerity program, and in particular, its labor market reforms, which went ahead nevertheless. Rajoy has been extremely reluctant to meet UGT and CCOO leaders, let alone engage in serious discussion of his policies with them.[29] Trade union leaders have questioned the government's right to adopt far-reaching reforms on the strength of its parliamentary majority alone, and have even called for a referendum on its more controversial policies.

Spain's financial and economic difficulties also partly account for the emergence of the so-called

[29] Surprisingly, Angela Merkel met UGT and CCOO leaders in Berlin to listen to their objections to the Spanish government's economic policy several weeks before they were finally able to see Rajoy in Madrid.

"15-M movement," which derives its name from the fact that it staged its first protests on the eve of the local and regional elections held on May 22, 2011. The so-called "indignados" have embraced a wide variety of causes and demands, ranging from immediate ones such as the expropriation of unoccupied housing for the benefit of those who have lost their homes after failing to repay their mortgages to more general issues concerning the fight against political corruption or the allegedly unrepresentative nature of existing political parties. Surprisingly, however, although social conditions have deteriorated further since it first made its appearance, the 15-M movement appears to have lost momentum in the course of 2012. To some extent, this reflects specific tactical dilemmas: having lambasted trade unionists for being an integral part of the political establishment they blame for many of Spain's ills, they are understandably ambivalent about taking part in union-sponsored strikes against the Rajoy government. Additionally, some indignado gatherings have become a pretext for acts of violence involving anti-system groups, particularly in Barcelona. Although polls suggest that many of the movement's goals and demands are still broadly popular with public opinion at large, it is doubtful whether it will have a long-term impact on Spanish political life.

The Impact of the Crisis on Foreign Policy

The current economic crisis is having a significant impact on Spanish foreign policy in at least three ways. Firstly, it is undermining Spain's international reputation and credibility. The country that was once seen as one of the great success stories of the second half of the 20th century is increasingly perceived as the "sick man of Europe." More specifically, by seeking assistance from abroad in order to deal with its own economic difficulties, its leaders are acknowledging that they are no longer in a position to govern effectively by themselves. Secondly, overcoming the crisis and its consequences is quite understandably the government's top priority; policy initiatives that do not bear directly on this goal will not receive much attention from the executive in the coming months and years. Finally, the budget cuts implemented by the current government (and its predecessor) in an attempt to reduce the deficit and curb public spending are severely restricting the funding that was hitherto available for a wide array of policies and instruments designed to enhance Spain's presence and influence abroad.

In spite of the above, it is important to note that the reputation and prestige of a modern, complex nation-state are neither built up nor destroyed overnight. It would be misleading, therefore, to exaggerate the impact of the crisis both on Spain's standing in the world and its ability to design and implement an effective foreign policy. Indeed, the results of the Elcano Global Presence Index (IEPG), which seeks to compare the international positioning of over 50 countries in an increasingly globalized world, would suggest that Spain's global presence has not yet been significantly affected by the crisis.[30] (It should be noted, however, that the IEPG measures a nation's global presence, not its "power" or "influence.")

The Defense and Security Dimension

The economic crisis is nevertheless clearly influencing the government's own perception of what it can achieve abroad. Spain's latest National Defence Directive, published in July 2012, acknowledges in its preamble that the economic crisis, which it describes in passing as "a threat to security," will require the government to "proceed with great caution" in its efforts to implement budget cuts while securing the means necessary

[30] The 2012 IEPG report, which measures economic, military, and "soft" presence, ranked the Southern European countries as follows: Italy (10th); Spain (11th); Greece (35th); and Portugal (41st). See http://www.iepg.es/?lang=en.

to guarantee an effective defense, and to act responsibly in using the limited resources available as efficiently as possible.[31] Judging from the tone and content of this document, it would appear that the government is concerned that the crisis could even undermine its military credibility, both vis-à-vis potential enemies who might generate "unshared threats," a euphemism traditionally used to describe Moroccan claims over Spain's North African enclaves (Ceuta and Melilla), and in the eyes of its allies in NATO and the EU.[32]

Notwithstanding these concerns, in July 2012, the government announced that the Ministry of Defense was planning to shed 15,000 troops and an additional 5,000 civilian employees over the course of the next 13 years.[33] Even more alarmingly, a month later, the Spanish Army confirmed that it had "mothballed" some 50 percent of its combat vehicles because the cost of keeping them operational was too high.[34] In the shorter term, the contingent of just over 1,000 Spanish troops currently in Lebanon (UNIFIL), the only UN mission in which Madrid is currently taking part, will be cut by 50 percent in the course of 2012 as a result of the ongoing decrease in military spending.[35] This should at least allow the government to honor its commitment to the International Security Assistance Force (ISAF). The Spanish contingent in Afghanistan, currently numbering some 1,500 troops, is scheduled to decrease by 10 percent in 2012 and by a further 40 percent in 2013, prior to its complete withdrawal in 2014. Not surprisingly perhaps, the new National Defense Directive does not have much to say about Spain's future contribution to international missions such as these.

The latest National Defense Directive is striking for its distinctly unilateralist tone. Some critics have argued that this is precisely the opposite of what is required in times of crisis, and have called on the government to contribute more effectively to the efforts of both NATO ("smart defense") and the EU ("pooling and sharing") to do more with less.[36] Others have gone so far as to claim that the directive "omits everything that might remotely be interpreted as a step toward a united European defense plan, though without this it is highly unlikely that a credible dissuasive capacity can exist, at a time when the United States is shifting forces from European territory toward the Pacific…" Furthermore, this alleged euroscepticism has been judged incompatible with the government's "proclaimed desire to move toward fiscal and even political union on the European scale."[37]

Budget Cuts and their Impact

It could be argued that the crisis is already accelerating the "Europeanization" of Spanish

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[31] For an analysis of the 2012 National Defense Directive, and a comparison with earlier versions, see: Instituto Espanol de Estudios Estrategicos (IEEE), "La Directiva de Defensa Nacional 2012," *Documento de Análisis*, No. 35/2012, August 7, 2012, http://www.ieee.es/Galerias/fichero/docs_analisis/2012/DIEEEA35-2012_DDN_IEEE.pdf.

[32] The possibility of a Moroccan attack against Ceuta and Melilla is described as an "unshared threat" ("amenaza no compartida") because NATO is under no treaty obligation to defend these enclaves. It would appear that the Spanish government does not set much store by Article 42.7 of the Treaty on European Union, according to which "if a member state is the victim of armed aggression on its territory, the other member states shall have toward it an obligation of aid and assistance by all the means in their power, in accordance with Article 51 of the United Nations Charter."

[33] The Spanish Armed Forces had already lost 20,000 troops during the previous six years.

[34] Miguel González, "El jefe del Ejército revela que el 50% de sus vehículos de combate están parados," *El País*, July 31, 2012, http://politica.elpais.com/politica/2012/07/31/actualidad/1343744179_200894.html.

[35] Spain put an end to its 18-year presence in Bosnia-Herzegovina in November 2011.

[36] Diego López Garrido, "Defensa nacional: regreso al pasado," *El País*, August 10, 2012, http://elpais.com/elpais/2012/08/07/opinion/1344351717_982529.html.

[37] "Step backwards in defense," *El País* editorial, August 7, 2012, http://elpais.com/elpais/2012/08/07/inenglish/1344361974_370658.html.

foreign policy, if only by default. In August 2012, the Foreign Ministry announced it would be closing its embassies in Yemen and Zimbabwe, with the result that in future Spanish interests there will be handled by the EU delegations in these countries. This type of measure should allow the ministry, which suffered an unprecedented 54 percent budget cut in March 2012, to concentrate its rapidly diminishing resources in countries (and policies) where they may be deployed to maximum effect.[38]

The need to redefine Spanish foreign policy in response to the economic crisis had been evident for some time. Even before the 2011 general election, a party spokesman had already announced that the PP's foreign policy would be dictated by the need to contribute to economic growth, job creation, and the recovery of Spain's prestige abroad.[39] The new foreign minister, José Manuel García Margallo, immediately placed economic diplomacy at the top of his agenda, and his department is currently designing an ambitious nation-branding effort (the so-called "Marca España" project), in an effort to counteract the impact of the economic crisis on Spain's image abroad by seeking to convince foreign investors and consumers that Spanish institutions, companies, and products continue to deserve their trust and support. It is also aiming to make up for the fact that 47 embassies and 54 consulates currently lack a commercial office by encouraging diplomats to take on new responsibilities in this area.[40]

The foreign policy area that has been most severely affected by the crisis is undoubtedly that of official development assistance (ODA). Spending in this area has been reduced dramatically from 0.43 percent of GDP in 2010 to 0.23 percent in 2012, by far the largest reduction witnessed amongst the OECD's 34 member states (including Greece). Although the government has yet to publish its ODA goals for 2013-16, it clearly aims to concentrate the limited resources currently available in those countries with strongest political and cultural ties with Spain, most notably in Latin America, the Caribbean, and the Maghreb, to the detriment of other (generally poorer) regions, such as sub-Saharan Africa. (The Spanish cooperation agency is also currently designing a plan to meet new requests from the Arab Spring countries). All of this is a major disappointment for those who had hoped to see a significant increase in Spain's influence and prestige abroad as a result of the massive increase in ODA witnessed under the Zapatero government, and for those who had sought to place development aid at the top of the Spanish foreign policy agenda (as was reflected in the decision, taken in 2004, to rename the government department in question the Ministry of Foreign Affairs *and Cooperation*). Nevertheless, it should be noted that an increase in ODA spending, however significant, does not necessarily result in more effective aid, nor does it guarantee an immediate political return for the donor country in question. Many experts have questioned the vision and effectiveness with which these vastly increased resources were allocated by Spanish ODA authorities in recent years, and the sharp decrease in funds should ensure that a serious attempt is made to disburse these scant resources more efficiently.[41]

Budget cuts have also resulted in a sharp decrease in Spanish contributions to a number of United Nations programs and initiatives, including the so-

[38] The ministry has announced the closure of consulates in Morocco (Larache) and Portugal (Valença do Minho and Vila Real de Santo António). This will leave Spain with 116 bilateral embassies, 11 multilateral ones, and 94 consulates worldwide.

[39] *El País*, August 28, 2012.

[40] Manuel Manrique, "Spanish foreign policy monitor: January-March 2012," *FRIDE Policy Brief*, No. 121, March 2012, http://www.fride.org/publication/1003/.

[41] See Kattya Cascante et al, "Wither cooperation policy?," *Analysis of the Real Instituto Elcano (ARI)*, No. 16/2012, March 7, 2012, http://www.realinstitutoelcano.org/wps/wcm/connect/elcano/elcano_es/zonas_es/ari16-2012.

called "Alliance of Civilizations," one of Zapatero's pet international schemes. This was originally conceived as a way of compensating for Spain's enthusiastic alignment with President George Bush's "global war on terror" under Prime Minister José María Aznar (1996-2004), and was jointly promoted by the Spanish and Turkish authorities.[42]

Europe: Is Spain Punching Below its Weight?

As argued above, the current crisis has undermined Spain's overall prestige and credibility. Some analysts would even claim that the country's economic difficulties have made it more vulnerable in its relations with other governments, particularly those with an axe to grind. A case in point would be the Argentine government's decision, taken in April 2012, to unilaterally expropriate YPF, an oil company belonging to the Spanish multinational REPSOL, on the largely spurious grounds that it was not fulfilling its contractual obligations. Those same analysts would argue that the Spanish government's inability to prevent the take-over, or to make the Argentine authorities pay for their outrageous behavior, is further evidence of the country's growing vulnerability and overall lack of international clout. Given that companies from other major Western nations have been treated in a similar fashion by the Argentine authorities in the past, however, this argument is far from water-tight.

It is difficult, if not impossible, to provide empirical evidence of the impact of the economic crisis on Spain's relations with its major European partners, or its role within the EU as whole. To begin with, many analysts would argue that Spain had already lost visibility and influence within the EU in the course of the past decade, even when its economy was growing considerably faster than the EU average. This trend has often been attributed to longer-term transformations, such as the loss of influence resulting from the successive enlargements that have taken place since Spain's accession in 1986 and the emergence of a more heterogeneous EU, most notably as a result of the Eastern enlargement.[43] Whatever the reason, most observers would agree that Spain has never recovered the leadership and influence it briefly enjoyed within the EU in the late 1980s and early 1990s. If Spain was punching above its weight then, today the opposite might well be the case.[44]

The economic and financial crisis has encouraged political elites to reconsider Spain's external commitments and allegiances. On the whole, however, both elite and popular commitment to the European project remains strong, in spite of the hardships incurred as a result of the austerity measures and structural reforms which are largely perceived as an external imposition. Unlike Greece, Spain does not have to worry about xenophobic far-right parties seeking to take advantage of the crisis to increase their popularity, and there have been no significant expressions of anti-German feeling, either at the elite or the popular level.

Interestingly, the crisis does not appear to have strengthened existing ties amongst the southern European member states, as might have been expected. From a Spanish perspective, this has not come as a surprise, however. Madrid has never enjoyed a particularly close relationship with Athens, either bilaterally or within the EU. Portugal is obviously of far greater importance

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[42] See Charles Powell, "A Second Transition, or More of the Same? Spain's Foreign Policy under Zapatero," *South European Society and Politics*, Vol. 14, No. 4, December 2009, pp. 519-536, http://transatlantic.sais-jhu.edu/publications/articles/2009_Spanish_Foreign_Policy_under_Zapatero_by_Charles_Powell.pdf.

[43] See Charles Powell, "Fifteen years on: Spanish membership in the European Union revisited," *Center for European Studies Working Paper*, No. 89, 2003, http://aei.pitt.edu/9138.

[44] This is the view advanced by Ignacio Molina and Juan Tovar, "The Year the other Bubble Burst: Spanish Foreign and Security Policy in 2010," *CIDOB International Yearbook 2011*, pp. 7-20, http://www.cidob.org/en/publicaciones/articulos/anuario_internacional_cidob/el_ano_en_que_estallo_la_otra_burbuja_la_politica_exterior_y_de_seguridad_espanola_en_20102.

to Spain, given the very significant investments and exports it has poured into its neighbor since both countries joined the EU in 1986. However, this unprecedented economic interdependence has only occasionally translated into a strong political partnership, partly because Portuguese elites remain fearful of Spanish "colonization." Additionally, the mantra constantly repeated by Spanish politicians to the effect that "Spain is not Portugal" in the wake of the latter's bailout could hardly be expected to improve relations.[45] Finally, the relationship with Rome has long been plagued by disconcerting contradictions and misperceptions. Given certain similarities between the two countries, they might have been expected to work well together both bilaterally and at the EU level, but this has not generally been the case. Spanish elites suffer from a curious superiority complex when it comes to dealing with their Italian counterparts, and the received wisdom in Spanish diplomatic circles is that, brilliant and creative though they may be, their Italian colleagues rarely deliver as promised. Italian officials, for their part, are somewhat bemused by what they sometimes perceive as the self-confidence (if not arrogance) of a relative newcomer to the European game, and are often privately critical of Spanish officials' self-importance.[46] Additionally, it should be noted that Spain and Italy perceive each other as economic rivals in some sectors and regions, most notably the energy and telecoms markets in Latin America.[47]

In Spain as elsewhere, it is generally believed that Germany holds the key to the solution of the eurozone crisis and indeed the survival of the single currency as we know it. Relations with Angela Merkel's government were never very close under Zapatero, but they were expected to improve after his replacement by Rajoy, who belongs to the same ideological family as the German chancellor. However, Rajoy is a somewhat parochial politician, who speaks no foreign languages and has limited European experience, and his efforts to establish a good rapport have met with mixed success. The same may be said of his dealings with French president François Hollande, who has complicated matters somewhat by openly cultivating relations with Rubalcaba, the current leader of the socialist opposition. All of this may explain why Rajoy has seemed curiously content to allow Monti to fight his corner for him, even though Spanish and Italian interests are by no means identical.

Latin America and the Mediterranean

Even before the economic crisis, Madrid was already experiencing difficulties in the two non-European regions of greatest importance to Spain. For well-known cultural, political, and economic reasons, Spain has traditionally set great store by its relations with Latin America, a region which currently receives a quarter of its investments and more than a third of its development aid. If anything, the economic crisis has increased the region's importance in Spanish eyes, since it is largely the growth experienced in recent years in countries such as Mexico, Brazil, Chile, Colombia, and Peru that is allowing Spain's major multinational corporations to survive the crisis relatively unscathed. Nevertheless, Spain's political influence and prestige in the region are clearly on the wane, a trend that was already visible before the current economic crisis set in.

One of the curious paradoxes of Spanish foreign policy is that it has a "Plan for Africa" and a "Plan

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[45] "Top politicians: Spain is not Portugal," *EUobserver*, March 25, 2011, http://euobserver.com/economic/32063.

[46] These comments reflect the attitude of a number of senior Spanish and Italian diplomats interviewed by the author in May-July 2012.

[47] In December 2007, Zapatero and Romano Prodi clashed in public over their countries' comparative wealth after Eurostat published data showing that Spain had overtaken Italy in terms of GDP per capita. Five years later, their successors seemed to be competing to see which of them could survive longest without having to request an EU bailout. See Ettore Livini, "Si infiamma il derby Italia-Spagna," *La Repubblica*, April 12, 2012, http://ricerca.repubblica.it/repubblica/archivio/repubblica/2012/04/12/si-infiamma-il-derby-italia-spagna-rajoy-piu.html.

for Asia," but it lacks a strategy for its major partner outside Europe.[48] This is partly because Spanish political and academic elites have traditionally seen themselves as part of a broader transatlantic community known as "Iberoamerica," a concept that was formally institutionalized in the early 1990s with the creation of an "Iberoamerican Community of Nations," an intergovernmental organization that bears comparison with the British Commonwealth. While this may have served a useful purpose 20 years ago, today it may represent more of a hindrance than an asset, for it has prevented Spanish policymakers from coming to terms with the major changes currently taking place in the region. At the same time, even those Latin Americans who still treasure their "special relationship" with Spain have become increasingly skeptical of the usefulness of the Iberoamerican project, a trend that Spain's current economic woes can only intensify.

Leaving aside that fact that the Iberoamerican project and Spanish membership of the EU were probably never fully compatible (as long-standing Latin American opposition to the Common Agricultural Policy suggests), Madrid has also found it increasingly difficult to act as an effective "bridge" between Latin America and Brussels. This is partly a consequence of successive EU enlargements, which brought to the table new member states that either had no interest in the region or proved reluctant to accept Spanish leadership. Additionally, the emergence of some Latin American states as major economic powers with their own leadership agendas (particularly Brazil) and the election of populist governments (in Venezuela and elsewhere) that resent Spanish influence have undermined Madrid's role in the region. Thus, in spite of its perceived leadership role in EU-Latin American relations, in recent years Spain has failed to advance negotiations between the EU and MERCOSUR, or between the EU and the Andean Community of Nations. Similarly, Spain has not been particularly active in promoting the EU's strategic partnerships with individual Latin American countries such as Brazil and Mexico.

Finally, Spain's leadership in the EU with regard to Latin America has also been undermined as a result of its tendency to politicize its bilateral relationships with some of the region's governments along partisan lines, most notably in Cuba and Venezuela.

Given all of the above, and taking into account the impact of the economic crisis, it is likely that in coming months and years Spain will devote less time and energy to EU-Latin America relations in order to concentrate on its strictly bilateral relations with a handful of trusted political and economic partners, most notably Mexico, Brazil, Chile, Colombia, and Peru.

As in the case of Latin America, most analysts would agree that the decline of Spain's influence in the Mediterranean also predates the current economic crisis. Spain was traditionally seen as a major player in the region, and its contribution to the Barcelona process in the 1990s was widely acknowledged. However, the latter's replacement by the French-inspired Union for the Mediterranean (UfM) was widely interpreted as evidence of this decline. If anything, Madrid's failure to respond to the UfM's poor performance in recent years would appear to confirm this view.

As was true of the rest of Southern Europe, the Arab Spring took Spain by surprise, and early reactions were somewhat ambivalent.[49] In the past,

[48] Susanne Gratius, "Why does Spain not have a policy for Latin America?," *FRIDE Policy Brief*, No. 29, January 2012, http://www.fride.org/publication/706/.

[49] Richard Gillespie, "Guiados por la crisis: la política exterior y de seguridad de España en 2011," *Anuario Internacional CIDOB 2012*, pp. 245-253, http://www.cidob.org/en/publications/articulos/anuario_internacional_cidob/guiados_por_la_crisis_la_politica_exterior_y_de_seguridad_en_espana_en_2011.

Spanish governments had generally engaged with existing regimes in an effort to encourage social and economic reforms carried out "from above," without exerting much pressure in favor of overt democratization. This was particularly true with regard to Morocco, where the royal family's close relationship with King Juan Carlos is regarded as a major political asset. To some extent, this approach may be seen as an indirect legacy of the Spanish transition, in which a reformist monarch paved the way for democracy, even though Spanish policymakers have always been careful not to give the impression that they were seeking to export the so-called "Spanish model."

In spite of the above, the Zapatero government was quite warm in its reaction to developments in Tunisia and Egypt, which were greeted with enthusiasm by Spanish public opinion. However, the economic crisis seriously limited the government's efforts to support democratization actively in these countries, which had to make do with very modest additional Spanish contributions to the European Investment Bank. At the same time, the Spanish executive was distinctly cautious about developments in Libya and Syria, and much less assertive than other EU member states in demanding changes of regime there. More surprisingly, perhaps, Spain has not played a vanguard role in attempting to involve the EU more actively in the region. Policymakers understand that the new context offers Spain an opportunity to recover some of its former influence, but have tended to favor bilateral rather than multilateral initiatives. Furthermore, the crisis has led them to concentrate their efforts on improving investment and commercial ties in the region, to the detriment of other, longer-term concerns. In short, it would appear that the crisis has hampered Spain's willingness and ability to provide significant leadership within the EU when it comes to designing and implementing innovative policies toward the Middle East and North Africa region.[50]

Spain and the United States

Spain's relationship with the United States has not been an easy one in recent years. Prime Minister Aznar spearheaded an ambitious attempt to develop a British-style "special relationship" with Washington in the wake of the 9/11 terrorist attacks, but this was rapidly reversed by his successor Zapatero on the grounds that it was incompatible with Spain's long-standing commitment to the European project. The bilateral relationship subsequently nose-dived during the second Bush administration, most notably as a result of Zapatero's unilateral decision to withdraw Spanish troops from Iraq in 2004. Ironically, in the wake of Obama's 2008 victory, the socialist prime minister deluded himself into thinking that he too could reach a special understanding with the White House, presumably on account of what he saw as ideological affinities with the new president, but this never materialized. Much to the government's chagrin, Obama did not visit Spain officially while Zapatero was in office.[51]

Zapatero had been particularly critical of Aznar's support for the Bush administration's foreign policy. It therefore came as a major surprise when, in October 2011, only weeks before the general election and without consulting parliament, he announced that Spain would be hosting the naval elements of NATO's anti-missile defense system. The prime minister justified this on the grounds that Spain lies "at the gateway to the Mediterranean," and was also quick to point out that the home porting of four Ballistic Missile

[50] Ana Echagüe, "Time for Spain to lead the EU's Mediterranean policy," *FRIDE Policy Brief*, No. 74, April 2011, http://www.fride.org/publication/903/.

[51] Charles Powell, "Spanish-US relations at the crossroads," *CIDOB International Yearbook 2009*, pp. 97-101, http://www.cidob.org/en/content/download/23012/267018/file/115_Powell_eng.pdf.

Defense-capable Aegis ships at Rota naval base in southern Spain as of 2014 would bring with it considerable economic benefits. This somewhat disingenuous attempt to justify a major foreign policy reversal on the flimsiest of economic grounds did not go down well with Spanish public opinion. Although the decision was well-received by the then-leader of the conservative opposition, subsequent negotiations between Washington and the new Rajoy government concerning the details of the agreement have proved laborious. Furthermore, the project has yet to be debated in parliament, where it may meet some opposition from left-wing parties. In short, the consequences of Zapatero's swan song may yet prove more controversial than originally expected.

As in other parts of Europe, Spanish political elites are under the growing impression that the United States is distancing itself from Europe, and that the economic crisis has strengthened and accelerated this dynamic. More specifically, the belief that the United States is increasingly interested in the Asia-Pacific region partly as a result of Europe's current economic difficulties is widely shared. While they may still pay lip-service to the importance of the transatlantic relationship, Spanish elites are generally under the impression that the crisis is weakening transatlantic economic cooperation.

The Obama administration's expressions of concern about the Spanish economy and its efforts to encourage European leaders to seek political solutions to the EU's economic governance problems have been well received in Spain.[52] However, both elites and the public at large probably feel that there is little the U.S. administration can do to overcome the current impasse, which is perceived as an almost exclusively European stalemate that only European actors will be able to resolve (if at all).

In spite of the above, Spanish policymakers are well aware of the importance of the economic relationship with the United States. The United States is currently Spain's number one trading partner outside the EU, with bilateral trade representing almost $22 billion in 2011. Additionally, Spanish foreign direct investment in the United States reached a record $47.5 billion in 2010, making Spain the 11th largest investor in the United States, a figure that will probably decline as a result of the crisis. Spanish companies are currently the largest foreign investors in the United States' renewable energy sector and are major participants in U.S. Department of Energy renewable energy programs. Spain also attracts a significant amount of U.S. FDI — $60 billion in 2010 — and U.S. corporations with a major footprint in Spain have expressed their willingness to continue to invest in the country in spite of its current economic difficulties. In early 2012, for example, the Ford motor company announced it would be investing €1.2 billion in its Almussafes (Valencia) plant over the next five years.

Limiting the Potentially Negative Consequences of the Crisis on the Transatlantic Community

The economic crisis is having a negative impact on the transatlantic relationship in a number of different ways. In the United States, it is raising fresh doubts as to the long-term viability of Europe as its major trade and investment partner, and there are also fears that a crisis-ridden, inward-looking EU will be less relevant and reliable as a partner when it comes to addressing global challenges. Conversely, the perception that the crisis is basically Europe's to solve, and that options for direct U.S. involvement are very limited, may lead Europeans to question the overall relevance of the transatlantic relationship. In Spain at least, the transatlantic

[52] Conversely, presidential candidate Mitt Romney's disparaging remarks about Spain, Italy, and Greece, which he has compared to bankrupt California, have probably had the opposite effect.

dimension has barely figured in the ongoing debate about the nature, evolution, and possible outcome of the crisis.

From a strictly Spanish perspective, the United States could contribute to mitigate the impact of the crisis by increasing its private sector investment; in spite of the crisis, FDI into Spain rose by 18.4 percent in 2011, of which 6.4 percent originated in the United States. A recent bilateral agreement on double taxation and new Spanish legislation to fight internet piracy may contribute to this goal. Conversely, Spain has yet to develop a viable strategy that would enable its companies to take full advantage of the Hispanic market — approximately 50 million U.S. residents speak Spanish — in sectors such as publishing, the media, and telecoms.

The EU and the United States could also do more to mitigate the impact of the crisis by unlocking transatlantic economic activity. As the interim report by the EU-U.S. High Level Working Group on Jobs and Growth published in June 2012 suggests, closer cooperation on the harmonization of regulations, tackling behind-the-border barriers and enforcing intellectual property rights (an issue that has seriously hampered U.S.-Spanish economic relations in recent years) could have a significant impact on transatlantic trade. Additionally, it could also help address shared market access problems in third countries (particularly in regions of special interest to Spain, such as Latin America), and to strengthen global rules and norms worldwide.[53]

The most effective way to reverse (or at least limit) the potentially negative consequences of the crisis on the transatlantic community would be to embrace a bold, high-profile initiative that both sides might find inspiring, providing the transatlantic relationship with a new, badly needed narrative for a post-crisis scenario. This is something that could probably best be achieved by means of a Transatlantic Free Trade Area (TAFTA), which, if sufficiently ambitious, could contribute significantly to the economic recovery of both the United States and the EU, Spain included. As Dan Hamilton has proposed, the new agreement should have three major interrelated goals: to renew and open-up the transatlantic market; to reposition the transatlantic partnership so as to better engage with third countries on the fundamental rules of the international economic order; and to extend the rules-based multilateral system to new members and new areas of activity, such as intellectual property, services, or discriminatory industrial policies.[54]

From a specifically Spanish perspective, in the longer term it would also make good sense to gradually extend the benefits of this Transatlantic Free Trade Area to Latin America and Africa, in keeping with the philosophy of the so-called Atlantic Basin Initiative, which seeks to redefine the way we currently perceive the Atlantic as an economic space.[55]

[53] See Secretary of State Hillary Clinton's remarks at the U.S.-Spain Council, June 23, 2012, http://www.state.gov/secretary/rm/2012/06/193978.htm.

[54] Daniel S. Hamilton and Pedro Schwartz, *A Transatlantic Free Trade Area. A Boost to Economic Growth?*, Brussels, New Direction, January 2012, http://newdirectionfoundation.org/content/transatlantic-free-trade-area-boost-economic-growth.

[55] See Daniel S. Hamilton (ed.), *Shoulder to Shoulder: Forging a Strategic U.S.-EU Partnership*, Washington, Center for Transatlantic Relations, 2010, http://transatlantic.sais-jhu.edu/publications/books/shoulder-to-shoulder-book-finaltext.pdf.

3 On the Brink
Greece and the European Financial Crisis

Theodore Couloumbis, Thanos Dokos, Dimitris Katsikas, and Dimitris A. Sotiropoulos

Major Economic Problems and Outlook for 2012-13

The crisis in Greece officially erupted in May 2010, when the Greek socialist government (PASOK) admitted that the country was unable to service its mounting public debt and resorted to the rescue mechanism put together by the "troika" of the European Commission (EC), the European Central Bank (ECB), and the International Monetary Fund (IMF). Greece was offered a first bailout package, which amounted to €110 billion and was accompanied by a harsh austerity program. The package was one of the biggest ever given to a single country, primarily due to the high costs of servicing the public debt, which at the time was in excess of €300 billion. Realizing that the objective of returning to the markets upon the completion of the bailout program was not attainable and that Greek public debt was not sustainable, Greece and the troika agreed upon a new bailout package in February 2012, which amounted to €130 billion (including part of the first package), as well as a significant restructuring of Greek public debt.

Following a short-lived initial euphoria after the agreement on the second bailout program, uncertainty and concern about Greece's prospects have returned with a vengeance. The country is going through its fifth consecutive year of recession, having suffered a cumulative 13.8 percent shrinkage of its GDP compared to pre-crisis levels. Last year was the hardest yet seen, with the economy contracting by 6.9 percent, while unemployment rose to 17.7 percent.[56] On the fiscal side, government deficit declined from 15.8 percent of GDP in 2009 to 9.1 percent in 2011 following a stringent fiscal consolidation program, which reduced the government's primary deficit from €24.1 billion in 2009 to €4.7 billion in 2011. Although the deficit numbers demonstrate significant progress in fiscal management, initial targets have nevertheless been missed repeatedly and by a large margin.

This deviation is the result of the combined pressure on economic activity from fiscal consolidation policies and the shortage of credit in the economy due to the country's banking sector difficulties.[57] The resulting recession has reduced tax revenues while increasing the social expenditure bill through increased unemployment benefit payments, thus forcing the government to engage in new rounds of fiscal consolidation measures, which again deepen the recession, further undermining achievement of the revised fiscal targets. This vicious circle is not allowing the Greek economy to recover, while maintaining a state of uncertainty about the economic prospects of Greece and raising doubts about the sustainability of Greek debt, factors that have deepened the crisis further by discouraging investment in the economy. As a result, forecasts have been revised downwards, with a severe recession of 5 percent projected for 2012, followed by stagnation in 2013, and growth expectations pushed back further to 2014.[58]

To make matters worse, political uncertainty following the failure to form a viable government after the May 6 elections and the announcement

[56] Hellenic Statistical Authority, "The Greek Economy," October 5, 2012, http://www.statistics.gr/portal/page/portal/ESYE/PAGE-economy. The average annual unemployment figure obscures the fact that unemployment rose steadily through 2011, a trend that has continued unabated in 2012, with unemployment reaching 24.4 percent in June 2012. See, Hellenic Statistical Authority, *Labour Force Survey: June 2012*, September 6, 2012, http://www.statistics.gr/portal/page/portal/ESYE/PAGE-themes?p_param=A0101&r_param=SJO02&y_param=2012_06.

[57] The Greek banking system has been unable to access the international interbank market since 2009 due to concerns about its exposure to the Greek sovereign bond market. The pressure on bank liquidity has intensified further by the flight of approximately €70 billion worth of deposits in the last two years.

[58] See European Commission, "European Economic Forecast. Spring 2012," European Economy, No. 1/2012, May 2012, http://ec.europa.eu/economy_finance/publications/european_economy/2012/ee1upd_en.htm; Bank of Greece, "The Governor's Annual Report 2011," April 2012, http://www.bankofgreece.gr/Pages/en/Publications/GovReport.aspx.

of new elections for June 17 undermined the fiscal consolidation process, reversing an unexpected primary surplus recorded in the first quarter of 2012 and putting Greece's commitment to the austerity program in doubt. Derailment of the bailout agreement could cut off funding by the troika, with potentially detrimental consequences for the Greek economy. Apart from the fact that funding is necessary to finance the still sizeable government primary deficit, an interruption in the flow of funds from Greece's lenders would also put significant achievements of the second bailout deal at risk, such as the recapitalization of Greek banks, necessary for the reinvigoration of the Greek economy, and would make it impossible to disburse approximately €6.5 billion of the Greek government's overdue payments to Greek private suppliers, which are vital for the languishing Greek economy. Should such a development materialize, it could potentially lead to a Greek exit from the eurozone with catastrophic effects for the Greek economy and society.

On the other hand, the results of the Greek election, in conjunction with recent changes in the European political landscape and the heightened uncertainty caused by Spain's recent troubles, provide a unique window of opportunity for the new Greek government to renegotiate specific aspects of the program that would facilitate its acceptance by the Greek population and therefore increase the probability of its success. The objective underlying such a renegotiation should be Greece's swift return to growth. A significant step in that direction could be provided by a more realistic and accommodating fiscal consolidation program, primarily through the extension of the agreed deadlines. This would reduce the program's depressive effects on the economy and result in increased tax revenues. It would also make fiscal consolidation targets more achievable and allow the government to put a stop to the vicious circle created by the continuous introduction of new rounds of recession-deepening austerity measures. The extension should be accompanied by a set of pro-growth policy initiatives at both the national and European levels. Such measures should include faster implementation of structural reforms, more flexible and efficient use of EU structural funds, as well as increased funding by the European Investment Bank, whose mandate and function need to be seriously reconsidered. In the same context, the implementation of the "Compact for Growth and Jobs," recently agreed at June's European Council, needs to be expedited to allow new instruments such as "project bonds" to be employed as soon as possible. Finally, a more unified and assertive stance at the European official level regarding Greece's place in the eurozone would go a long way toward reducing the uncertainty surrounding Greece's future, thereby alleviating one of the most important factors inhibiting foreign investment into the country.

The Political and Social Impact of the Crisis in Greece

In contrast to opposition parties in Italy, Portugal, and Spain, where some modus vivendi has been found between government and opposition, the Greek parties of the opposition, i.e. primarily the center-right New Democracy and the two parties of the left (SYRIZA and KKE), reacted negatively to the first bailout package. They mobilized their followers to participate in large-scale demonstrations and to support social movements, such as the Greek "indignants," who gathered every day between March and July 2011 in large squares of Greek cities, and the "won't pay" movement, which focused on refusing to pay increased public transportation fees, toll fees on national highways, and a property tax included in electricity bills. Demonstrations peaked periodically and sometimes became violent. The political mobilization quieted down after November 2011, when Prime Minister George Papandreou's unwise move to call a referendum on the bailout package provoked the negative reactions of EU leaders and even the back benchers of his own political party, and forced him to step down and hand over power to a coalition government led by a technocrat (the Lucas Papademos cabinet that lasted from November 2011 to May 2012).

The formation of a coalition government in November 2011 was made possible by New Democracy, which changed its anti-bailout stance and decided to become a coalition partner. The party reversed its previous position by voting for the second bailout package in February 2012. This was essential for the country's survival, but it cost New Democracy dearly, as its share of the vote dropped from 33 percent in the 2009 elections to 19 percent in the May 2012 elections. PASOK suffered even more though in the same elections as its share dropped from 44 percent to 13 percent, while SYRIZA's share of the vote soared from 5 to 16 percent. This radical left party came in second place, just behind New Democracy but ahead of PASOK. Even so, no government was formed and fresh elections were called for June 2012.

The political impact of the economic crisis was multifaceted in its first two years (May 2010-May 2012). First, large numbers of Greeks chose atypical channels of political participation. Resistance to the austerity policies took forms that at times verged on rejecting parliamentarism, as protesters verbally and physically attacked individual MPs belonging to the two largest parties (PASOK and New Democracy). This type of behavior was the culmination of long simmering political cynicism and alienation, which first became visible in the late 1980s, but grew out of all proportion in the 2000s. Distrust toward political institutions and elites fed on long-term patronage and corruption — protracted patronage exercised by the two parties, which used to staff the public sector with their political supporters before or after each election, combined with accusations of high-level corruption that were never cleared up.

Second, political polarization became exacerbated after May 2010. Two large camps, the pro-bailout and the anti-bailout forces, formed. The inability or reluctance of Greek political parties to converge on a rescue strategy contrasts starkly with the more consensual strategies of Italian, Portuguese, and Spanish parties during the same period. This feature of the Greek party system must be understood in the context of a very polarized, almost Manichean political culture that has permeated the Greek political scene since that country's civil war, which pitted royalists and centrists against communists (1946-49).

Third, a new party system emerged as the traditional contenders for power. PASOK and New Democracy, which had together obtained 77 percent of the vote in the 2009 elections, saw their combined share of the vote decline to 31 percent in May 2012. In those elections, not only did SYRIZA come in second place just behind New Democracy, leaving PASOK in third place, but smaller parties gained parliamentary representation (on the right, the nationalist-minded Independent Greeks and the neo-Nazi Golden Dawn party; on the left, the pro-European Democratic Left party). All newcomers to parliament were against the bailout package. In general then, the new party system is much more fragmented than the earlier two-party system. It is also a party system in which the cleavage is not only between right and left, but also between pro-bailout and anti-bailout forces.

Such political developments reflect deeper social shifts, associated with the social impact of the economic crisis. It is telling that in May 2012, the SYRIZA party polled disproportionately among the unemployed, civil servants, and private sector workers. This is because the radical left had rejected outright salary cuts and had issued political messages in support of the public sector and the rights of the low-salaried groups that had been addressed by PASOK in 1981-85 with astounding success (PASOK ruled in 1981-85 and again in 1993-2004).

Furthermore, the crisis has caused an ideological shift with regard to Greece-EU relations. Euroscepticism, which has been on the rise in other European democracies, has probably become hegemonic in Greece. The left holds Greece's EU partners responsible for imposing a straitjacket on Greece that has caused deep depression, soaring unemployment, and drastic salary cuts, leaving little possibilities for growth in the near future. Indeed, even the troika officials have admitted that in the first bailout package (of May 2010), the mix between measures boosting growth and decreasing public spending was not right. The left blames Greece's two-party system for having accepting such measures.

Third, as a result of the wrong mix of policies in the first bailout package, the reluctance of most of the socialist (and later on coalition) government ministers to proceed with structural reforms, and the fierce opposition of professionals (pharmacists, doctors, lawyers, engineers) and the employees of state-owned enterprises, the Greek state took measures that hit the rest of society very hard. Starting in spring 2010, the salaried strata in both the private sector and the civil service were overtaxed. In 2010-11, civil servants saw their annual income decline by as much as 25-27 percent. In 2012, on the basis of the second bailout package (of February 2012), the minimum monthly salary in the private sector was cut by 22 percent (and 32 percent for first-time employees under the age of 25).

The right blames the trade unions in the public sector and the left for fiercely resisting the structural reforms included in the first bailout package. Indeed, very few if any privatizations have gone through. With few exceptions, there have been no mergers of large public organizations to decrease government expenditure. The fact that the budget deficit was reduced by 5 percentage points (from 15 percent to 10 percent of GDP) in 12 months (January — December 2010) is attributed to horizontal, across-the-board salary cuts in the civil service and the termination (without renewal) of the short-term employment contracts of public employees who had been hired on a fixed term or project basis.

Fourth, the salary cuts and slashing of the budget deficit led to economic depression, which in turn provoked a rise in unemployment. In the first trimester of 2012, more than 1.2 million Greeks were unemployed out of a total population of 11.3 million (2011 figures). For the long-term unemployed, the currency in which they will receive their meager unemployment benefit (€359 per month) is of less importance than the experience of unemployment itself.

And fifth, although statistical data on poverty and income inequality are only available after two years, it can be argued that another social outcome of the crisis is the rise in poverty and the increase in income disparities. On one hand, the number of people without shelter or access to food in Athens is too visible to be neglected. On the other hand, successive reports on tax evasion and transfers of large amounts of savings from Greece to Western European countries in 2010-12 indicate that the more well-to-do self-employed (i.e. professionals and owners of large or medium-sized businesses) have experienced a fate clearly quite different from that of the low- and middle-income salaried strata. Capital flight from Greece took place long before the economic crisis transformed into a political one in May-June 2012.

The elections of June 2012, called after the inconclusive ones of May 2012, confirmed that the political and social results of the crisis are here to stay: a new multi-party system that includes the extreme right replacing the old two-party system; a new, increasing polarization between the pro-European center-right and the Eurosceptic radical left; the return of class-based politics as the salaried strata, the unemployed, and the young vote primarily for the left, whereas the other social strata and age groups vote for the Right; and the ideological divide between pro-European voters committed to the euro at any cost and the rest, who entertain hopes that Greece will distance itself from the eurozone, if not leave the EU altogether.

The Impact of the Crisis on Greek Foreign Policy

Greece's (and Europe's) crisis is mainly economic but also political in nature. The geopolitical dimensions of the crisis have been largely ignored by analysts and decision-makers. If Greece fails to recover and is forced to leave the eurozone, there will be, according to most experts, a highly negative economic and political fall-out on the euro and the EU (several experts and officials question whether the eurozone would even survive such a contingency). It will be argued that, in addition, there will probably be severe repercussions for regional stability in Southeastern Europe and the Eastern Mediterranean, as well as for the EU's and NATO's ability to play a substantial role in those regions.[59]

Indeed, allowing Greece to become a weak or even semi-failed state will have an impact well beyond its immediate borders. Under the current circumstances, Greece could be defined as a pivotal state, albeit in a negative way.[60] Yet it was — and has the potential to become again — a useful player in a number of foreign and security policy areas, including EU relations with Turkey, the Cyprus problem, EU enlargement in the Western Balkans, Black Sea cooperation, EU and NATO policies in the Eastern Mediterranean, energy security, and immigration management. On all of those issues, the ability — and perhaps the willingness — of Greece to make a positive contribution should no longer be taken for granted. It might be useful at this point to look briefly at the basic premises and priorities of, as well as the impact the crisis could have on Greek foreign policy.

A preliminary assessment would conclude that the country's image, prestige, and credibility have been dealt a very serious blow and its influence both inside the EU but also in its neighborhood has been severely affected. The economic means available for conducting foreign policy (in terms of both "classical" and economic diplomacy) have been substantially curtailed. The decision has been taken by successive Greek governments to significantly reduce defense expenditures and, in this context, Greece's participation in international peacekeeping and other operations (ISAF/Afghanistan, KFOR/Kosovo, and naval operations to combat piracy in the Red Sea) has already been trimmed down. Greece's ability to promote the integration of the Western Balkans in the EU has also been reduced (despite its Agenda 2014 Initiative). To the extent that Greece was a significant economic actor in Southeastern Europe, the region has suffered

[59] This paper makes no effort to absolve Greece of its substantial responsibility for its crisis. But Europe's performance in crisis management has not been exactly stellar. Furthermore, completely ignoring the geopolitical consequences of the Greek crisis is yet another symptom of the European foreign policy malaise. Europe is sliding into strategic and institutional insignificance, losing its global role and influence as it becomes more and more inward looking as a result of its own economic and political crisis.

[60] A pivotal state is defined as a state whose fate is critical for regional and international stability; which is geostrategically important for the United States and its allies; that has an uncertain future; and that has the potential to make a significant beneficial or harmful effect on its region. See Robert Chase, Emily Hill, and Paul Kennedy (eds.), *The Pivotal States. A New Framework for U.S. Policy in the Developing World*, Norton, New York, 1999, pp. 6-7.

economically (especially the banking sector, but also foreign direct investment/FDI) as a result of the Greek crisis. Discussions with Turkey (the so-called "exploratory talks" at the level of senior diplomats) for the full normalization of bilateral relations have not been making any progress,[61] and Greece's potential moderating influence in efforts to resolve the Cyprus problem is virtually absent. Finally, during a period of wide-ranging or evolving changes in the Middle East, Greece's role has been minimal, despite its historically close relations with the Arab world. In fact, the gradual development of substantive strategic ties with Israel and the mutual respect between Greece and Iran could allow Athens to play the role under specific circumstances of a complementary mediating bridge between Tehran and the EU/West.

It should be mentioned here that even before the current economic and, by extension, political and social crisis, Greece has been underperforming in the foreign policy field, allowing some of its regional impact in Southeastern Europe to slip away and letting its active role inside the European Union to gradually atrophy. An inward looking and rather passive foreign policy approach resulted in relatively few foreign policy initiatives and a failure to take advantage of opportunities for multilateral initiatives or the formation of tactical and strategic alliances. Currently, Greek foreign policy urgently needs to readjust to a changing regional, global security, and economic environment and, through economic diplomacy, contribute to the national effort to rebuild the economy. Moreover, it must achieve these goals with limited resources and under significant time pressure.

[61] Despite some past progress in the exploratory talks for the full normalization of Greek-Turkish relations, it appears increasingly unlikely that there will be a lasting agreement in the near future. It would, perhaps, be wiser if both sides explored ideas for confidence-building measures and functional interim solutions regarding overflights, air-space violations, and dogfights.

Moving from geographical to functional issues, the management of immigration flows, an issue with important external and internal dimensions for several EU countries, has been a continuing uphill struggle for Greece (it is estimated that more than 100,000 illegal immigrants from Asia and Africa cross its borders annually, a trend that has been going on for several years, bringing the total number of illegal immigrants in Greece to unbearably high levels). Greece is the EU's most sensitive external border in the context of immigration.

Moving to the energy sector, there is a mix of bad, but also (potentially) good news. First the bad: whereas the fate of the "southern leg" of the South Stream natural gas pipeline is still uncertain; as a result of a decision of the Bulgarian government, the proposed Burgas-Alexandroupolis oil pipeline should be considered officially "dead." On the other hand, there is good news in regards to the hydrocarbon deposits discovered in the Eastern Mediterranean, in the exclusive economic zones of Cyprus and Israel, and potentially south of Crete. Moreover, there is a good chance that the Shah-Deniz consortium will choose a pipeline (Trans-Adriatic Pipeline/TAP) for the Southern Gas Corridor that will cross Greek territory.[62]

Possible Scenarios

At this critical juncture, faced with negative short- and medium-term prospects and considerable uncertainty, what are the likely scenarios for Greece's foreign and security policy? Fully aware of the difficulties, three generalized scenarios will be outlined to help understand the potential evolution

[62] Energy-related projects can be instrumental in Greece's effort to repair its image, reacquire a leading regional role, increase its influence, and accumulate "diplomatic capital." In this context, the Southern Gas Corridor can play an important role. See for instance Thanos Dokos and Theodoros Tsakiris, "A Strategic Challenge: The Role of Greece in Europe's Southern Gas Corridor Strategy," *ELIAMEP Policy Paper*, No. 17, February 2012, http://www.eliamep.gr/wp-content/uploads/2012/02/policy-paper.pdf.

of Greece's foreign policy. Reality is, of course, much more complex, as challenges and issues interact with each other, and there are innumerable variations and combinations of these three "ideal" scenarios, as well as scores of intervening global, regional, and domestic variables. We will try here to present Greece's potential as a regional security producer vs. the consequences of Greece becoming a weak and fragile state, incapable of making a contribution to European foreign and security policy.

First Scenario: "Stormy"

It may be difficult to imagine a developed country, a full member of the EU and NATO, becoming a weak or dysfunctional state. It will most likely not materialize in the case of Greece. However, the resilience of a developed country, the margin of safety, and the distance between order and disorder in a period of prolonged and deep recession, without an exit from the crisis in sight, may prove to be narrower than expected. Greece turning ultra-nationalist in its foreign policy and ultra-rightist in its domestic politics is not the most likely scenario, but it can no longer be ruled out as a possibility. If the current crisis continues without any visible signs of improvement, then the ability of the present or future Greek governments to fulfill the country's basic obligations vis-à-vis its European and NATO partners or to be a security producer in Southeastern Europe may be at serious risk.

In this scenario, Greece would be forced to leave the eurozone and, soon after, the EU, having attained the dubious distinction of being the first and only country forced to leave those institutions. The strong feelings of bitterness and humiliation would contribute to a considerable strengthening of ultra-nationalist forces, a development that would also be reflected in foreign policy choices. With little appetite and capacity left for self-criticism, and fed-up with extremely negative adjectives, continuous criticism, and stereotyping by Greece's European partners, Greek public opinion would attribute the blame for Greece's economic collapse exclusively to the "German drive for European hegemony," the "predatory nature" of the Western financial system, and the EU's perceived lack of solidarity. As a result, many Greeks would feel betrayed by the West and would be ready to turn to the East (Russia and China). Greece might remain a member of the Atlantic Alliance on paper but would not participate in future NATO operations. Access to Greek military installations (including Souda Bay) would be extremely limited, despite the increased needs of NATO and the EU as a result of Middle Eastern instability.[63]

Greek-Turkish relations could return to the levels of the early 1990s, as rising nationalism in Greece and neo-Ottoman tendencies in Turkey cause a deterioration of bilateral relations. Tensions would rise in Cyprus as both Turkey and Greece harden their respective positions and bi-communal negotiations would be suspended. The island's newly discovered energy wealth could become a source of serious friction and the growing discontent of Turkish Cypriots vis-à-vis Ankara's policies, first manifested in 2011, might complicate the situation further.

Faced with domestic problems as the Republic of Macedonia's Albanian community continues to move closer to its Kosovo brethren, that country's leadership could harden its position toward Greece even more. Greece in turn could revert to its previous position of not accepting a hyphenated name that would include the word Macedonia in her neighbor's name and announce that any agreement for the resolution of the bilateral

[63] A clear majority of professionals (diplomats and military officers), as well as decision- and opinion-makers (politicians, businessmen/industrialists, journalists) would be opposed to such a policy shift, but their credibility and influence would be seriously diminished under this scenario. They might succeed in moderating the impact or extent of the policy shift, but would not prevent the shift itself.

dispute would have to be approved by a popular referendum. As a result, the two countries' peoples could grow increasingly alienated and frustrated by the other side's behavior at the general expense of European integration of the Western Balkans.

Formerly a key regional actor, and in most cases a producer of security, Greece, in this unlikely scenario, would become marginalized and, more often than not, a source of instability in Southeastern Europe. The Greek economic presence and investment in the region would shrink accordingly. In the Middle East, Greece would remain virtually absent from a region in which it has traditionally good cultural and political ties with major local players.

Thankfully, the "stormy" scenario outlined above is the least probable of the three presented here (although several of its "predictions" may materialize in one form or another), and much can be done to prevent it.

Second Scenario: "Cloudy"

In this scenario, Greece would be forced to leave the eurozone but would remain in the EU (although its status would be rather unclear as the country would, for all intents and purposes, be on probation and isolated). Its participation in EU functions would be limited to the essential. Both euroscepticism and ultra-nationalism would be on the rise.

Greek-U.S. relations would be Janus-like, as there would continue to be cooperation in some areas, facilitated by the close Greek-Israeli relations, but also lack of trust or even competition in others. Overall, Greece would remain a country with limited strategic value for Washington. Greece's contribution to NATO operations would be scaled down considerably because of financial constraints. The country might still offer its facilities for use in NATO operations in the Eastern Mediterranean, but the benefits of Greek membership would be sub-optimal for the country and the Alliance.

Regarding its relationship with Brazil, Russia, India, China, and South Africa (the BRICS), Greece might occasionally play the "Russian card," without, however, a clear shift in its foreign policy orientation. As a result, some Europeans would continue to view Greece as too "pro-Russia," whilst Moscow would view Greece as "not pro-Russia enough." Greece would be unable, and probably unwilling, to decline offers of Chinese FDI. The Chinese presence and influence in Greece would grow steadily, without any clear direction and planning on the Greek side.

Greek-Turkish relations would remain erratic and unstable. There will be no progress in high politics, although economic relations might continue at a decent level and people-to-people contacts continue to increase. Overall, the relationship would remain fragile and crisis-prone, especially as the importance of the exploitation of energy resources would rise in the Greek agenda. The post-1974 status quo would continue in Cyprus. Even though Turkey would probably be content to let time change the demographic structure of the occupied North, the Turkish Cypriots would remain unhappy with the situation, but would have little room for maneuver. An increasing majority of Greek Cypriots would support the continuation of the island's division rather than joint rule with the Turkish Cypriots (and Turkey). Although one of the three guarantor powers of Cyprus, Greece would no longer be an active player on the island nation.

The diplomatic stalemate between Greece and the Republic of Macedonia would continue at considerable cost for both sides. Greece might feel compelled to withdraw from the 1995 Interim Agreement, as the prime minister of the Republic of Macedonia might continue to sacrifice the country's long-term interests for short-term political profit.

Despite pressure from European countries and the United States, neither side would be willing to take the necessary extra step to reach an agreement with a mutually acceptable hyphenated name for the Republic of Macedonia. Greece would maintain part of its economic presence and political influence in the Balkans, even though its ability to influence regional developments in a stabilizing manner would be significantly curtailed because of its political and economic weakness, its isolation inside the EU, and bilateral problems with the Republic of Macedonia and Albania.

Greece's involvement and general presence in the Middle East would remain quite limited, mainly through bilateral relations with Israel, and mostly memories of cordial relations with the Arab world. Greece would also provide rather limited active participation and contributions to EU policies vis-à-vis the Mediterranean and the Middle East.

Third Scenario: "Sunny"

"Smart" EU solidarity would allow Greece to manage its economic crisis at an acceptable cost and become once again a member in good standing of both the eurozone and the Union itself. Indeed, Greece could again become quite active in the context of the EU's foreign and security policy.

Greece's basic foreign policy orientation would remain fundamentally European (and in parallel euro-Atlantic), but an effort would be made to diversify its relations with key global and regional powers. There would be a marked improvement in U.S.-Greek relations as a result of continuously improving Greek-Israeli relations in contrast to the uncertainty in important circles in Washington about Turkey's regional role, the fluidity caused by the Arab revolts, and the concern about the rise of radical Islam in some Arab countries. Also, despite financial constraints, Greece could upgrade its contribution to NATO stabilization efforts in the Eastern Mediterranean (and also in combating piracy in the Red Sea).

Greek-Russian cooperation in energy and other issues might blossom and Greece would become an additional "bridge" between the EU and Russia, working quietly to assist in the full normalization of relations and the development of a strategic partnership between three status quo powers (United States, EU, and Russia) in the emerging international system. Greece would become an economic gateway for China in Southeastern and Central Europe. Political relations between Athens and Beijing would flourish, in a balanced way, without substantial divergence from European policies toward the emerging superpower.

Athens and Ankara would reach an agreement along the general lines of the ideas discussed during the exploratory talks and decide to permanently "bury the hatchet." The full normalization of relations would be followed by substantially improved economic relations between the two countries leading to reduced defense expenditures in Greece. (It should be noted, however, that such a development in Greek-Turkish relations may have limited relevance in the context of EU-Turkish relations because of the positions adopted by other European capitals). Greece and Turkey would adopt a win-win approach to the negotiations and the Cyprus problem would reach a lasting settlement, with the whole island becoming an active part of the EU. Cyprus could evolve into a complementary energy supplier for the EU, as well as the regional headquarters for EU activities vis-à-vis the Middle East (a role that would be strengthened if Cyprus were to consider membership in NATO's Partnership for Peace).

Greek investment and political leadership, after the full normalization of relations with the Republic of Macedonia and Albania, would again become important stabilizing factors for Southeastern

Europe. Athens could make a strong contribution to EU efforts and policies for enlargement in the Western Balkans. Once those countries join the Union, an active Southeast European bloc would be formed to promote common interests.

In the Eastern Mediterranean/Middle East, Greece would aim to become an active player in the context of EU regional policies by energetically offering its good offices as an acceptable interlocutor to both Israel and the Palestinians/Arabs. Also, exploiting its traditionally good relations with Iran, Athens might try to become a complementary bridge between the West and Tehran.

Implications for Transatlantic Cooperation

As described previously, Greece has not been an active player in the transatlantic context in the past few years, mainly due to the economic crisis but also because of a relatively introverted approach to foreign policy issues. This has happened at a time when the transformation/evolution taking place in the Eastern Mediterranean and North Africa is far from complete. NATO, the EU, and the United States have been trying to manage successive regional crises with rather mixed results. The contribution of all southern European members of NATO and the EU is extremely important, yet all have been faced with grave economic and political difficulties and their ability to rise to the challenge — different in every case — has not been very impressive.

In two of the three scenarios presented in the previous section, the consequences of the crisis for transatlantic cooperation would range from highly negative to catastrophic, as Greece's forced exit from the eurozone (and the EU) would cause a strong backlash in the country's relations with the United States and its role in NATO. Combining this with the reduced defense budgets and foreign policy capabilities of all Southern European states, as well as their increasing unwillingness or inability to participate actively in the shaping of NATO and EU policies vis-à-vis the evolving and changing Middle East, it is easy to conclude that transatlantic policies on issues of much importance for the transatlantic partners — political change in the Arab world, the role of radical political Islam, energy security, nuclear proliferation, population movements, etc. — are likely to have a rapidly diminishing impact in the future.

Policy Recommendations

Given the extremely unstable and fluid situation in Europe's periphery — including the Arab uprisings, the tension with Iran, the uncertainties regarding EU-Turkish relations, and the direction of Russian foreign policy in the new Putin era — can Europe afford the creation of a security vacuum and a "black hole" in this critical region? Even if the EU could live with Greece's economic collapse (although even that hypothesis is challenged by experts, not because of the size of the Greek economy but due to the highly symbolic, but very tangible damage to the eurozone's credibility), one should ask whether a country with Greece's geopolitical location and its "special relationship" with countries such as Russia, Israel, much of the Arab world, and even Iran, would constitute an acceptable loss for the transatlantic community.

Obviously, a "new Greece" would certainly be a useful instrument for European foreign and security policy in regions of critical importance for European security and interests. Needless to say, even under the best of circumstances it will take a very determined effort and at least two to three years to get the country out of the current crisis.

Greek foreign policymakers will function, at least for the near future, under the Damocles sword of the country's economic crisis. This imposes a number of constraints and limitations. In addition, as key organizations such as the EU and NATO are changing in an effort to adapt to new global and regional trends, Greece needs to find its own niche in the distribution of regional roles and convince its partners and allies of the added value it can contribute to common endeavors — a difficult task, indeed, for a country with limited resources, but the alternative is strategic irrelevance in the wider region.

The key concept for Greek foreign policy in the next few years will be the smart use of its resources in fields like energy (where Greece should try to enlarge its footprint on the energy map), relations with emerging powers,[64] strengthening of its relationship with Israel while maintaining close ties with the Arab world, offering its good offices to interested parties, regaining its role and influence in Southeastern Europe, and becoming more active inside the EU. To facilitate the achievement of those priority tasks, a number of structural reforms in the Ministry of Foreign Affairs and the wider foreign policy structure will be necessary (with an emphasis on economic and energy diplomacy). Furthermore, a number of important changes will have to be made in the national security sphere (security sector reform and "smart defense" to maintain Greek combat efficiency at lower levels of defense expenditure). Economies of scale, cooperative schemes, full exploitation of high efficiency organizational and operational models and doctrines, as well as the use of new technologies might be part of the answer in Greece's problems in the defense sector. To this end, Greece should take full advantage of EU and NATO opportunities for training, defense reform, security sector reform, crisis management and disaster management systems, and strategic planning mechanisms.

Attempts could also be made to create opportunities for more Greek participation — but at no extra cost — in NATO activities, such as fellowships for Greek officers in U.S. or other NATO military academies and war colleges, security sector reform activities on Greek soil for some of the democratizing Arab countries, more active participation in Mediterranean Initiative/ICI activities, etc. One could also explore ways to cover Greece's participation in anti-piracy efforts (perhaps through a combination of private sources, e.g. Greek ship-owners, and support from interested states). Greece could also serve as a convenient venue for track-two or even track-one diplomacy for various regional problems. Finally, the increasing strategic cooperation between Greece and Israel might prove to be a useful development for Washington in a variety of ways.

[64] There is an emerging consensus among politicians, government officials, and analysts that, while maintaining and even further emphasizing its European and transatlantic orientation, there is no reason why Greece cannot develop its relations with other major powers, including Russia and China, in the energy and trade sectors, respectively.

4 Fate and Freedom
Portugal and the European Financial Crisis
Paulo Gorjão

The financial crisis that began in the United States and subsequently spread to several European economies has underscored the high degree of economic and financial interdependence at both regional and global levels. Southern Europe in particular became the eye of the storm with a series of countries requiring massive international assistance in order to cope with mounting market pressures on their external ratings and debt borrowing costs. Portugal was the third country, after Greece and Ireland, to request such support.

Unsurprisingly, the terms associated with such help have heavily restricted the targeted governments' room for action, forcing them to engage in a radical reshaping of their economic policy agendas. Portugal is no exception: it has been compelled to substantially review and change a considerable part of its domestic policies. However, the actual impact of these changes on the foreign policies of Southern European countries remains elusive. This applies, in particular to the transatlantic dimension of their external relations.

This chapter aims to contribute to a better understanding of the challenges that Portugal has faced and continues to face, its efforts to deal with them, and the implications for its foreign policy. It starts by highlighting the major economic problems that the country will have to deal with in the short and medium term, as the austerity measures begin to "bite" and the economic outlook remains bleak. It then turns to the impact that the current crisis has had on a number of political and institutional dimensions at the national level, with a special emphasis on the latest elections that brought the current government to power. Portuguese foreign policy is then analyzed in light of these new circumstances, with a particular focus on transatlantic relations. The final sections offer some concluding remarks and policy recommendations aimed at preventing or at least containing the negative impact of the ongoing crisis upon relations across the Atlantic.

* The author would like to thank to António Martins da Cruz, António Monteiro, Luís Amado, Pedro Seabra and Vasco Rato, as well as IAI's reviewers, for their insights and views.

An Economic Straitjacket

Ever since the international troika, made up of representatives of the International Monetary Fund (IMF), the European Central Bank (ECB), and the European Commission arrived in Lisbon in 2011, there has been no doubt about who would dictate the developments of Portuguese economic policy over the coming years. Portugal has found itself in a straightjacket ever since, contending with a series of rigorous obligations with which it is forced to comply. Indeed, in exchange for a €78 billion bailout, Portugal was forced to introduce a wide range of sectorial reforms and accept periodic assessments of its actual implementation of the internationally agreed terms. In this way, Portugal has been placed under close and strict surveillance. The government has no option but to submit to and pass each scheduled review in order to regain badly needed external credibility. For the time being, this has been achieved, as the consecutive reviews appear to indicate.

The severe austerity measures, however, have taken a high toll on Portuguese society and may become a major obstacle to an effective recovery. Unemployment, in particular, reached an all-time high of 15.9 percent in August 2012 — it was "only" 12.7 percent in August 2011 and 10.9 percent in December 2010, i.e. before the austerity measures were adopted — and is expected to rise above 16 percent in 2013. Equally important, unemployment among youth — those aged between 15 and 24 — has increased steeply, reaching 35.9 percent in August 2012. It was 30.3 percent the year before.

Consumer spending is declining, and so are tax revenues. By the end of September 2012, the cumulative decline in tax revenue was 4.9 percent. In the second supplementary budget, tax revenue decline for 2012 was predicted at 5 percent, which means the government has a very small margin of error until the end of the year. The economic situation is becoming so desperate that there is the risk that Portugal may not be able to meet its goal of reducing this year's budget deficit to 5 percent (a target previously set at 4.5 percent), notwithstanding the fact that in September 2012, the troika granted Portugal an extra year, (until 2014) to get its budget deficit below the European Union (EU) ceiling of 3 percent of GDP. Meanwhile, Portugal will remain in recession in 2013, with an economy set to contract by 3 percent this year and a further 1 percent in 2013. Projections for the Portuguese economy in 2013 are surrounded by great uncertainty and, therefore, contain a greater margin of error. Consequently, one should not exclude the possibility that the adverse recessionary effects of the new measures of fiscal consolidation could turn out to be higher than those projected by the government.

Since the financial crisis started in Europe, bank lending to companies and households has become a serious problem in Portugal. After a deal with the Portuguese government, the heavyweights in the country's banking sector — including the two biggest private banks, Banco Comercial Português (BCP) and Banco Português de Investimento (BPI), as well as the state-owned Caixa Geral de Depósitos (CGD)[65] — chose to resort to public financing for more than €6.65 billion to improve their liquidity and thus meet the new standards established by the European Banking Authority. In August 2012, Portuguese banks granted only €3.2 billion in loans, according to the latest data provided by the Bank of Portugal, the lowest monthly figure since 2003.

In addition to all these internal hindrances, the country's economic prospects are constrained by and dependent upon exogenous factors much more than is publicly perceived. Indeed, given the deep concerns over the eurozone's cohesiveness as a whole, any decisions taken (or the lack thereof) at EU level have an almost automatic impact on how markets perceive the long-term credibility of Portuguese efforts. In other words, whenever European leaders end one of their multiple summits without any concrete results, doubts about the viability of the Portuguese austerity program increase. By contrast, when they agree on new steps to tackle the crisis, the country is given new breathing space and renewed chances of success.

Moreover, there are still deep concerns regarding a possible contagion effect from any deteriorating situation in other eurozone countries, like Greece, but especially Italy and Spain. In particular, given Portugal's overwhelming exposure to and economic dependence on Spain — Portugal's first importing and exporting market — the Portuguese economy is likely to face even more disturbing woes. If Spain's problems were to increase or not be solved, Portuguese exports, the central bulwark of the government's plans for recovery, will likely be the first to suffer.

It is therefore not surprising that rumors over the possibility of a second bailout or an additional extension of the deadline of the first have circulated. In any case, although it is not impossible, it will be difficult for Portugal to regain market access anytime soon, let alone in 2013, as the troika program and government predicted. Although Portugal is implementing the measures agreed with international lenders, there is a growing sense that a stable economic outlook is not entirely in Portuguese hands, but rather depends on developments at the European level.

[65] CGD, as a publicly owned institution, is not eligible for bailout money and as such, will receive €1 billion from other government funds.

Changing Tables at Home

Of the political consequences triggered by the bailout request of April 2011, the most important is undoubtedly the change in Portugal's political leadership. Indeed, the sequence of events represented the swan song for former Prime Minister José Sócrates, who resigned in March 2011 after having failed to secure the passing of new austerity measures in Parliament. At the subsequent parliamentary elections, held on June 5, 2011, Pedro Passos Coelho, leader of the then opposition Social Democratic Party (PSD) secured 33.3 percent of the popular vote. However, having failed to secure an absolute majority in parliament, Passos Coelho formed a coalition with the smaller Democratic and Social Centre-People's Party (CDS-PP) led by Paulo Portas. This ensured the new right-wing cabinet enough parliamentary support for the painful austerity measures that were already anticipated at that time.[66] Even before the elections, Passos Coelho had committed himself to complying with the terms negotiated with the international lenders. It was therefore no surprise that his electoral program was closely aligned with, and in some cases even went beyond the remedies prescribed by the troika. On the other hand, as a result of the election, Portugal's institutional context featured a government and a president, Aníbal Cavaco Silva, from the same political party, PSD. This provided additional assurances that, given the political stability, the government would stick to its ambitious reform program.

The main opposition party — the Socialist Party (PS) led by António José Seguro, who succeeded Sócrates after the latter lost the June 2011 parliamentary election — has distanced itself from the government's austerity plans, championing a more expansionary fiscal policy while not breaking entirely with the memorandum of agreement with the international troika, to which it had previously subscribed.

There has, however, been increasing pressure from within the PS to renege on the agreement, or at least to renegotiate it, as it is seen as highly damaging for the party's electoral prospects. While trying to act responsibly, the fact is that the PS cannot ignore the prevailing public mood in Portugal. Indeed, in line with what is happening elsewhere in Europe, the anti-austerity mood has reached dangerous levels in Portugal, as shown by the recent strikes and protests in Lisbon. Impressive anti-austerity rallies were held on September 15, organized mainly through social networks (but with significant mass media publicity), and on September 29, organized by CGTP-IN, the largest trade union federation. Portugal has not witnessed such large demonstrations since the fall of the dictatorship and the subsequent regime change in 1974-76.

Although public opinion seemed to initially support most of the measures taken by Passos Coelho's government, after 15 months of austerity measures, it is now evaporating. In 2011, outspoken discontent was confined mainly to specific sectors of society, such as public workers and their trade unions, hit hard by the reforms and fiscal squeeze. However, bearing in mind the events of September 15, it is likely that in 2013 anti-austerity protests will gather an increasing number of supporters from all walks of life, i.e. from the public and private sectors, young and old, as well as the employed and unemployed. In Portugal, business associations and trade unions have traditionally been able to reach a considerable level of consensus. This had been touted as one of Portugal's positive features within the European context, but there are several signs that, if further austerity measures are enacted — and the 2013 state budget is even harsher than the previous one — social tensions

[66] For a more complete recollection of all the unfolding events in Portugal in 2011 see, for example, Paulo Gorjão, "Portugal in 2011: The Downgrade of All Fears," in *IPRIS Lusophone Countries Bulletin: 2011 Review*, March 2012, p. 33-38, http://www.ipris.org/php/download.php?fid=709.

will escalate, putting this consensus at risk. Furthermore, the latest poll published in October 2012 by the weekly newspaper *Expresso* showed that, if parliamentary elections were held, the PSD would only garner 30 percent of the vote and thus lose to PS (34.8 percent), while the CDS-PP party would be confirmed as the political kingmaker with 10 percent of the vote. Equally revealing, and confirming the PSD's (and the CDS-PP's) declining popularity, the PSD lost the regional elections that took place on October 14 in the Azores Islands against the PS party.

Moreover, popular discontent about austerity measures is so intense that it is not clear if the current coalition government will survive until the end of its mandate. If the current government falls apart, it would be the second consecutive government to collapse because of the financial crisis. Indeed, according to another October survey published by *Expresso*, after just 15 months in power, an astounding 69.4 percent of Portuguese say they have lost trust in the government, while 70.8 percent believe that the austerity measures have already gone beyond bearable limits. Moreover, the 2012 edition of the annual survey *Transatlantic Trends* found that 89 percent of Portuguese believed they had been personally affected by the financial crisis, while 55 percent said that the euro had had a negative effect on the Portuguese economy.[67]

Far-left and far-right parties do not seem poised to benefit from this growing popular disillusionment, a trend confirmed by the latest polls, but the abstention rate is likely to grow. Last but not least, popular disillusionment toward the democratic process is also growing, in large part due to the painful austerity measures. A poll conducted in September and published by the daily newspaper *Diário de Notícias*, found that 87 percent of Portuguese were disillusioned with democracy. It is indeed ironic that EU membership, which was one of the main drivers of the consolidation of Portuguese democracy is partially responsible today for this erosion of public confidence toward the democratic process.

Foreign Policy Impact

Foreign policy has also been affected by the prevailing austerity mood. The top priority has been to minimize the impact of the economic troubles on the country's external agenda. In the words of Foreign Minister Paulo Portas, much work needs to be done in order to "improve the perception of Portugal abroad."[68]

In that sense, Europe has been at the center of Portuguese diplomatic action, which has largely focused on the negotiations for the international bailout. Moreover, the EU's successive attempts to provide a credible institutional and systemic response to the crisis, through new instruments such as the European Stability Mechanism (ESM) or the Fiscal Compact Treaty, also required special attention from Portuguese authorities.

As Germany spearheaded the initiatives to cope with the eurozone crisis, this inevitably caused tensions with EU members that do not share the same austerity-driven policies. However, having submitted to the troika's conditions, Portugal has had no choice but to align itself with Germany. As long as Portugal needs international assistance, this position is unlikely to change. Indeed Portugal was the first country to ratify the Fiscal Compact Treaty in April 2012, in a bid to show its full commitment to the German-led integration push. This contributed to dispelling doubts about the government's posture within the EU.

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67 *Transatlantic Trends*, German Marshall Fund, 2012, http://www.transatlantictrends.org.

68 "Prioridade é 'melhorar a percepção de Portugal no exterior'," *Lusa*, July 18, 2011, http://economico.sapo.pt/noticias/nprint/122851.html.

However, despite Europe's continuing centrality in the country's foreign policy, Portugal has also started to look for other potential markets for its exports. Making good use of the Lusophone connections, countries like Angola and Brazil have been the main targets of this diversification strategy. Alternative sources of financing, whether for the country's public debt or for investment in the massive privatization process, have also been found in such faraway destinations as China.[69] Untapped Latin American markets, such as Colombia and Peru, have also been given new attention as reflected by a series of high-level visits and private investment initiatives.[70]

As for the Mediterranean region and especially the Maghreb countries, all previous efforts made by Sócrates' government to expand Portugal's clout could not withstand the combined effect of the financial crisis and political turmoil associated with the Arab Spring. This led to a loss of momentum, even though authorities remain interested in exploring new economic and trade opportunities.

This focus on export growth and new business deals could be considered the trademark of the current government's foreign policy. Indeed, if one were to single out one particular goal that cuts across the entire political agenda, economic diplomacy in support of exports and investment in Portugal would feature prominently. Diplomacy is now basically placed at the service of economic recovery.[71] Almost all official visits and contacts, with the exception of the ones previously institutionalized, are fully dictated by economic goals.

In the coming years, transatlantic relations, EU integration, and relations with the Lusophone countries will no doubt remain the three main directions of Portugal's foreign policy. The European financial crisis, however, is leading to a new balance among these three pillars of Portuguese diplomacy. More importantly, it is creating space for the emergence and consolidation of new relationships and interests.[72]

Transatlantic Implications

While transatlantic relations have traditionally been considered one of the three main pillars of Portugal's foreign policy strategy, the current context has understandably resulted in a certain shift in the country's immediate priorities. Whereas before the crisis, there was a visible consonance with the United States on a number of issues and Washington remained a regular stopover for Portuguese politicians, there is now a sense that financial constraints impose the need to look more urgently at other emerging centers of power.

Nevertheless, over the last few years, some pressing bilateral issues have required constant and close contact between the two governments. First and foremost there have been deep consultations on the ongoing NATO mission in Afghanistan, at both the bilateral and multilateral level. Despite budgetary cuts and the need for fiscal austerity, Portugal has kept its military presence in the country so far and, unlike many of its allies, has committed itself to funding a support package of €1 million for the Afghan government in the post-2014 transition period. However, Portugal, like other European countries, will probably be forced to cut defense spending in the coming years, which is likely to

[69] Paulo Gorjão, "Portugal and China: The rise of a new strategic geography?," *IPRIS Viewpoints*, No. 81, January 2012, http://www.ipris.org/php/download.php?fid=696.

[70] Pedro Seabra, "Is Portugal rediscovering Latin America?," *IPRIS Lusophone Countries Bulletin*, No. 24, October 2011, p. 3-6, http://www.ipris.org/php/download.php?fid=651.

[71] Among the many measures adopted, one could single out the reorganization of the Portuguese diplomatic network in the world at large, as well as the transference of the formal supervision of the Portuguese Trade and Investment Agency (AICEP) to the Foreign Ministry.

[72] See Paulo Gorjão, "Portugal and the Geopolitical Repercussions of the European Financial Crisis" (*IPRIS Viewpoints*, No. 102, June 2012).

cause new disagreements between the United States and its European allies regarding burden sharing.

A top priority for the United States is the impact the financial crisis in Europe is likely to have on its own economic outlook, especially given that economic recovery in the United States remains anemic. The Obama administration is following developments within the EU closely, and any measure that might strengthen the EU's financial outlook — such as, among others, Portugal's own successful implementation of the bailout measures — are of interest. Indeed, Portugal is still seen as a potential counter-example to Greece's internal disarray and therefore worthy of open support and encouragement from the United States. Thus, the frequent U.S. acknowledgements of Portugal's commitment to far reaching structural and economic reform.[73]

But we must also consider the wider implications of the eurozone crisis, which is not about markets alone, or at least, not anymore. For example, any scenario that includes Greece's default and its exit from the eurozone — the so-called "Grexit" — would have significant geopolitical repercussions, as Greece is not only an EU member, but also an important NATO partner.

At the same time, the United States is concerned about the growing role of other external actors in Europe. Specifically, the massive Chinese capital that has made its way into several European economies is undoubtedly viewed with suspicion by U.S. policymakers, who think that such a "scramble for Europe" could hurt U.S. interests.[74] Portugal is a case in point because of the significant investments made by Chinese companies during the last year-and-a-half: €2.69 billion for a 21.35 percent share in EDP (Portugal's biggest power generation and distribution company) and a 25 percent take in REN (the Portuguese Transmission System Operator) — for €387.2 million. These investments comprise a far-reaching involvement in the country's energy infrastructure. To this, one must add the undisclosed, but surely considerable, amounts of Portuguese public debt in Chinese hands. Such growing Chinese leverage, both in Portugal and in Europe more generally, has not gone unnoticed and can easily be perceived as a potential threat to U.S. influence on the continent.

From a Portuguese perspective, this falls in line with the policy of actively courting new investors. Nevertheless, Portugal would prefer to rely on U.S. private investment to support its economic recovery. Recent statements by Foreign Minister Paulo Portas in the United States, underscoring the upcoming business opportunities and the momentum created by the program of privatizations, attest to this attitude.

What Lies Ahead

Since the end of the Cold War, transatlantic relations have had to cope with successive crises. The financial crisis has shown that the United States and its European allies need to devise a new "transatlantic bargain." A new Marshall Plan would be welcome, but is highly unlikely. In any event, the United States and the EU, together with other relevant international stakeholders, will

[73] See among others The White House, *Joint Statement of the President of the United States and the President of Portugal*, November 9, 2011, http://www.whitehouse.gov/the-press-office/2011/11/09/joint-statement-president-united-states-and-president-portugal; U.S. Department of State, *Joint Press Availability with Portuguese Foreign Minister Paulo Portas After Their Meeting*, September 27, 2011, http://www.state.gov/secretary/rm/2011/09/174075.htm.

[74] François Godement, Jonas Parello-Plesner and Alice Richard, "The Scramble for Europe," *ECFR Policy Brief*, No. 37, July 2011, http://ecfr.eu/content/entry/chinas_scramble_for_europe. For more on this subject, see, for example, Thilo Hanemann and Daniel H. Rosen, *China Invests in Europe. Patterns, Impacts and Policy Implications*, New York, Rhodium Group, June 2012, http://rhgroup.net/reports/china-invests-in-europe-patterns-impacts-and-policy-issues.

need to coordinate the inevitable reforms to be implemented worldwide. Financial institutions, like the ECB and the Federal Reserve, should coordinate their responses and work together to cope with the ongoing systemic crisis.

The end of the euro and the possible disintegration of the EU would open a Pandora's box. From the point of view of the United States, as well as Europe, this would be a no-win situation with unpredictable political, military, and economic consequences. Without joint political and financial responses to the ongoing European financial crisis and to the imbalances at play, the current erosion of transatlantic ties will continue to deepen.

Confronted with the need for macro-economic adjustment on a global scale, the United States and its European allies should reshape transatlantic relations rather than look for new partners and allies elsewhere. Even though transatlantic relations may be structurally challenged in the coming years and decades, both the United States and its European allies recognize that their ties remain mutually beneficial. In fact, the survival of EU integration is crucial for the maintenance of U.S. primacy. Likewise, the maintenance of U.S. hegemony matters for the EU.

The United States should pressure its European allies to adopt systemic answers to the financial crisis. The financial crisis will not be overcome and the euro will not survive without additional EU political integration, with member states transferring additional portions of sovereignty to European institutions. In other words, the European financial crisis will be overcome only if member states reach credible agreements involving measures to stimulate economic growth, the mutualization of public debt, as well as additional steps toward a federal Europe. If that happens, the United States will probably have to adapt to a new balance of power within the EU, as well as to new EU decision-making mechanisms. Moreover, the United States will increasingly have to work with its European allies at a multilateral instead of bilateral level.

Whatever the final outcome of the financial crisis, nothing will remain the same in the EU. Philip Stephens, associate editor of the *Financial Times*, recalled that "EU institutions are the product of historical circumstance and political vision" and, therefore, "the eurozone is not predestined to collapse under the weight of its own contradictions, but neither is its survival inevitable."[75] Likewise, we could make the same remarks regarding the future of transatlantic relations: the erosion is not inevitable, but the same is true of its survival.

José Ortega y Gasset, a Spanish philosopher and essayist, once wrote: "I am I and my circumstance." In a similar vein, political life is at the same time fate and freedom. Historical circumstances limit our options. Still, there are crucial decisions to be made. Inevitably, Americans and Europeans will have to deal with fate and freedom. Hopefully, political vision will be able to tame historical circumstance.

[75] Philip Stephens, "Soviet collapse holds a lesson for the euro," *Financial Times*, June 28, 2012.

5 Conclusions

Andrea Dessì and Ettore Greco

The current financial crisis is severely undermining Europe's standing on the world stage, limiting its ability to influence global events while weakening the self-confidence of individual member states. Ten years ago only a minority questioned the benefits of joining the euro, and the survival of the European project was rarely a topic of serious debate. Today, four years since the start of the global financial crisis, the survival of Europe's single currency can no longer be considered a given, and a growing chorus of voices is expressing doubts about its fiscal as well as political sustainability.

The prospect of a prolonged period of negative economic growth, combined with unsustainable levels of public debt, high borrowing costs, rising unemployment, and a resurgence of populist and anti-European sentiments are the most worrying developments associated with Europe's financial crisis. Deep imbalances between northern and southern Europe, between creditor and debtor countries, have also been exposed by the financial crisis and this has exasperated tensions between individual member states while underscoring the limits and contradictions of a eurozone project that has failed to progress from a single currency into a fully fledged fiscal and political union.

The failure of European leaders to devise a strong and unified response to the economic troubles plaguing the "old continent" is also reflective of a deeper political and leadership crisis; a reality that pre-dates Europe's current financial predicament but has no doubt been further highlighted by it. On the whole, and in contrast with the United States' more decisive reaction to the crisis, European nations spent months bickering over what measures to implement as each state held a different vision of how to respond. Devising a common strategy for the 27 EU member states was always going to be an uphill battle. However, three years since the advent of the sovereign debt crisis and as Europe stumbles into a double-dip recession, the EU's hesitant and at times contradictory response to the financial crisis has exposed both a worrying lack of leadership and vision among European leaders and the continued predominance of national interests over those of unity and solidarity that are meant to form the very basis of the European project.

The EU's response to the crisis emerged from a basic trade-off agreement that condition a stronger EU commitment to solidarity for struggling European economies on the granting of greater budgetary oversight to EU institutions. The entering into effect of the European Stability Mechanism (ESM) in October 2012 and a related commitment to create a budgetary union, the so-called Fiscal Compact agreement, which is due to enter into effect in January 2013, are signs of progress, but much more remains to be done in order to restore Europe's self-confidence and standing on the global stage. In many respects a turning point was reached in June/July 2012 with a commitment by the European Central Bank (ECB) to implement an unlimited, albeit conditional, bond-buying scheme aimed at alleviating the debt of struggling European economies (in effect acting as a lender of last resort). Moreover, plans for a European banking union have also been unveiled. However, while many of these mechanisms have been agreed upon and signed by EU member states, they have yet to be tested in the context of the crisis. Skepticism remains regarding the actual ability of member states, particularly in Southern Europe, to abide by the necessary commitments to balance budgets as part of the Fiscal Compact treaty, while there is great uncertainty surrounding what conditions the ECB will require from individual member states in order to activate its bond-buying mechanism. Furthermore, tough negotiations are unfolding concerning the legal framework of the banking union, particularly concerning its scope and instruments. Finally, with regards to the ESM, which is due to serve as a financial firewall against bankruptcy in Europe, some doubts persist over the ability to raise the €500 billion lending capacity agreed to by member states.

Meanwhile, new challenges are emerging across the eurozone that are further highlighting the need for cohesion and unity of purpose in the EU's response to the crisis. Fears of a Greek default have not been overcome and negotiations continue for a tackling of the country's public debt and the scheduling of the next bailout round needed to sanitize Greek finances. Moreover, the growing prospect of a Spanish bailout request could again herald a new wave of contagion fears across eurozone economies, thus negatively affecting market confidence in the eurozone's recovery. Political uncertainty surrounding Italy's upcoming elections scheduled for early 2013, and the continued economic stagnation plaguing the eurozone as a whole have further dampened the optimism that had hesitantly increased during the summer months of 2012.

Indeed, recent economic data on the euro's 17 member states do not provide much room for optimism. The eurozone economy shrank by 0.2 percent between April and June 2012, with Italy, Portugal, and Spain trapped in a recession lasting four consecutive quarters and Greece now entering its sixth consecutive year of recession.[76] The notable exception is Germany, which grew by 0.3 percent in the second quarter of 2012. But a recent study by four German institutes has raised the specter of a German recession as GDP forecasts for 2013 have been halved, demonstrating that no European country is immune from the crisis.[77]

Unemployment rates across the eurozone are especially worrying, touching a new high of 11.6 percent in September 2012 (10.6 percent among EU-27 countries). Southern European countries have registered the highest rates of unemployment, with over 50 percent of the under-25 population in both Greece and Spain currently out of a job.[78] Such data have led to repeated warnings that Europe risks facing a "lost generation" as 7.8 million young people are currently out of a job and not in education or training.[79] The lack of jobs, combined with a widespread realization that economic recovery is still a distant scenario, are widely perceived as major threats for the survival of the eurozone. Moreover, the social impact of the crisis and the growing tide of popular frustration with austerity cuts also risks creating a powerful backlash against the European project as a whole. The tide of popular and trade union protests across Spain, Portugal, Greece, and Italy are also the result of gradual weakening of institutional channels for social dialogue. Many mainstream political parties have witnessed a significant decline in popular support as a result of their management of the crisis. Growing tensions between the center and the periphery, both within and among EU member states, is further complicating the political and diplomatic scene across Europe. The resurgence of secessionist tendencies in Catalonia, Spain's richest region, is a sign of the growing risk that the financial crisis can lead, in some countries, to disrupting constitutional tensions.

Europe's diminishing resources are no doubt having an impact on its ability to influence events on the global stage. In particular, Southern European countries, the hardest hit by the crisis, risk being

[76] Eurostat, "Flash estimates for the third quarter of 2012," 159/2012, November 15, 2012, http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-15112012-AP/EN/2-15112012-AP-EN.PDF.

[77] "German institutes warn of recession, halve 2013 forecast," *AFP*, October 11, 2012, http://www.france24.com/en/20121011-german-institutes-warn-recession-halve-2013-forecast.

[78] Eurostat, "euro area unemployment rate at 11.6 percent," 155/2012, October 31, 2012, http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/3-31102012-BP/EN/3-31102012-BP-EN.PDF.

[79] Honor Mahony, "EU faces 'lost generation' of almost 8 million young people," *Eurobserver*, September 7, 2012, http://euobserver.com/economic/117458.

marginalized within Europe and lose influence in devising new strategies for the neighborhood, especially with regard to the Southern Mediterranean region. The economic crisis has come to dominate both the domestic and foreign policy priorities of all Southern European states, giving rise to instances of intra-EU competition as each struggles to advance and protect its economic interests in the neighborhood. As Southern European countries attempt to diversify their external economic and trade strategies, leading to new agreements with such countries as China or Russia, tensions between EU member states as well as with the United States could also grow. Bilateral diplomacy has taken center stage, undermining efforts to create a multilateral framework to coordinate EU activities in the neighborhood.

With the prospect of an economic recovery being pushed back to mid-2013, much uncertainty remains regarding the future fiscal and political stability of Europe. Given the volatile and susceptible nature of markets, consumer confidence and perceptions are key to the economic recovery of both Europe and the United States, but in light of the continued divisions and disagreements among EU member states, there is a high risk of yet another setback. Only time will tell if the various mechanisms agreed to at the EU level will prove effective in containing and countering the economic troubles plaguing Europe, but given that the crisis can no longer be described solely in economic terms, a far-reaching political agreement in Europe is also necessary to restore confidence in the EU's future.

Two of Europe's major strengths — the appeal of the so-called European "model" and the economic resources that have traditionally been at Europe's disposal when acting on the global stage — are now being undermined by the current financial crisis. Unless European leaders can agree on the necessity for greater political and fiscal integration, the EU's international footprint will suffer as a result. Europe's persistent divisions and the associated difficulty of devising a united foreign policy is a major threat to Europe's standing on the world stage. European leaders must redouble their efforts aimed at achieving a full political and fiscal Union, not least as a means to be able to speak with one voice with the United States and thus strengthen its negotiating position. Thus, just as a repackaging of the transatlantic relationship is necessary in order to underscore the benefits this relationship holds for both sides, a serious reflection must also take place within individual European states in order to highlight the significant social, political, and economic benefits that would follow from a complete political and economic union in Europe.

Possible areas of contention between EU member states and the United States could emerge with regards to defense spending and burden sharing, especially in light of the United States' increased focus on Asia. While some progress has been made on NATO's Smart Defense program, European nations are still showing little willingness to assume more responsibilities in the military and defense fields. The limits of European military capabilities were put on display during the NATO campaign in Libya, when the United States was forced to intervene and resupply EU countries with military hardware less than a month into the fighting.

A greater unity of purpose and action between Southern EU countries could prove beneficial for both European and transatlantic cooperation. However, three main factors may continue to work against this objective. First, the geopolitical priorities of Southern European countries do not always coincide. Greece, in particular, is involved in thorny disputes centered on the Eastern Mediterranean, whereas both Italy and Spain have cultivated preferential relations with North African countries.

Second, in the current circumstances Southern European countries do not want to be seen, understandably, as forming a bloc of "troubled countries," and all have instead concentrated their diplomatic energy on convincing creditor countries, Germany in particular, of their fiscal reliability and the effectiveness of their reform efforts. So, for instance, the priority for the Greek leadership has been to come to an agreement with German Chancellor Angela Merkel allowing for the continuation of the bailout process rather than to forge a united front with the other troubled Southern European countries. By the same token, the Italian Prime Minister Mario Monti has aimed, above all, to reestablish a triangular dialogue with France and Germany as a way of relaunching Italy's role within the EU.

Third, heavily absorbed by their domestic quandaries, Southern European countries appear to have renounced any steady effort to reshape the EU's Mediterranean policy in light of the ongoing political transformations in the region. Yet, they are all keenly interested in a more active EU-U.S. involvement in supporting the reformist and democratic components of the Arab Spring movements, and in an open-minded approach by the West toward the new leadership in the Arab world, as well as a relaunching of regional cooperation in the Mediterranean.

Moreover, all Southern European countries are also pushing for the establishment of new forms and instruments of economic solidarity within the EU and hence are more inclined than other member states to cede further portions of sovereignty to Brussels. Historically, both their leadership and their public opinion have been among the most ardent supporters of the European integration process, although anti-EU sentiments have become more widespread as a reaction to the painful austerity measures adopted under EU auspices. Furthermore, even in the current economic predicament, which puts severe constraints on the resources available for external policies, they have tried to keep their international commitments, including those undertaken within the transatlantic framework. These aspects may provide a basis for Southern European countries to undertake common foreign policy initiatives in various international contexts.

In the European realm, Southern European countries should pursue two fundamental aims that are in their best long-term national interests: a stronger economic governance by the EU, including a greater capacity to raise and pool common resources to stimulate growth, and the start of a new negotiation process to create a true political union, as advocated not only by the heads of the EU institutions but also by many member states, including Germany. Southern European countries should also undertake a common initiative aimed at renewing a serious debate within the EU on its Mediterranean policy. The goal here should be replacing the failed Union for the Mediterranean with a new regional cooperation framework that can combine economic, security, and political cooperation. Indeed, the political changes underway in the Arab world offer unprecedented opportunities for new forms of cooperation and integration in the Mediterranean region, but these can be successfully pursued only if bilateral ties are complemented by region-wide multilateral instruments.

Southern European countries also hold vital interests in the consolidation of the transatlantic relationship. First of all, as they struggle to redress their financial situation and improve their competitiveness, deeper economic integration between the two shores of the Atlantic can bring them substantial benefits. Leaders on both sides have renewed efforts to establish a Transatlantic Free Trade Area (TAFTA) and support for such an agreement is mounting considerably, despite persistent disagreements on the abandonment of tariff barriers on agricultural goods. The elimination of a large part of the existing non-tariff barriers could boost EU and U.S. output while increasing job opportunities on both sides of the Atlantic. A TAFTA agreement would also ground the transatlantic relationship on a more level playing field, while providing concrete evidence of its economic benefits. This would also increase the economic opportunities for Southern European countries and stimulate the export-oriented sectors of their economies.

Second, the role of Southern European countries is key to the advancement of the transatlantic agenda in the Mediterranean. Thanks to their deep-rooted relations with Southern Mediterranean countries, especially in North Africa, they can play a major role in forging a common transatlantic strategy to help the processes of democratic and political change in the region. Their diplomatic resources are far from negligible and can become of great value when addressing future crises in North Africa and the Middle East, as shown by their active involvement in Lebanon and Libya. Moreover, Southern European countries are indispensable Mediterranean actors in such fields as economic cooperation, cultural dialogue, and soft security. Indeed, the transatlantic agenda can only be attractive for the countries of the region if it is comprehensive, going beyond its hard security components.

Third, NATO's projection and presence in the Mediterranean and in the Middle East could grow in the future both in terms of new initiatives aimed at cooperative security — through the reinforcement of the Mediterranean dialogue and the individual partnerships — and of military engagement for crisis management and post-conflict reconstruction. Even in this regard and despite the shortcomings of their defense apparatuses, Southern European countries have demonstrated an ability to make a major contribution. In particular, participation in NATO peace support operations have been seen by their leadership as a key way for asserting their role both within the alliance and, more generally, on the international scene. In light of the United States' increased focus on Asia and its related effort to reprioritize its commitments in the military and defense fields, the continued willingness of Southern European states to actively take part in NATO operations is not only beneficial for U.S. interests but may also contribute to a gradual shift toward a more functional geographical burden sharing in the transatlantic relationship.

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