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The Future of the European Union Enlargement and Its Challenges

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Abstract

The European Union (EU) is one of the most progressive and pervasive political and economic institutions in the world today. The Union consists of 28 member states, implying almost 500 million inhabitants. The creation of the EU itself has been a revolutionary act never encountered before in history, as several sovereign countries agreed on the long-term target of the generation of a common region of unitary legislation.

Since its inception in the 50s, the EU has taken huge strides toward further integration and enlargement in the hope that it will provide peace, security and equality for its citizens and promote economic and social cohesion. Enumerating the advantages and opportunities resulting for economy, societies and individuals in the EU, one always has to take into consideration the serious challenges the formation of the Union poses to the particular member states and to their inhabitants.

It has achieved a lot in many fields through a process of voluntary integration between the nation-states of Europe. Hence, it would not be unwise to conjecture that the EU is a unity within pluralism since it can unify various actors for achieving a set of shared objectives. Over fifty years later, the EU is neither a pure intergovernmental organization, nor a true federal state. However, the EU is teetering on the brink of stagnating or 'eurosclerosis' in the face of financial crises in Greece as well as others in the EU, notably Portugal and Spain. The still-unfolding crises have questioned the eurozone's ability to design a scheme capable of dealing with the threat of sovereign default. The specter of evolving challenges hangs over the region and continues to cloud its future.

This paper attempts to examine some of the key contemporary challenges confronting the European Union, and to explain how they are challenging for the EU while paying a close attention to the possible solutions to the problems. The aim of this paper is analyzing the following challenges: The first issue is the future shape of enlargement of the EU. The second structural challenge is democratic deficit that has often been described as the distance between the EU institutions and citizens. The third challenge is dealing with sovereign defaults which we can examine the case of Greece and the future of euro. The final challenge is foreign policy dilemma.

Introduction

After World War II, moves towards European integration were seen by many as an escape from the extreme forms of nationalism that had devastated the continent. The 1948 Hague Congress was a pivotal moment in European federal history, as it led to the creation of the European Movement and also of the College of Europe, a place where Europe's future leaders would live and study together. 1951 saw the creation of the European Coal and Steel Community, which was declared to be "a first step in the federation of Europe", starting with the aim of eliminating the possibility of further wars between its member states by means of pooling the national heavy industries. The founding members of the Community were Belgium, France, Italy, Luxembourg, the Netherlands, and West Germany.

In 1957, the six countries signed the Treaty of Rome, which extended the earlier cooperation within the European Coal and Steel Community and created the European Economic Community, establishing a customs union. They also signed another treaty on the same day creating the European Atomic Energy Community for cooperation in developing nuclear energy. Both treaties came into force in 1958.

Throughout the 1960s tensions began to show with France seeking to limit supranational power. However, in 1965 an agreement was reached and hence in 1967 the Merger Treaty was signed in Brussels. It came into force on 1 July 1967 and created a single set of institutions for the three communities, which were collectively referred to as the *European Communities*, although commonly just as the *European Community*.

In 1973 the Communities enlarged to include Denmark (including Greenland, which later left the Community in 1985), Ireland, and the United Kingdom. Norway had negotiated to join at the same time but Norwegian voters rejected membership in a referendum and so Norway remained outside. In 1979, the first direct, democratic elections to the European Parliament were held.

Greece joined in 1981, Portugal and Spain in 1986. In 1985, the Schengen Agreement led the way toward the creation of open borders without passport controls between most member states and some non-member states. In 1986, the European flag began to be used by the Community and the Single European Act was signed.

In 1990, after the fall of the Iron Curtain, the former East Germany became part of the Community as part of a newly united Germany. With enlargement towards European formerly communist countries as well as Cyprus and Malta on the agenda, the Copenhagen criteria for candidate members to join the European Union were agreed.

The European Union was formally established when the Maastricht Treaty—whose main architects were Helmut Kohl and François Mitterrand—came into force on 1 November 1993, and in 1995 Austria, Finland and Sweden joined the newly established EU. In 2002, euro notes and coins replaced national currencies in 12 of the member states. Since then, the Eurozone has increased to encompass 17 countries. In 2004, the EU saw its biggest enlargement to date when Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia joined the Union.

On 1 January 2007, Romania and Bulgaria became the EU's members. In the same year Slovenia adopted the euro, followed in 2008 by Cyprus and Malta, by Slovakia in 2009 and by Estonia in 2011. In June 2009, the 2009 Parliament elections were held leading to a renewal of Barroso's Commission Presidency, and in July 2009 Iceland formally applied for EU membership.

On 1 December 2009, the Lisbon Treaty entered into force and reformed many aspects of the EU. In particular it changed the legal structure of the European Union, merging the EU three pillars system into a single legal entity provisioned with legal personality, and it created a permanent President of the European Council, the first of which is Herman Van Rompuy, and a strengthened High Representative, Catherine Ashton.

On 9 December 2011, Croatia signed the EU accession treaty. The EU accession referendum was held in Croatia on 22 January 2012, with the majority voting for Croatia's accession to the European Union making it the 28th member state as of July 2013.

The European Union received the 2012 Nobel Peace Prize for having "contributed to the advancement of peace and reconciliation, democracy and human rights in Europe." The Nobel Committee stated that "that dreadful suffering in World War II demonstrated the need for a new Europe [...] today war between Germany and France is unthinkable". These shows how, through well-aimed efforts and by building up mutual confidence, historical enemies can become close partners.¹

But after the two enlargements in 2004 and 2007, more difficulties and problems seem to occur. There are some major questions for our considerations: How to integrate the new member states? Will the economic situation in these countries improve? To what extent is the enlargement profitable for the old member states?

Enlargement of the European Union

Enlargement is one of the most powerful means of the European Union's policy. The enlargement policy serves the strategic interests of the EU in terms of stability and peace, security and conflict prevention, and as the basic postulate of creating the EU in general. The aim of the EU is certainly a compact unit with stable, prosperous and democratic neighbors. This policy of enlargement contributed to more prosperity and growth opportunities, also to increasing connectivity of the transport and energy routes, as well as the reputation of the EU in the world. On the basis of common values and common interests, the EU and its neighbors can be more efficient in coping with current challenges. Accordingly, the consistent application of the Lisbon Treaty, which applies to the future enlargement policy, is more important than ever before. This consensus is based on the principles of strengthening commitments, fair and strict conditionality and establishing better communication with the public, combined with the ability of the EU to integrate new members.²

The last two enlargements in 2004 and 2007 automatically generate an "increase in structural diversity in terms of wealth, law, administration, local habits and culture".³ Apparently, not all members will implement EU policies and postulations in a uniform way. One currently highly discussed question occurs: Will the Union's institutions be able to cope with the increasing administrative, cultural and economic diversity of its members? With each country having different problems and being unequally economically developed, there is no "one-size-fits-all

solution”. As a consequence, each wave of enlargements entails a significant internal restructuring and ratification of institutions. Furthermore, the Union’s fiscal policy and spending are always an issue of discussion. How much money should be provided to each particular country in each particular year and, what is more important, is this money allocated to the right institutions? A big problem - especially for the two latest members Romania and Bulgaria - is misemployment and abuse of European funds. Adding new countries to the Union always means adapting their problems and making them European problems. The two gravest problems of those two countries represent at the same time two of the EU’s problems: Corruption and Organized crime. Coping with these problems remains one of the most difficult to control problems of contemporary Europe. In general, other particular challenges for the East-European countries have a historical background. Being given that most of these countries have been part of a Socialist and Communist bloc before 1989, their accession to the Union meant a further milestone in their way “Westward”. Their strategy of modernization and democratization contains the general post-communist long-term aim of economic growth, stability and prosperity.⁴

Joining countries do not only have to accept the “acquets communautaire”, they also must satisfy certain economic, democratic and social conditions. Indeed, two countries are holding accession negotiations at present: Turkey and the Former Yugoslav Republic of Macedonia. Generally, it can be stated that a big percentage of Europeans fear that a further enlargement could threaten the Union’s progress, intensified by uncertainty about cost of the procedure.

In the long term, other countries belonging geographically to Europe are likely to apply for membership, including the Balkan states as well as Moldova, Belarus and Ukraine, whose policy is already pro-European at this moment. Basically, as far as those countries match the criteria needed to join the Union and the current treaties are replaced by a new one (like the Treaty of Lisbon, see chapter 4.1) allowing the number of Member States to be more than the current maximal amount of 28, the European institutions have no reason for rejecting their membership. However, with more and more countries joining, cultural, linguistic and economic differences within the Union increase, thus not only engraving problems of EU institutions, bureaucracy and fiscal policy, but also challenging the process of European integration and people’s satisfaction.⁵

Challenges of the European Union

The EU is a unity within pluralism since it can unify various actors for achieving a set of shares objectives. Over fifty years later, the EU is neither a pure intergovernmental organization, nor a true federal state. However, one thing is clear: the EU is teetering on the brink of stagnating or ‘euroscelerosis in the face of financial crises in Greece as well as others in the EU, notably Portugal and Spain. The still-unfolding crises have questioned the eurozone’s ability to design a scheme capable of dealing with the threat of sovereign default. The specter of evolving challenges hangs over the region and continues to cloud its future. This article attempts to explain some of the main challenges of the EU as follows:

1. The future shape of enlargement of the EU: the case for Turkey

The first challenge is dealing with the future shape of enlargement of the European Union. The origins of the adoption of a single currency, the euro traces back to the establishment of the Economic and Monetary Union in 1999, when main focus was on greater economic cooperation through a single currency. Neo-functionalists underscored the casual importance of spillover resulting from economic cooperation. Integration in one area produces a demand for integration in others. According to the theory of optimal currency areas, independent states form a currency union on the condition that the benefits of joining outweigh the costs. Such was the rationale behind the adoption of euro. Gains already generated by the single market and capital liberalization could not be fully materialized unless accompanied by monetary union. In addition, in the absence of a single currency, the problem of competitive devaluations would deteriorate as a result of greater openness, thereby posing a threat to the single market.

The debt problem for Greece emerged in the wake of 2008's banking crisis and 2009's recession when the European periphery was able to borrow at interest rates that were too low relative to their fiscal health. Greece, which was the fastest growing economy in the euro-zone during the 2000s, ran a large structural deficit due to overspending in some areas, such as defense. Eurozone finance ministers have approved two bailout packages for Greece over the past two years. The problem still remains: Greece has yet to overcome its debt crisis. The Eurozone debt crisis has also led to a major increase in Spain's financing costs, sparking grave concerns that it might be forced to tread in Greece's steps in seeking a bailout package. German officials believe that Monetary union is unprepared for extremely severe situations. Speculation is rife that Greece should be thrown out of the Eurozone. Opponents of this view suggest that such anticipated opt-out would instigate a massive banking crisis and would further deteriorate the financial crisis.⁶

According to the OCA theory, a state faced with asymmetric shocks should consider two alternative strategies: (a) to devalue its currency; or (b) to combine stable exchange rates with wage reductions and increased labor mobility. If the economic and social costs of the second strategy are huge and burdensome compared to the first solution, then that states should not join a monetary union. Meanwhile, some experts have opined that one way out of this dilemma seems to be to call in the International Monetary Fund. Others argue that this is not an appropriate and sound approach in general, and that the EU is in dire need of a comprehensive and long-term plan capable of tackling the crisis of sovereign default. Meanwhile, the EU leaders have hammered out two major proposals in an attempt to guarantee fiscal stability in the long-term. The first proposal is the creation of a common fund responsible for bailing out, with strict conditions, an EU member country. This reactive tool is sometimes dubbed as the European Monetary Fund. The second is a single authority responsible for tax policy oversight and government spending coordination of EU member countries. This preventive tool is dubbed the European Treasury. The monetary fund would be supported by EU member governments, and the treasury would be supported by the European Commission. To conclude, the above-mentioned challenges facing the EU regarding the future of the euro and developing solutions to overcome potential sovereign debts are critical. Many warned that EU was not an optimal currency area and lacked a common fiscal policy. Realists have argued that member states have adopted the single currency as a matter of rational self-interest in an attempt to challenge US dollar hegemony. The problem in the Eurozone is that if the European project wants to survive, it needs major political reforms such as flexible labor markets and major fiscal transfers between states.

The recent research agendas about the enlargement of the European Union have been characterized by ongoing debates between pro-Europeans in favor of further integration and enlargement and euroskeptics, who are against further enlargement. The Eastern and enlargement of 2004 and 2007 were considered a significant turning-point for the EU cohesion policies. Proponents and opponents of the EU enlargement are now divided over Turkey's accession to the EU. The 2004 and 2007 enlargements included a total of 12 new members that were significantly poorer and, with the exception of Malta and Cyprus, less experienced with democracy. The move ended an era in which the EU was widely regarded as a wealthy club of West European states. Currently several questions related to the future shape of the EU merit pondering: Should EU enlargement continue? Has enlargement been a successful external policy of the European Union? What are the implications of Turkey's accession? Would the EU benefit from Turkey's membership? Concerns over further EU enlargement come at a time when five countries are currently recognized by the EU as official candidates for membership: Croatia, Iceland, Macedonia, Montenegro, and Turkey.

At this point, it seems adequate to differentiate between Turkey on the one, and the two Balkan states on the other hand. The main reason to do so is the countries' population. Since Turkey has about 70 Million inhabitants, an accession of this country would have heavier consequences for the Union than an accession of Macedonia or Croatia having a population of 2 Million and 4,5 Million respectively.

Proponents of Turkey's accession argue that the country has big regional power, a large economy and a large military force. Moreover, they await a significant economic growth of the country allowing EU states to benefit from. The country's big area and population would be a good delivery market for existing EU member states. Also, the facts that Turkey has improved in human rights issues and has been applying for membership for 40 years by now militate in favor of an accession.

However, there are severe arguments against a membership. Firstly, with the country neglecting key principles like "freedom of expression", with women frequently having a lower status than men and with military having a too heavy influence on government, key features of a liberal democracy are not matched. Secondly, after joining, the 70 Million Turks would represent the second populous country of the Union, thus becoming a grave counterbalance of Germany, France and the UK. This argument is enforced by expectations that Turkey's population will significantly grow in the next decades, whereas most European countries face a demographic decline, which will lead to Turkey surpassing Germany in number of seats in European institutions. Thirdly, an admission would involve costs up to 10 billion € a year for the EU. At last, it is the country's location itself which creates questions: Does Turkey as a whole geographically belongs to Europe? If Turkey joins, what would happen to other possible applicants like Russia and Morocco, whose application has already been rejected on geographic basis?

Another problem always occurring when a state promulgates its candidacy is the reaction of European Union citizens. "Turkey's membership is supported by 28% of the public among EU member states" and one of the major reasons for Dutch and French people to reject the

Constitutional Treaty in 2005 was reluctance concerning Eastern-European enlargement policy and the extension of membership to Turkey.

Intergovernmentalists tend to explain the recent enlargements in terms of national interests and relative power of existing member states and candidate countries and domestic and sectorial interests. Like rationalists, they argue that a non-member will seek membership, and an incumbent will endorse their membership if the resulting benefits outweigh the costs. From the rationalist perspective, Turkey is a strategic country with a dynamic economy. With a population of 78.7m, Turkey is slightly smaller than Germany (the largest country in the EU) which has a population of 81.4m. The Turkish economy grew 10.2 percent in the first half of 2011. The Paris-based think-tank, the OECD predicts it will become the second biggest economy in Europe, after Germany, by 2050. Turkey can play a key role in obviating the obstacles to the implementation of the Nabucco pipeline project, which will herald a new era in Europe's energy security. The gas pipeline project is expected to reduce EU dependency on Russian gas.

With Turkey, some argue, the EU would be a much bigger payer on the global stage especially at a time when international issues are coming down the pike and there is risk that Turkey may face east or west. Constructivists question why the member states of the EU would themselves agree to sustain significant costs to enable further enlargement. They argue that the agreement to enlarge cannot be explained merely by material factors or rational interests. For constructivists, questions of identity, culture and ideational factors are a key determinant of enlargement. Hence, they argue that the greater the normative match between the EU and a non-member, the more likely are the incumbents to accept its accession. Therefore, from the constructivist viewpoint, it can be construed that Turkey's accession may cause further identity conundrums for the EU. The diversity of cultures has often been considered Europe's greatest treasure. Nordics like Swedes brought traditions of openness, social justice, and environmental awareness. It is unclear whether inclusion of Turkey would have similar effects. Given the turbulent economic and political situation in Europe, it would be more fitting to slow down the process of enlargement and move toward the deepening of EU integration.

Even though neofunctionalism and (liberal) intergovernmentalism continue to dominate the debates on integration theories, there is a new scrutiny over complex policy making in the EU and Multi-level governance aimed at generating a theory of the workings and development of the EU. At a time when the governing style of the EU has been characterized as excessively bureaucratic and just as democratic deficit is regarded as one of the most crucial legitimization challenges facing the union, the largely unstructured nature of many of the interactions involved in multilevel governance appear to provide opportunities for regions or other actors outside official positions to impose priorities other than those of Brussels. The Union is currently trying to overcome the chronic problem of democratic legitimacy by means of developing more parliamentary control over executive among other means. The open method of coordination is a relatively new and intergovernmental means of governance in the EU. It is based on the voluntary cooperation of its member states and helps the Union to become more involved with the delivery of public service. The bargaining style originating from the OMC and other soft law instruments restores alleged draconian and legalistic image of 'Brussels' and help deepen the integration process because effective governance may produce greater and deeper integration.⁷

In general, proponents of enlargement highlight several reasons to convince citizens that inclusion of more countries in EU would be beneficial for the incumbents. They argue that further enlargement has over the years helped transform many European states into functioning democracies and more affluent countries. This is while under the Maastricht Treaty, the EU asserts that the enlargement door remains open to any European country that is able to meet and implement the political and economic benchmarks, known as the “Copenhagen Criteria.” The europa also point to other advantages of increased membership, including spreading the stability and prosperity in the EU to the middle class and Eastern Europe. They also suggest that enlargement will generate economic growth in both old and new member states. Expansion of the internal market to over 500 million consumers offer major growth opportunities for all member states. It will provide a strong boost to Foreign Direct Investment, while creating impetus for keener international competitiveness.⁸ As the future members conform to EU rules on pollution of air and water, their environment becomes safer for their own citizens, and for those in adjoining countries. There would also be opportunities to import lower-cost skilled labor in areas where there are severe labor shortage and by so doing to offset the adverse effects of ageing population in the EU.

Euroskeptics, on the other hand, point to several disadvantages of further EU expansion, arguing that enlargement may prompt the influx of low-cost or unwanted migrant workers. They expound on the disparity of normative and ideational values between Turkey and the EU nationals. Many fear that reckless enlargement akin to the times when Greece joined the EU would be tantamount to repetition of old mistakes. As the EU continues on an enlargement project, economic challenges will arise and some skeptics argue for a more centralized form of rule in order to curb the challenges posed by integration. Opponents of enlargement argue that the Balkan countries have weak states, less competitive economies and less FDI than did the Central Europeans, and lack a political consensus on giving priority to EU accession. Turkey’s state and economy are much stronger, but the country is embroiled in an ongoing debate about secularism and the role of religion in the public life.⁹

2. Structural Democratic Deficit

The second structural challenge of the European Union is democratic deficit that has often been described as the distance between the EU institutions and citizens. The origins of the acclaimed democratic deficit date back to 1950 when the proposal to establish a supranational High Authority came under criticism as the Dutch and Benelux leaders warned of the emergence of a ‘dictatorship of experts’ that needed to be harnessed under the control of governments. According to the rational choice institutionalism, institutions are of paramount importance in shaping policy outcomes.¹⁰

In a similar vein, the deficit stems from the fact that as the governments have delegated powers to the European level, domestic public opinion and national parliaments are out of touch with policy-making in Brussels, thereby creating a degree of ‘policy drift’ away from the preferences of some European wide average citizens. This proposition has been dismissed by intergovernmentalists, who argue that there is a close affinity between the preferences of citizens and EU policy outcomes since the governments are elected by their citizens, and it is the governments who run the EU and have control over the EU institutions. Since the inception of

the European Coal and Steel Community in 1951, several EU research agendas have been characterized by debates about democratic accountability and interest representation and how a 'will of the people' can be discovered. Until the early 1990s the EU was essentially a consensual system of governance, whereby citizens were amenable to delegate responsibility to their leaders to tackle the European integration project. In 1992 when the Danish said no to the Maastricht treaty, the so-called "permissive consensus" went down the drain. These legitimacy problems were subsequently further underlined by the low turnout in the June 1994 European elections.

Nowadays politicians are faced with a dilemma. They can either adhere to the practice of consensus politics, which risks further division between the public sphere and the elites, or seek to politicize the question of Europe in both domestic and EU levels. In this context the means of mass communication play a major role in turning relevant societal problems into topics of concern, and allow the public sphere to relate to the same topics. Meanwhile, some scholars such as Hix and Follesdal argue that constitutional and institutional making of the EU lacks political contestation, depriving the EU from political competition. One way to prevail over the problem of democratic deficit and to connect political decision-making on the EU level with national politics, they suggest, is to set in motion some rather simple and small-scale institutional reforms that will help provoke political debates and contestation engendering EU-wide polemics on EU issues. They also propose to allow for an electoral contest for the office of Commission President by national parliaments or citizens in the hope that it will generate an open and transparent competition. Some argue that cosmetology committees are a new ways to solve the legitimacy problems in supranational decision-making, because these committees are clear manifestations of non-hierarchical governance structures which operate based on persuasion, argument and discursive processes. By the same token, the intrusions of the EU into spheres of national autonomy are compensated for by this form of pluralist legitimacy at the supranational level, albeit access to these committees is restricted to government elites.¹¹

It is worthwhile to note that in recent years the concept of 'civil society' has come under spotlight in the context of a resurfacing the notion of participatory democracy. It has often been argued that the future of the EU rests on civil society. The Treaty establishing a Constitution for Europe, as well as its successor, the Lisbon 'Reform Treaty', encapsulates the main references to the significance of participatory governance and the salience of improving civil society. The establishment of the European Economic and Social Committee and the Committee of the Regions has contributed greatly to the increase in overall role of citizens in Brusselsizing EU policies. However, the bulk of responsibility rests on the shoulders of national government leaders to engage more in policy discourse with their citizens. All in all, Hix argues that public support for the EU has declined while the volume and density of interest group activities in Brussels has increased. Citizens are not convinced that a vibrant civil society in Brussels is sufficient to legitimize government at the European level. While neo-functionalists attach great importance to the autonomous influence of supranational institutions and civil society as well as the role of interests groups, the challenges remain to ensure that the chronic problem of democratic deficit is tackled and that the voices of organized civil society are heard and taken into account.¹²

There is no swift solution to the problem of democracy in a system that is part intergovernmental and part federal.¹³ Legitimacy requires reforms at both national and European levels but since

EU laws are enacted through governments, national parliaments need to be more involved in the EU's work.

3. Sovereign defaults: the case of Greece

The third challenge is dealing with sovereign defaults which we can examine the case of Greece and the future shape of enlargement. A sovereign default is the failure or refusal of the government of a sovereign state to pay back its debt in full. It may be accompanied by a formal declaration of a government not to pay (repudiation) or only partially pay its debts (due receivables), or the de facto cessation of due payments. Most authorities will limit the use of "default" to mean failure to abide by the terms of bonds or other debt instruments. Having borrowed more than it can repay, Greece may default, which would generate a rapid, hard-to-contain financial crisis driven by investor panic—a "contagion". In our interconnected global economy, a European contagion would infect others in many ways e.g. a slower Europe may buy less widgets from China, which could mean less Chinese demand for European steel to build new factories. And Greece isn't the only domino waiting to fall. Spain, Portugal, Ireland and Italy are all looking vulnerable. To make matters worse, it is now more expensive for these struggling governments to borrow money. In return for accepting the risk of government defaults, banks are demanding higher interest rates on their loans. That makes it harder for governments to repay their debts, which, in turn, increases the chances of a default.¹⁴

After a tortuous process, the majority of private holders of Greek government bonds had agreed by end of 2012 to trade in their bonds for new longer-dated ones with less than half the face value of the old ones and a low interest rate. The biggest sovereign-debt restructuring in history allowed Greece to wipe some €100 billion (\$130 billion) from its debts of around €350 billion. It will also be the first test of the resilience of the financial system to the payment on sovereign bonds of credit-default swaps, a form of insurance against bad debts.

Holder of €152 billion of the €177 billion of sovereign bonds issued under Greek law signed up to the swap. The rest—those who did not respond to the bond-exchange offer or the holders of around €9 billion of bonds who opposed it—were forced to accept the deal. The Greek government invoked a recently enacted law that bound all private bondholders to the bond-swap if more than two-thirds of them consented to it. Holders of around €20 billion of the €29 billion of Greek bonds included under foreign law also agreed to the swap.

The threat of coercion might explain why big holders like banks and pension funds chose not to contest the terms of the swap. But Greece needed to achieve close to 100% participation in the bond-swap to unlock its second bail-out package from international lenders. That meant it had to force the small group of malcontents to swallow the deal, which in turn meant it could no longer be seen as voluntary. That triggered a "credit event" and started a process that will lead to a payout of CDS insurance on Greek bonds.

Financial markets took the news with a shrug, even though for months European officials have looked with horror at the prospect of a sovereign-credit event in the euro zone. Their angst stemmed partly from earlier official pledges that Greece would not default or restructure its debts: a "voluntary" loss-taking by private investors would have allowed that fiction to be

upheld. Euro-zone policymakers may also have been anxious not to trigger payouts to amoral “speculators” who had bet against a country going bust.

Their disquiet also had deeper roots. Corporate defaults that lead to payment of CDS insurance are routine but a sovereign credit event is a novelty. There was natural anxiety about how it would go. Natural but misplaced. The notional value of Greek sovereign bonds insured by CDSs is around \$69 billion, according to DTCC, a data repository. But banks and hedge funds have offsetting exposures, having issued some CDS insurance contracts and bought others. Once these wash out, the net exposure to a Greek default is a more modest €3.2 billion. The losses incurred by insurers on Greek CDSs would have to be heavily concentrated to threaten the financial system. And since the new Greek bonds issued in the swap have some market value (though they are already trading at a deep discount), the money changing hands after the precise payout is determined in 2012 will be somewhat less than that figure. The real problem would have been if the Greek bond swap had not triggered payouts on CDSs, ruining their credibility as a source of protection against future sovereign defaults, and raising government-borrowing costs.¹⁵

Other aspects of the restructuring are more troubling. One is that the European Central Bank (ECB) was able to sidestep a coercive write-down of its Greek bonds, acquired as part of a programme to stabilize bond markets in troubled euro-zone countries. That will undermine its power to stop future market panic through bond purchases, since investors now know that the larger the ECB holding of a country's bonds is, the bigger the write-down private investors would suffer in a restructuring.¹⁶

4. Foreign policy dilemma

The EU seeks two main types of policies towards the rest of the world: economic policies, through trade transactions and humanitarian aid; and foreign and security policy, through the Common Foreign and Security Policy. Foreign and security policy issues dominated the EU agendas at the beginning of the 1990s following the revolutions in Central and Eastern Europe, the demise of the Soviet empire and the end of the Cold War. Since the Amsterdam Treaty, which strengthened defense policy cooperation in Europe, the EU has been very active in the area of foreign policy. It is noteworthy to mention that the failure of the EU in the Yugoslav region posed serious questions to the role of EU and how it can prevent or resolve European-wide conflicts. Europe failed to stop the disintegration of Yugoslavia as Europe witnessed its worst bloodshed since World War II. The EU's incapability to act decisively in the Balkans was repeated during the Kosovo war in 1998 to 1999 when the European Council stressed the EU's 'moral obligation' to address the humanitarian disasters in the 'middle of Europe, while relying on the US-led NATO missions to halt the Serb offensive. Such was the inaction from the EU in the area of foreign policy until the Union showcased its most striking diplomatic performance in 2008, when the French European Presidency Council played a significant role in devising a peace plan in the war between Russia and Georgia in Abkhazia and South Ossetia.

At this critical juncture in world politics, the EU is developing towards being a major, yet unevenly balanced, player in global politics. While the EU mainly uses its soft power instrument of economic trade and humanitarian aid, a more robust foreign policy performance and a stronger foreign policy identity deem necessary, especially when international issues arise. With

China challenging the US's status quo hegemonic power, I argue that the EU needs to speak with one voice and that can be achieved by harmonization and synthesization of its foreign policy priorities in times of international conflicts. While it is not realistic to believe that the EU will be able to challenge the hegemony of the US as the only military superpower, recent developments suggest that the EU may be on its way to becoming a more credible partner for the US in world politics.¹⁷

Conclusion

The European Union is neither a pure intergovernmental organization, nor a true federal state. As National interests matter and states are becoming all the more reluctant to delegate more powers and sovereignty to the European Union. Identity politics play a fundamental role in the European Union's quest to transform its future shape. The goals of Europe 2020 strategy need to be achieved through commitment, cooperation and action both at national and EU levels. The European Union is unlikely to be able to meet the challenges in Europe without greater state capacity or more democratic legitimacy.

Regarding the current situation and relations within the European Union, it is more realistic to view EU as a means to overcome the period of crisis, i.e. to pass through a period of consolidation and reform of institutional arrangements. This period may be crucial for the future of the European Union in a way that improves the economic and political dimensions of integration. A lot of attention and energy is aimed at the institutionalization of the mechanism of crisis management in the Eurozone. This is a good and important goal. However, a more important challenge - which is mostly covered by the accompanying debate - is the need to prevent crisis. At the EU summit, held before Christmas 2010, the heads of European states and governments agreed in general to replace the existing European Fund for Financial Stability until 2013, by a new permanent mechanism of European stability (to stabilize the euro area, as well as vulnerable members in the Eurozone and those that might experience a financial crisis). Such a decision, having in mind how fast it was taken, leaves an impression that the institutional frame for the Eurozone stays incomplete, until the clear rules on how to manage financial crisis are determined.

So far, the institutional changes related to the effectiveness of the new Lisbon Treaty enabled the election of the new (first) permanent President of the European Council (five-year term), and the High Representative and Commission Vice-President (in charge of Foreign and Security Policy). The formation of the EU Foreign Service (European External Action Service) is a new political and organizational challenge for the EU and its member states, which means that EU will need several years to overcome the present psychology of an imperative of implementing national interests, and become fully operational only through the coordination of the common foreign policy of the EU on the international level.

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