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Neofunctionalism Vs Liberal Intergovernmentalism; The Creation Of The European Stability Mechanism And The Limits Of Political Theory

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Abstract

The aim of this study is to determine the expanatory and predictive value of the two predominant schools of thought on state integration, namely neofunctionalism and liberal intergovernmentalism, of supranationalist or state-centric theory, with respect to the creation of the European Stability Mechanism (ESM) and the "Pact for the Euro" on March 25, 2011 in Brussels.

After a 14-month long period of great controversy among the supranational agents of the European Commission and the representatives of member states of the Economic and Monatery Union (EMU) during 2010, the European Council established a permanent mechanism, which is supposed to grant the stability of the common currency. On the one hand there is the ESM, which allows for a redistribution of funds within the EMU in order to bolster indebted member states' (such as Greece, Portugal, Ireland) fiscal portfolios, and which enhances the automatism of early sanctions imposed by the European Commission in order to more effectively enforce the "convergence criteria" as formulated by the Stability and Growth Pact (SGP). On the other hand there is the "Pact for the Euro", which represents a permanent intergovernmental conference of EMU and other EU member states aiming for the harmonization of inner-European economic and fiscal policy.

This study provides for an analysis of the political process leading to the creation of this new piece of European legislation on the one hand, and on the other of the precise institutional outcome according to the two theories' assumptions and explanatory mechanisms.

The fact, that the political process was decisively influenced by supranational agency as much as intergovernmental bargaing, and further, that "spillover" was absent, that issue-specific interests were divergent rather than convergent lead to the

conclusion, that both of the theories are only partly fit to account for the process as much as the outcome. This potential step toward *de facto* economic union and integrated fiscal policy was caused by an external shock, and can therefore hardly be described as incremental. Yet on the other hand, it also represents the consequence of an endogenous process perpetuating a compromise between the parties of the traditional debate among monetarists and economists, which is built on the procedural parallelity of immediate further monetary integration and the harmonization of inner-European economic and fiscal policy.

CHAPTER 1
Introduction

In the year of 2010, a new chapter has been added to the history of the integration of European states. After great debate and controversy among the members of the Economic and Monetary Union (EMU), which represents the very core of European integration, states decided to abandon fundamental rules of the existing treaty work, and to provide financial assistance to indebted members on the brink of insolvency.

A financial umbrella, a rescue fund of 500 billion Euros, was created by EMU members pooling state funds under the name of the European Financial Stability Facility (EFSF). It was designed to not only provide funds to Greece, and later Ireland, but to also bolster the portfolios of Spain, and Portugal, and to safeguard the imperiled common currency as a whole. The total sum of the fund of EU financial support was raised to 700 billion Euro with the creation of the permanent European Stability Mechanism (ESM) in March 2011.

The conflict, which became apparent among especially French and German governments over this issue represented probably the most serious stress on both states' relationship since the unification of Germany in 1990. While the French government quickly took position alongside the European Commission for financial aid within the Union, the German government objected and found itself in opposition to the European Commission on the one hand, and the government of the decisive EMU member state of France on the other.

The Stability and Growth Pact (SGP, adopted in 1996) represents the common framework for states' economic performance and formulates convergence criteria which states are supposed to meet in order to secure the stability of the common currency and the economic welfare of the Union. However, the efficiency of this pact had been in doubt: the sanctioning mechanisms had not functioned, and convergence was volatile, especially since the two most potent member states, namely Germany and France failed to meet criteria in 2003. During the recent Euro crisis it became apparent that a further integration of European economic and fiscal policy, and a harmonization of European economic capability across the EU would be indispensable in order to grant for stability and in order to preserve EMU in its present form.

The installation of a permanent mechanism to, on the one hand, support indebted member states through the ESM, and, on the other, to level out macroeconomic imbalances within the Union is a *de facto* step away from original EMU legislation. The pooling of such substantive treasure of member states for a common purpose has fueled renewed debate over the necessity of tightened compliance mechanisms, a tightened SGP, and extended delegation of national domains to EU authorities.

The aim of my study is to determine whether state-centric or rather supranationalist approaches are more fit to explain this new dynamic within the EMU.

In order to approach the question as to whether intergovernmentalist or neofunctionalist schools of thought are best fit to explain this recent European process, whether supranationalism or state-centrism represent the determining factors in this particular integrative step, I would now like to turn to an overview of those respective schools.

Supranationalism

Supranationalism defines a genre of political thought, which identifies state integration as a process undermining national sovereignty and aiming to the establishment of a greater structure organized by authority beyond national state governments.

Neofunctionalism:

Neofunctionalism was initially formulated by Ernst Haas in 1958[1] (Leon Lindberg is also a renowned proponent of this supranational school of thought), and was very influential in the early days of European integration.

The theory holds that state integration is brought about by the entrepreneurship of supranational agents, who engage states in the pooling of sovereignty on issues of common interest, thereby creating continuous so-called "spillovers" to related policy areas, which function as a motor to integration fueled by transnational socio-economic synergies. In consistence with the theory the idea of the "ever closer union"[2] identified an irreversible process of states increasingly rendering sovereignty to supranational bodies, which take on a life and political ambitions of their own, while national governments incrementally lose sovereignty also due to unintended outcomes of previous decisions. The Treaty of Rome creating the European Economic Community, extending the ECSC and Euratom to a common market, serves as the most supportive piece of evidence for the claim of neofunctionalism.

However setbacks in the process of European integration soon led Haas to abandon initial assertiveness about the automatism of neofunctionalism.

Conceding to criticism with respect to the lack of explanatory capacity, Haas continued to argue for the macro-foundational value of the theory: "Neofunctionalists rely on the primacy of incremental decision-making over grand design"[3]. He however acknowledges the notion, that neofunctionalism is limited with regards to precise measurement of successful or non-successful integration, "Neo-functionalists do not agree on a dependent variable"[4]. European supranational entrepreneurship, especially

[1] Ernst B. Haas, *„The Uniting of Europe“*, Stanford: Stanford University Press, 1958
[2] *The Treaty of Rome,* Rome, 1957
[3] Ernst B. Haas, „The Study of Regional Integration: Reflections on the Joy and Anguish of Pretheorizing“, *International Organization* 24, no 4 (1970), p. 627
[4] Haas, 1970, p. 628

represented institutionally by the European Commission, has played a great role in the process of European integration. Supranational bodies and structures, such as the Central European Bank (CEB), the European Court of Justice (ECJ), or also the European Court of Human Rights (ECHR) have assumed great significance for national policy makers. Yet, the history of this process also provides for much evidence on the great impact of member states' individual interests. Now, after the Treaty of Lisbon, which represents the status of legal European integration, member states' direct impact on the institutional framework and political reality of the EU continues to be at the center of day-to-day decision making.

What theory is it then, that best explains the recent and current events within EMU. Supranational Grand design? Or state centric procedural analysis?

State-Centrism

State-Centrism refers to schools of thought which define state integration as institutionalized cooperation and harmonization of national policy on the basis of negotiation among states essentially retaining national sovereignty.

Intergovernmentalism:

Intergovernmentalism was intially formulated by Stanley Hoffman[5]. Hoffman rejected the idea, that supranationalism is an automatic mechanism to integration caused by economic interests, and held, that states continue to control the process of European integration. On the grounds of the assumption, that nation states will continue to promote national interest and generally reject the delegation of sovereignty, he argued, that the integration of European security and defense policy would not happen.

[5] Stanley Hoffmann, *The State of War: Essays on the Theory and Practice of International Politics,* New York: Praeger, 1965

The Three Pillar System, established by the Treaty of Maastricht confirms Hoffmann's approach. While "Communities" matters involved supranational bodies, security, defense as much as judicial and police matters were decided upon exclusively by intergovernmental procedures. Very recent events and controversy regarding the intervention in Libya in 2011 provide evidence for the continuous relevance of Hoffmann's conclusion.

However the central claim of state-centric scholars such as Hoffmann, that states do not cede sovereignty, has increasingly lost support in observable evidence, especially in the context of qualified majority voting (QMV) procedures within principal intergovernmental bodies which abolish single member states' right to veto. QMV has assumed much greater scope and application since the Treaty of Amsterdam, and the Treaty of Lisbon in particular. About two thirds of all policy matters are decided upon via QMV. In addition, the significance of the European supranational judicial system has become quite substantial to national political processes.

Andrew Moravcsik's Liberal Intergovernmentalism represents the result of a revision of intergovernmentalism as a theoretical approach to European integration.

Liberal Intergovernmentalism:

Moravcsik perpetuates a state-centric perspective on integrative processes, and yet seeks to incorporate transnational economic factors. He criticizes Haas's lack of microfoundation and neofunctionalism's lack of responsiveness to external events. He establishes three explanatory variables based on the proposition of Alan Milward:

"a) national preferences develop in response to exogenuous changes in the nature of issue-specific functional interdependence, b) interstate negotiation proceeds on the basis of relative bargaining power, c) delegation to supranational institutions is designed to facilitate credible commitments."[6]

Liberal intergovernmentalism seeks to incorporate the acknowledgement of intra- and transnational socio-economic dynamics, which neofunctionalists identified as the basis for spillover effects. These dynamics, which in LI theory can be caused or by external or internal circumstances, determine states' interest, and integrative outcomes are produced by intergovernmental negotiations. Supranational bodies, from a liberal intergovernmentalist point of view, represent the final product of the process, rather than the motor. Integration is not achieved by spillover, but rather "convergent interests" of negotiating states.

Since the introduction and extension of QMV procedures to intergovernmental processes within the EU, bargaining power has gained in political momentum. According to Moravcsik, in addition to "asymmetric interdependence"[3] as a basis for bargaining, it has assumed new determining factors such as coalition building within intergovernmental bodies.

Although Moravcsik's liberal intergovernmentalism has been accredited as the most comprehensive explanatory model for state integration, the question remains:

How can successful integration best be accounted for? The recent developments in EMU represent a formidable case in order to investigate the mechanisms at work of this new, potentially fundamental step in European integration, and may allow us to enrich the conversation about either supranationalism or state-centrism delivering on the dependent variable, which is European integration.

[6] Andrew Moravcsik, „The European Constitutional Compromise and the neofunctionalist legacy“, *Journal of European Public Policy*, no 2 (2005), p. 359

Research Design

I claim, that both theoretical approaches, neofunctionalism as much as liberal intergovernmentalism, are only partly fit to account for the political process leading to the creation of ESM on the one hand, and the precise institutional outcome on the other. Yet, while liberal intergovernmentalism, in this case, fails to live up to its promise of superior explanatory value with respect to process as much as outcome, neofunctionalism due to its macrofoundational understanding of the process retains a certain predictive value, although it partly fails to explain the process and entirely to predict the precise institutional outcome.

While the theoretic framework of this study, as outlined above, relies on seminal literature, I will acquire the relevant data for the research project mainly from newspaper articles, television news, interviews and institutions' official publications as much as secondary sources, such as journal articles and books.

On the one hand, it will be necessary to look at data on supranational bodies' involvement in the process as much as in the precise institutional design, actors such as the European Commission and the CEB, and on the other, data on controversial political processes among member states. As anticipated in the introduction, the process leading to the creation of ESM and "the Pact for the Euro" was greatly characterized by a memorable controversy within the so-called axis Paris-Berlin. The relationship of France and Germany had ever since the foundation of the European Coal and Steel Community had a central significance for the process of European integration, and both nations represent the greatest contributors to ESM today. Contrasting the positions and actions of France and Germany in the process will therefore be of particular interest.

In Chapter 2, I will first provide an overview of the evolution of the EU's institutional framework with a focus on the relation between supranational and intergovernmental elements determining integrative treaty work. I will further provide for a brief history of EMU, which the ESM is a feature of.

This data will be presented with a focus on evidence on the two contrasting theories in preparation of the later analysis. I will then go into greater detail documenting the chronology of events that led to the creation of ESM and the "Pact for the Euro" on March, 25, 2011.This substantial historical account is necessary to be able to understand the political process leading to the creation of ESM as much as the meaning of its precise institutional design.

In the following analysis, in Chapter 3, I will seek to interpret data according to key paradigms of the contrasting theories, neofunctionalism and liberal intergovernmentsalism:

I will seek to find evidence on the impact of supranational agency and national interests in the context of intergovernmental bargaining as determining factors on the creation of ESM and the "Pact for the Euro". I will further investigate this step in European integration as an incremental, endogenous process, and/or as a reaction to external shocks and events. In order to accomplish this, I will find evidence on the explanatory mechanisms of both theories, such as on the impact of spillover, or on the development and impact of convergent interests on the institutional outcome.

This procedure should allow me to understand the dynamics of the political process leading to the creation of ESM and the "Pact for the Euro", and to determine in conclusion, whether supranationalism or state-centrism represents the best approach to account for the process and/or the institutional outcome.

Chapter 2

Supranationalism vs State-centrism Overview Of The EU Institutional Framework

The institutional framework of the European Union comprises supranational as much as intergovernmental elements and reflects two theoretical approaches to the phenomenon of state integration, namely, neo-functionalism and intergovernmentalism. Decision-making procedures within the EU vary according to the policy area in question, and the involvement of the different institutions in their relation to each other changes with the issue at hand. Up until the adoption of the Treaty of Lisbon in 2009, supranational instititutions in general assumed their primary relevance with respect to issue areas that fell under what was known as the first of three pillars, the European Communities Pillar.

The first European Community was founded in 1951 among six members, namely, France, Germany, Belgium, Luxemburg, Netherlands and Italy with the Treaty of Paris. Modelled after the so-called "Schuman Plan", which had been formulated by the French foreign minister Robert Schuman, the European Coal and Steel Community (ECSC) was created. The ECSC's primary objective was to integrate French and German heavy industry along the rivers Rhine and Ruhr, which had represented the nucleus of French and especially German military power during the first half of the 20th century. The ECSC "established the institutional structure of European integration."[7] A decision-making mechanism was desgined, that would consist of a supranational body comprising "administrative and political"[7] functions, namely the High Authority (which would later become the European Commission); an intergovernmental body authorized to approve supranational agency, the Council of Minsters (today the Council); an independent supranational judicial system, the

[7] David Armstrong, Lorna Lloyd & John Redmond, eds. *International Organisation in World Politics*. Hampshire, UK: Palgrave Macmillan, 2004, p. 143

Court of Justice, to control for compliance with the treaty; and a supranational democratic assembly, the Common Assembly (now the European parliament), to supervise and provide for democratic legitimacy.

The Treaty of Rome in 1957 extended this supranational/intergovernmental decision-making mechanism, the "Communities Method," beyond the coal and steel industry creating the European Economic Community (EEC) and the European Atomic Energy Community (EAEC or Euratom). The former created a common market and a customs union among the community's members, and was supposed to harmonize social policies. Internal tariff barriers were to be abolished step by step, and a common external tariff created, free movement of people and capital was promoted, a common transport policy was adressed, and a European investment bank was founded. The EAEC was also modelled after the ECSC, and represented a common approach to the industrialization of nuclear technology.

While the now three communities, namely the ECSC, the EEC, and Euratom had shared a common Court, and Assembly, they all had their own Commission (High Authority), and Council. The treaty of Brussels of 1965 integrated all three communities and replaced the three supranational bodies as much as the three intergovernmental bodies with one single body respectively.

Yet, the early 60s had been characterized by French scepticism with respect to the power of supranational agency in the process of European integration.[8] It was the Commission's authority to initiate community policy, and the Councils conceptual influence was rather modest, especially once a general course of action was adopted, since it took unanimity to alter measures taken by the Commission. French President DeGaulle represents one French official, who can certainly not be described as a

[8] Neill Nugent, *The Government and Politics of the European Union*, Durham: Duke University Press, 2003, p.558

supranational entrepreneur. The Fouchet plan, which was not adopted after all, represented the general's proposal for a "Europe de Patries", a system of institutionalized intergovernmental bargaining.

After DeGaulle's loss of power in 1968, which represented the beginning of a phase of enlargement of the EEC that would span almost 15 years, and which would provide great obstacles on the way to the "ever closer union", the supranational agents of the Commission initiated a process which was supposed to establish the so-called Economic and Monetary Union (EMU). Despite sebacks with respect to monetary and especially economic integration, and after an intermediary, less ambitious project, namely the European Monetary System (EMS), EMU was revived in 1988 by the supranational agency of the President of the European Commission at the time, Jacques Delors, and the Single European Act (SEA). A single currency and a single market ultimately represented the core of a renewed "deepening" of the Union as much as of the post-Cold War process of European integration

The Economic and Monetary Union, which today represents the most integrated feature of the EU, represented an essential issue area of the first pillar of the Three Pillar System, as established by the Treaty of Maastricht in 1992. EMU's most exclusive supranational feature is the Central European Bank, which was also created with the Treaty of Maastricht, and is supposed to administer and control for the stability of the Euro. It was designed to be entirely independent from intergovernmental as much as other EU supranational bodies in order to watch member states' compliance with the so-called "convergence criteria" formulated by the SGP.

The Three Pillar System organizes all policy areas related to the completion and administration of the single European market through the "Community Method" of decision making. As suggested above, the European commission would make proposals to the Council, which would vote on these issues by qualified majority vote (QMV, a procedure of weighted voting replacing unanimity and extended in scope especially with the Treaty of Amsterdam in 1997), and decisions would then be referred to the examination and assent of the European parliament. Policy initiative was generally the responsibility of supranational agents, the intergovernmental Council of member states' ministers would have the authority to decide, and the supranational European parliament was consulted in order to demonstrate Democratic legitimacy.[9]

The other two pillars comprised foreign and defense policies on the one hand, and judicial and police matters on the other. Both policy areas were dealt with mostly intergovernmentally and with respect to foreign and defense policy by unanimous vote.

While EMU as the central feature of European integration after 1990 is strongly associated with supranational agency as its initiator, the Treaty of Maastricht, according to a study of the Centre for European Studies at the University of Oslo[10], on the other hand represented the beginning of a development, that would assert the position of member states and the role of the intergovernmental council, and further enhance the position of the supranational European Parliament (EP), which since 1979 had been elected by Europe's population, vis-a-vis the Commission. The Council was given the right to initiate EU policy, which had formerly been a monopoly of the Commission, and the so-called co-decision procedure strengthened

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[9] Europa: Gateway to the European Union, europa.eu, http://europa.eu/legislation_summaries/index_en.htm

[10] Hussein Kassim and Anand Menon, *European Integration since the 1990s: Member States and the European Commission*, University of Oslo: Centre for European Studies, 2004

the legislative influence of the EP in comparison to both, the Council, and the Commission. While traditionally the Commission had assumed administrative as much as political relevance, her political influence, meaning her opportunity for supranational entrepreneurship was increasingly undermined, and her administrative function was emphasized.

Intergovernmental EU summits and conferences increased in number, and the process leading to the Treaty of Lisbon in 2009 was characterized, by of course enlargement in Eastern Europe, and further integration of policy on an intergovernmental basis closely tied to democratic legitimization through the EP, and national parliaments. The qualified majority voting procedure was continously extended in scope across policy areas of the Community Pillar as much as the Judicial Pillar.

The Treaty of Lisbon, which was signed in 2007 and adopted in 2009, after the original Constitutional Treaty of Rome from 2004 had failed to be ratified by signatory member states, represents the status quo of the EU's legal foundation. When having a close look at the central institutional innovations of the Treaty of Lisbon, its intergovernmentalist nature becomes apparent. An exit clause was introduced, which provides member states with the option to withdraw from the Union, the Council has been given a permanent president (28 months renewable term), and the qualified majority vote was not only again extended in scope, but thresholds were lowered, thereby extending the Council's authority and efficiency, and member states' sacrifice of national sovereignty. The traditional weighted voting procedure, which would give Council members different amounts of votes according to their population size was replaced by the so-called "double majority" voting procedure, which would require at least 55% of the Council's members representing at least 67% of the Union's population in order to adopt a decision. In a case, in which the Council acts without initiative from the Commission, a majority of at least 72% of the Council's members have to agree.[11]

While the Commission's competencies were reduced rather than extended, an additional supranational body was created with respect to a common foreign and defense policy (CFDP). The European External Action Service (EEAS), led by the High Representative of the EU for Foreign Affairs and Security Policy is supposed to promote harmonized approaches among intergovernmentally deciding member states. So far the success of the supranational entrepreneurship of this young agency is questionable, especially, as mentioned earlier, when looking at the EU's dissonant reaction to the recent events in Libya.

I conclude this section of my study, namely an evolutionary overview of the EU's institutional framework according to neofunctionalist/supranational and intergovernmentalist/state-centric elements, with the notion, that this data is crucial in order to understand the political process leading to the creation of ESM and the "Pact for the Euro" in March 2011. Yet, since ESM is a feature of EMU in particular, and since the common currency represents the key to common economic policy as it is sought in the Pact, I would now like to turn to a brief, but yet decently detailed account of the history of EMU.

A brief history of EMU

The Euro as we know it today is the result of a initiative of the Commission in the late 80s, yet this initiative built on a contemporary historical process, that should be outlined in more detail.

[11] Europa: Gateway to the European Union, europa.eu, http://europa.eu/legislation_summaries/index_en.htm

Member states' interest in monetary integration had already become apparent during the late 1960s, when the weaknesses of the Dollar, and the Bretton Woods system became acute. The French franc lost value, while the German mark gained.[12]

During the Hague summit in 1969 the Council created a committee to propose a course of action that should lead to monetary and further economic integration. While the result, the Werner Report, came up with a clear concept for monetary union, the definition of economic union remained ambigous and the debate on how to accomplish EMU until 1980 was characterized by two opposing positions. On the one hand there were the "monetarists", who held that "monetary union should be implemented immediately"[13], and that "fixing of exchange rates...would compel member states to pursue complementary macroeconomic policies". This position was promoted by an alliance of the member states of France, Belgium, Luxemburg, and the Commission. On the other hand there were the "economists", who said, that macroeconomic balancing would be the first step, since without "fixing exchange rates was not sustainable". This position was represented by the member states of Germany and the Netherlands. The EMU system, as proposed by the Werner committee, aimed to reduce member states' currency fluctuations and allowed for limited inner-European financial aid to bolster weaker members through the European Monetary Cooperation Fund (EMCF).

However, due to the mentioned incompleteness of, and controversy within EMU on the one hand, and on the other due to the global monetary crisis caused by the breakdown of the Bretton Woods system, the establishment of economic and monetary union by 1980 failed in the early 70s.

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[12] R.A. Mundell, *The European Monetary System 50 years after Bretton Woods: A Comparison Between Two Systems*, Project Europe 1985-95, Siena 1994, http://www.columbia.edu/~ram15/ABrettwds.htm

[13] Armstrong Lloyd and Redmond, 2004, p. 163

As a consequence of a Franco-German initiative the idea was revived and the system was replaced in 1978 by a similar, yet less ambitious model, the European Monetary System (EMS). The EMS incorporated the European Currency Unit (ECU), a weighted average of the participating currencies, the Exchange Rate Mechanism (ERM), which would contain bilateral currency fluctuations, and credit facilities, that would allow for assistance to weaker members through low-interest loans, and were supposed to prevent speculation.

The EMS was quite successful in providing for currency stability, and when consensus grew, that European market potential could only be fully exploited, if monetary integration would finally be accomplished, the SEA in 1988 established a three-stage-plan, which would create a common currency in Europe by 1999.

To this end, Article 121(1) of the Treaty establishing the European Community (Maastricht 1991) defined convergence criteria which represented the requirement for any member to join the common system. Member states were expected to keep annual fiscal debt below 3% of GDP and reduce gross fiscal debt to 60% of GDP. The guidelines represented a compromise between, monetarists and economists. The introduction of a common currency was paralleled by the introduction of a process to harmonize monetary and economic policy, and was agreed upon on the basis of a "no bail-out"clause, which would forbid members to support others' fiscal debt.[14]

In 1995 the German Minister of Finance at the time Theo Waigel proposed a "Stability Pact for Europe", calling for automatic sanctioning in the case of a member state failing to meet convergence criteria from 1999 on. In 1996 the SGP was

[14] Jonas Fischer, Lars Jonung and Martin Larch, *101 Proposals to reform the Stability and Growth Pact. Why so many? A survey*, Economic Paper, no 267, Brussels: European Commission, 2006

adopted, but again represented a compromise, and the automatism of sanctions was not as strict as the German government would have liked it to be.[15]

After a good start of the Euro and the SGP, first problems became apparent, when the global economy turned down after 9/11, and provoked doubt about the SGP's efficiency in difficult times. Germany and Portugal were the first to "breach the 3% of GDP reference value"[16]. Both Germany and France failed to meet the criteria in 2004, and the Commission's request for "further action" ("while at the same time postponing the deadline for meeting the 3% limit by one year, to 2005"), which was tied to the implementation of sanctions in the case of renewed failure to comply, was ruled out by a blocking minority of France, Germany, Italy and the UK in the Council.

On March 20, 2005, the Council of European Ministers of Finance adopted a reform "Improving the implementation of the Stability and Growth Pact". This new pact, while leaving the criteria intact, was designed to on the one hand allow for more flexibility and on other to improve implementation by strengthening the "preventive arm" of the SGP, and of the Commission as "Guardians of the Treaty". Debt to GDP ratios as much as "potential growth and the sustainability of public finances",[17] were to be assessed on a country-to-country basis. The Commission was given the authority to make recommendations to member states in order to prevent failure to meet criteria without approval of the Council. However the weak corrective arm of the Commission was not strengthened, and over all the new Pact represented an enhancement of the descriptive value rather than the normative value of this piece of legislation.

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[15] Armstrong, Lloyd and Redmond, 2004, p.163
[16] Fischer, Jonung and Larch, 2006, p. 9
[17] Fischer, Jonung and Larch, 2006, p. 23

Just a few weeks ago, close to 6 years after the adoption of the new Pact, member states' came to adopt further alterations as concequence of EMU threatening to fail over all. On March 15, 2011, the Council on Economic and Financial Affairs agreed to the strengthening of the corrective arm of the SGP in particular. An early sanction mechanism would make it possible to demand a deposit of diverging member states' of 0.2% of GDP already at the time an excessive budget procedure is decided upon by the Council, and if a recommendation of the Council to correct "the deficit is not followed", a fine will be automatic. The automatism of the sanctioning mechanism was slightly enhanced through the "reverse majority rule", which implies the Commission's proposal to impose a fine to be binding, unless it is "turned down by the Council via qualified majority vote." Further budgetary frameworks and surveillance would be standardized according to EU guidelines.

The agreement also calls for a "broadening" of "the surveillance of the member states' economic policies"[18]. Aiming to prevent and correct "excessive macroeconomic imbalances", an "excessive imbalance procedure" was introduced, which gives the Commission and the Council the authority to impose a "yearly fine equal to 0.1% of GDP" again via the "reverse majority rule". The excessive imbalance procedure allows for much more flexibility than the excessive budget procedure, but it is especially noteworthy, because, virtually for the first time, it adresses the implementation of economic union directly.

I conclude this section of my study, which provides for a historical account of EMU, with the notion, that all fines imposed on member states through the new mechanism would be pooled to assist member states in difficulty. Further, the data on the institutional framework of EMU and the EU as a whole as oulined above

[18] EUCO Press Release, *Council reaches agreement on measures to strengthen economic governance*, Brussels: Council of the European Union, March 15, 2011

according to their respective historic evolutions and theoretical foundations, is necessary to be able to understand the political process leading to the creation of ESM and "The Pact for the Euro" on March 25, 2011.

Before I get to determine, whether supranational or state-centrist, whether neofunctionalist or liberal intergovernmentalist theoretic paradigms are best fit to explain this deflection on the dependent variable, namely European integration, I would now have to provide a detailed account of the events leading to the creation of ESM and the related "Pact for the Euro".

Chronology of events leading to the creation of ESM

I will provide a detailed chronological account of the political processes which led to the creation of the permanent European Stability Mechanism (ESM) on March 25, 2011. An examination of the role played by different EU institutions and of the controversial positions of member states will provide for insights into the fiber of the decision-making process, and relations of power within EMU and the EU as a whole.

On the 17th of February 2009 the European Commission published a report on the economic performance of 17 member states. Convergence criteria as established by the Treaty of Maastricht, which require member states to keep the fiscal budget deficit under 3% of GDP had already been violated in 2008 by France, Greece, Spain, Ireland, Latvia and Malta. In the middle of the economic downturn that had been caused by the global financial crisis in 2008, and had forced European member states to provide substantial bail out packages to stressed national banks, the economic health of those countries in particular continued to suffer. The European Commissioner of Economic and Monetary Affairs at the time, Joaquin Almunia, stated that EU members were "going through a very serious crisis that is taking its toll on public finances"[19]. Especially Ireland was anticipated to substantially exceed fiscal budget deficit limits by 6.5 % of GDP (a total of 9.5%), yet Almunia immediately suggested, that "the Commission will use the full flexibility imbedded (in EU rules), when considering the next steps under the excessive deficit procedure in the weeks to come". The convergence criteria of the SGP were primarily established to safe-guard the stability of the common currency, which had experienced a peak in strength in 2007, 1.6 Dollars per Euro, and had fallen under 1.1 Dollars per Euro in late 2008. Violations of deficit limits, as mentioned had been occuring regularly in the past, however the scope of the new developments caused the European Commission to utter concerns "about the volatility of the exchange rate in EU countries".

After national elections in Greece in October 2009 the incoming government led by the new prime minister George Papandreou reported an anticipated budget deficit of 12.7% of GDP. The numbers previously published by the former Greek administration led by Kostas Karamanlis had suggested an expected deficit of only 5%, and grave flaws in the information politics between the EU and the member state of Greece became apparent. The loss of trust, and of the belief in the ability of Greece to consolidate her fiscal budget and to service debt, led to the down rating of Greek state-bonds "by two of the main rating agencies, Fitch and Standard & Poor's"[20]. Despite temporary relaxation of the situation, due to Greece's successful sale of bonds in the value of $25 billion, and a new government plan to cut the deficit, EU officials began considering a rescue package behind the scenes.

When it became apparent in the course of the following months, that the problem may not be solved easily, European leaders stated general will to support Greece as a

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[19] Spiegel Online, „EU Concerned as Countries Violate Deficit Rules", http://www.spiegel.de/international/europe/0,1518,608513,00.html

[20] From the print edition, „A very European crisis", *The Economist*, February 4, 2010, http://www.economist.com/node/15452594

member of EMU, however the debate on how to accomplish the stabilization of Greek debt and of the Greek state, was going to be characterized by grave controversy among EMU members and EU institutions.

Germany in particular displayed great reluctance and hesitation with respect to quick moves, that were likely to undermine the original framework of EMU, and the "no-bail-out" clause of the Treaty of Maastricht, which Germany had insisted upon back in the day. An article in the New York Times from February 15, 2010, documents the disapproval of the German public with two thirds of the population voting against a Greek bail out in polls. Slightly above half of German citizens would further have prefered Greece to be expelled "from the euro group entirely, if its mountain of debt threatened the stability of the currency union"[21]. Opposition formed way beyond public opinion: National economic and financial elites, which represent the traditional clientel and power base of the Christian Democratic Union, and Angela Merkel's administration, became increasingly vocal about the unacceptibility of such severe violation of EMU law. Up to date the issue of the Euro crisis causes major friction among economic and political leaders in Germany. It led not only to a most controversial publication by Hans-Olaf Henkel, a former president of the Association of German Industry (one of the most powerful lobbying groups in the country), suggesting Germany to quit EMU, but also to the abandonment of Axel Weber's (head of the German federal bank) most promising candidacy for presidency of the CEB.

German negotiators adapted the idea of an ordered process of insolvency for Greece as a possible option on the bargaining table in Brussels. According to an

[21] Nicholas Kulish, „Opposition Grows in Germany to Bailout for Greece“, *New York Times*, February 2, 2010, http://www.nytimes.com/2010/02/16/world/europe/16germany.html

article in the German magazine the "SPIEGEL" from March 26, 2010, the German chancellor Angela Merkel had initially tried to entirely keep the Greece issue off the agenda of the scheduled EU summit on March 26, 2010.[22] When the unavoidability of adressing the topic became apparent, due to quickly dropping exchange rates during that same week, she laid out three conditions for an agreement on any European aid plan. First, the German administration demanded a precise defintion of "last resort", secondly the involvement of the International Monetary Fund (IMF) in the project, and third the tightening of the SGP. While successfully defending conditions one and two, against opposition, especially with regards to IMF involvement, from EU agencies as much as from what the German press came to call the "Club Med" fraction - a coalition of the Euro member states of France, Spain, Italy, Greece and Portugal - she failed in obtaining legal agreements on tightening SGP. It was agreed, that unanimity among the 17 Euro zone states would be required for any money to flow in the case of an emergency making specific loans necessary. German concerns about the lack of coercive mechanisms within the EU in order to grant for Greece's austerity, which after all were supported by opposing members' rejection of the legal "deepening" of the SGP, are likely to have primarily caused Germany to adopt the position of the IMF to enter the picture. IMF programmes on the one hand provide for effective compliance control and on the other incorporate tools for the involvement of the private sector in granting the sustainability of an aid receiving state's debt.[23]On April 11, 2010 the Council agreed to provide loans of up to 30 billion Euro to Greece

[22] Carsten Volkery, *Auswaerts Glaenzen, Daheim Zaudern*, www.spiegel.de, 03/26/2010, http://www.spiegel.de/politik/ausland/0,1518,685898,00.html
[23] Carsten Volkery, „Merkel's Risky Hand of Brussels Poker", *Der Spiegel*, March 26, 2010, http://www.spiegel.de/international/europe/0,1518,685771,00.html

at an interest rate of close to 5 % in order to prevent Greek insolvency as a payment deadline was approaching on May 9, 2010.[24]

However, when it became apparent 10 days later in a public statement of the European Union's official statistics agency (eurostat) that Greek numbers on the 2009 budget had not been accurate, and that the actual deficit had been at 13.6% rather than 12.7% of GDP, rating agencies again cut ratings for Greek state bonds. The news represented a shock to markets, and within three days, ratings for Spain and Portugal were also lowered. In an emergency meeting on May 9th, 2010 the ministers of finance of the 27 members of the EU agreed in Brussels on a historic bail-out package for indebted member states, creating the European Financial Stability Facility. "EFSF is a Luxembourg-registered company owned by Euro Area Member States. It is headed by Klaus Regling, former Director-General for economic and financial affairs at the European Commission"[25]. The EFSF administers two thirds of the rescue package designed for the bail-out of member states for the sake of the stability of the common currency as a whole. It was designed as a temporary tool, and was supposed to stop activity in 2013.

The over all aid system has four structural components: Up to 60 billion Euros are provided by European Commission loans based on the mechanisms established to solve non-Eurozone, EU members' balance-of-payment problems. In addition, if needed, Eurozone members grant for a volume of 440 billion Euros in total on the grounds of bilateral guarantees. Further, modelled after the plan for the Greek bail out the IMF contributed 250 billion Euros, which sums up to a total of 750 billion Euros.

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[24] Wall Street Journal Online, „Europe's Debt Crisis“ (Interactive Timeline), http://online.wsj.com/article/SB10001424052748704448304575195863350731920.html

[25] European Financial Stability Facility, „About EFSF“, http://www.efsf.europa.eu/about/index.html

A bilateral meeting between the heads of the member states of France and Germany in Deauville, had preceded the EU summit in Brussels on December 17, 2010. The relationship of the two countries, and their leaders Angela Merkel and Nicholas Sarlozy, had suffered from great controversy over the events of the year. Many of the intergovernmental processes had been characterized by the opposing positions of two coalitions of Eurogroup member states. One was led by France, Italy and Spain, and the other by Germany, the Netherlands and Finland. The bilateral meeting in France represented a reconciliation of the decisive axis Paris-Berlin, and although this exclusive negotiation caused discontent to other member states, the Franco-German agreement was finally supported in Brussels.

It was agreed, that a "permanent stabilization mechanism" was necessary to strengthen the Union and the common currency. It was decided to continue to pool funds among the 16 Eurogroup members, to assist stressed member states beyond the inital deadline in 2013, and to create the European Stability Mechanism (ESM). While the details of the structural design of ESM were postponed to the spring summit in March 2011, the cornerstones were outlined, based on the Franco-German deal:

"Last Resort" was defined as a case of danger to the stability of the entire Euro zone, and unanimity in the Council was required in order to activate the fund. Further, loans would be subject to strict conditionality and the IMF would continue to be involved on the basis of earlier negotiations. Most importantly, so-called "Collective Action Clauses" (CACs) were introduced, which involve the private sector in the assurance of the sustainability of a member states' debt. More precisely, investors would have to agree to a haircut, similar to an ordered procedure of insolvency modelled after the mechanisms of the IMF, and debt restructuring. [26]

Revision of the Treaty of Lisbon would be necessary in order to create the permanent European Stability Mechanism, however it became clear, that a further delegation of sovereignty may require referenda in certain member states, and the negative experience with (for example) Ireland’s ratification of the treaty led members to design ESM on an intergovernmental basis, which would still require ratification of national parliaments, but no referenda.

Further, German chancellor Angela Merkel in her press conference on December 17, 2010 in Brussels said, that "during the debate over the macroeconomic situation, we saw on the one hand, that improved culture of stability is needed, yet on the other support for growth potential as well"[27]. This statement suggests, that a further integration of inner European economic policy is ahead. On the one hand economic aid funds will be transferred across national borders, and a harmonization of economic capability within the EU will be adressed. On the other hand a further harmonization of fiscal policy is desired.

Already in September 2010 the European Commission had put forward a package of "legislative proposals" concerning ‚EU economic governance". The President of the European Commission Jose Manuel Barroso stated: "For the first time we address decisively the preventive arm of the Stability and Growth Pact; for the first time we

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[26] Euroactiv, „Merkel, Sarkozy agree on EU treaty change to handle crises“,http://www.euractiv.com/en/future-eu/merkel-sarkozy-agree-eu-treaty-change-handle-crises-news-498902
[27] Angela Merkel, EU Council press conference, December 17, 2010, http://www.youtube.com/watch?v=kSmy5foFbTA

propose that sanctions must be implemented much earlier in the process; for the first time we propose a structured system to deal with macroeconomic imbalances".[28]

This plan would have given new power to the Commission such as direct influence on member states' taxation and fiscal spending policies through "early sanction mechanisms" applied by the Commission without approval of the Council, which would only have a say through the so-called "reverse voting mechanism".

However the outcome of the EU summit on March 24 and 25, 2011, did not quite match the vision of the Commission, although all aspects suggested by the proposal were discussed.

Institutional outcome

An institutional deepening of the SGP under supranational authority of the Commission was not achieved. While the automatism of the Commission's sanction mechanisms was enhanced, the "reverse majority rule" stands for the Council's continous authority. Furthermore a system of intergovernmental "political peer pressure" was designed in order to adress the harmonization of inner-European economic and fiscal policy.

This "Pact for the Euro" includes the 17 members of the Euro group plus Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania. The conclusive document of the March 2011 Council holds, that the "Pact focusses primarily on areas that fall under national competence and are key for increasing competitiveness and avoiding harmful imbalances"[29]. The United Kingdom, Sweden, Hungary and the Czech Republic are not part of this agreement. An annual review of best national practices shall lead to concrete measure taken by member states to enhance competitiveness, the

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[28] Jose Manuel Barroso, Joint press conference with Commissioner Olli Rehn, Brussels, September 29, 2010, http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/10/494

[29] EUCO, *Conclusions*, Brussels, Council of the European Union, March 25, 2011

sustainability of public finances and the stability of the financial sector. These commitments would then be implemented and supervised by the Commission. This method is going to be applied to all of the four areas, eventually including additional supranational bodies, such as the European Systemic Risk Board (a European institute for bank control) or the CEB.

The ESM was structured as follows:

It is managed by a Board of Governors, consisting of the EMU member states. The European Commissioner for Economic and Monetary Affairs, and the President of the CEB will attend meetings as observers. In addition there will be a Board of Directors, and the agreement holds, that "voting weights within the Board of Governors and the Board of Directors will be proportional to the Member States' respective subscriptions to the capital of the ESM. A qualified majority is defined as 80 percent of the votes."[20] Further, the ESM will start to operate in 2013, when the EFSF mandate expires, and will have 700 billion Euro in funds, 200 billion Euro in addition to the EFSF's 500 billion. The CEB determines the contribution of each member to the fund according to shares in CEB's capital, population size and GDP.

I conclude this chapter, the "Chronology of events and institutional outcomes" with a brief description of the rather complex decision making procedure of the ESM:When assistance is demanded by a Euro zone member state, the Eurogroup informs the Council and requests the Commission and the CEB to assess the question of "last resort" and the sustainability of the member states' debt. The Commission will then, together with the CEB and the IMF negotiate the conditionality of an aid programme, which is then to be approved by the Council and then the Board of Governors. Commission, CEB and IMF will then supervise compliance and report to the Council and to the Board of Directors. Commission and Council will further inform the European Parliament on ESM's operations. ESM decision-making procedures involve on the one hand intergovernmental settings within the Euro group as much as within the broader EU framework, and on the other the supranational bodies of the Commission, the CEB and the European Parliament. In addition non Euro-group as much as non-EU states are permitted to get involved if desired, and the IMF continues to participate in the design and implementation of austerity programs for receiving states. The intergovernmental body of the Council has the authority to initiate the process, and to approve specific programmes. The key decision-making bodies of the ESM are intergovernmental, and supranational bodies rather play an administrative role.

CHAPTER 3

Chapter 3 provides for an analysis of data on the political process that led to the institutional outcome of the creation of ESM and the "Pact for the Euro" by an agreement of the Council of the European Union on March 25, 2011 in Brussels. As oulined in the Research Design, according to central pillars of the contrasting theories neofunctionalism and liberal intergovernmentalism, I will seek to find evidence on supranational agency as determining factor in the process and the institutional outcome. Secondly I will investigate member states' interest and the significance of intergovernmental bargaining in the process and as reflected by the institutional outcome. The opposing positions of the member states of France and Germany, which had characterized the process will be of particular interest in this context. A brief discussion of the concept of national preferences in this context will be added.

Then I will investigate the creation of ESM and the "Pact for the Euro" as an incremental, endogenous process, as neofunctionalism would suggest on the one hand, and on the other analyse the impact of external events on the process, as liberal intergovernmentalism holds.

Supranational Agency

Besides ensuring the stability of the Euro, leveling out macroeconomic imbalances within the Euro zone had ever since the introduction of the common currency in 1999 been of central concern to the authority of the European Commission. Countries of such diverse levels of productivity sharing a common currency, as is the case among the member states of EMU, find themselves running into distributive problems. But since measures necessary to effectively impact states' competitiveness, on the one hand involve policy areas sensible to the very core of state sovereignty, such as taxation and details of fiscal spending, and on the other would require massive redistribution of capital within the Union, the Commission had hardly been able to circumvent member states' opposition.

The debate over the Euro crisis, wich ultimately resulted in the creation of ESM, displayed the fact, that heads of state came to agree with supranational agents on the necessity of a further integration of economic policies with all its implications for national politics in order to preserve not only the common currency, but also the over all project of the Union. The debate on this issue among supranational agents and member states perpetuated a pattern of the economically more potent states' (the North) supporting the Commission's call for an extension of supranational authority with respect to member states' internal fiscal policy, while opposing an extension of supranational authority to increase and direct community funds. On the other hand, the economically less potent states, and potential receivers of aid tended to support more supranational authority with respect to funds, while opposing extension of supranational authority with respect to national fiscal policy.

The position of the commission was made clear by Joaquin Almunia: "In the euro area…default does not exist"[30].

As mentioned, in September 2010 the Commission, building on concepts previously developed in the context of the ‚deepenening" of the SGP, had put forward a first concrete proposal for the creation of a revised and complementary institutional framework which was supposed to establish a permanent mechanism that would realize monetary stability and a harmonization of economic capability.This proposal gave the Commission the authority to formulate common economic policies, and to trigger the stability mechanism, which consists on the one hand of the implementation

[30] Reuters, „DAVOS-EU's Almunia: no chance Greece default, euro zone exit", January 9, 2010, http://www.reuters.com/article/2010/01/29/davos-almunia-idUSLAE00004520100129

of early sanctions in order to ensure member states' compliance to the convergence criteria, and on the other the direction of pooled member states' funds. Besides the mentioned conflict between France and Germany on quick moves bailing out Greece, and further delegation of sovereignty, the conflict between the German administration and the Commission had also been a central feature of the process leading to the creation of ESM.[31] According to an article in the German newspaper the "Handelsblatt", German chancellor Angela Merkel, and President of the European Commission Jose Manuel Baroso (who was elected in 2004 especially thanks to the support of Angela Merkel leading the German opposition at the time), who during the greatly complicated negotiations over the Treaty of Lisbon in 2009 had still worked together, fought a "power struggle" against each other during the entire episode from Greece to Brussels.

Once it was agreed, that the Euro zone should be preserved as it is, actors fought over the precise institutional design of a permanent mechanism. The question of sovereignty was central to the controversy among the supranational agents in the Commission and German state representatives.

Naturally supranational agents, and the European Commission as the principal "executive body" of the European Union, understood the arising problems, namely the potential unsustainability of fiscal debt in particluar EMU member states, as a call to after all entrust the European Union as supranational institution with the solution for the sake of the common welfare. Increasingly assertive self-determination of supranational organs represent a theoretic automatism imbedded in the neofunctionalist framework, and it is fair to say, that the Commission during the crisis

[31] www.handelsblatt.de, *Merkel und Barroso wollen Euro-Streit schlichten*, January 23, 2011, http://www.handelsblatt.com/politik/international/merkel-und-barroso-wollen-euro-streit-schlichten/3771306.html

fought to embody the supranational approach to European integration by claiming more executive power.

Further, in early 2011 the conflict between the Commission and the German government continued, when the Commission called for an additional strengthening of the fund, that should be provided to the ESM. The Commission was ultimately successful with the initiative to raise the pool to 80 billion in paid-in capital and 620 billion Euro in guarantees despite German reluctance to agree. Obviously, there is evidence on a decisive impact of supranational agency on the integrative process, but not so much on the precise institutional outcome. The central objectives of ESM and the "Pact for the Euro" are consistent with the Commission's definition of necessity to deepen EMU. Yet, as mentioned, the authority of the Commission with respect to automatic early sanctioning mechanisms in order to ensure member states' compliance with the SGP was enhanced, but not entirely delegated by the Council, which preserves the right to annul the Commission's policies through the reverse majority rule. The task to realize macroeconomic balance within the EU was not assigned to the supranational body of the Commission but to an intergovernmental setting, which operates via political pressure, rather than binding rule.

The "Pact for The Euro" provides for an extension of the EU's institutional influence on member states' fiscal policy, and ESM for an extension of inter-state redistribution of capital as much as tightened SGP compliance mechanisms. Although the Commission's early position, that Greece should be supported by the other EMU members, clashed heavily with the intitial position of the decisive member state of Germany, there has not only been a provision of member states' funds to Greece, but also a process has been initiated, that may lead to a further *de facto* integration of European economic and fiscal policy, and a harmonization of economic capability within the European Union. The fact of the matter is, that despite great controversy among member states and the Commission, the outcome respresents a step in integration, which embraces the involvement of supranational bodies in the conception and implementation of programmes to consolidate indebted member states' national budget deficits.

Yet, the institutional role the Commission will play in the new mechanism is rather of an administrative, than an executive nature. The institutional design of the ESM, as agreed on by member states during the EU summit in Brussels on March 24 and 25, 2011, clearly entrusts intergovernmental bodies with the ultimate decision-making authority. The initiative triggering the mechanism comes from the Euro group members, and while the Commission is entrusted with "assessments" of the dimension of stressed member states' problems, the intergovernmental bodies, such as the Council, the Board of Governors and the Board of Directors have to approve decisions made by the Commission. The Commission further shares the task to tailor detailed programmes for ESM supported states with the CEB and the IMF, and is again required to have proposals approved in the intergovernmental settings.

The intergovernmental "peer pressure" method, that has been created to tackle the harmonization of EMU members' economic and fiscal policies in order to prevent future crises, will still have to prove efficiency, but at the time being supranational agents have no decision-making authority in this process, and only get involved, when the ESM has been initiated by EMU members.

Intergovernmental Bargaining

The political, inter-state process, intergovernmental bargaining on the basis of national preferences, which after all serve to define national interest, clearly determined the design of the ESM and of the "Pact for the Euro". Sovereignty of member states is factually only delegated as a consequence of QMV in intergovernmental procedures eliminating single members' right to veto, once a case of "last resort" is agreed upon.

While specific economic interests were divergent, rather than"convergent", states' common interest in the preservation of the Euro in its present form made an agreement on further institutional integration after all possible.

All actors involved eventually came to link the future of EMU to the future of the European Union itself, and an abandonment of this project was apparently as unacceptable to the opposing member state of Germany as it had been to the European Commission and virtually also to the French government.

The following two scenarios were imaginable as an alternative to the preservation of the Euro as it is. First, there is the withdrawal of insolvent member states from EMU, a haircut at the cost of private investors, and a devaluation of a new national currency in order to regain competitiveness. The second option, that has been drawn up by European economists such as Michel Gedot or Axel Weber, and which continues to impact the debate on European economic integration, is to split the Euro zone in half and create a "South Euro" and a "North Euro". Most enthusiastic proponents of this vision, such as Hans Olaf Henkel[32], a former President of the Association of German Industry and former supporter of the Euro, could even imagine a model, that would not integrate France and Germany. Although the bulk of economic analysts continues to question the sustainability of the Euro, and although weak member states' need for room to devaluate continues to be heralded in the business world, political actors refuse to adopt such a course of action at the time being.

[32] Hans Olaf Henkel, „Rettet unser Geld“, Muenchen: Heyne 2010

When the systemic relevance of Greece's possible default became apparent by the cut in ratings of Spain's, and Portugal's credibility as a consequence to the adjusted numbers on the Greek budget deficit in early 2010, the consensus on the common interest among member states, that EMU should be preserved, served as the guide to the final agreement made in March 2011.

While France had early taken position alongside the European Commission in favor of supporting Greece, and of preserving the Euro zone as a whole, Germany had intially considered the option of convincing Greece to quit EMU.

Apparently, in the early stages of this crisis, which would soon expand to the member states of Spain, Ireland and Portugal, the German administration did not identify the systemic relevance of Greece's anticipated bankruptcy. And as soon as it came apparent, that actors were potentially deciding on the future of the very Union, a common position was found rather quickly.

The remarkable thing about this particular process is that the dividing line led up the Rhine river. It is certainly not a novelty to the history of European integration that France and Germany would start negotiating on the grounds of opposing positions, but both countries represent the largest contributors to ESM funds providing for more than 47 per cent of the paid-in capital of 80 billion, and of the 420 billion in guarantees.

<u>The German Position</u>

The German position stands for a member state, that is unwilling to cease sovereignty, because it first and foremost has to serve the interest of the national electorate. While the German government is consistent in its political will to preserve EMU over all, it is conscious of the fact, that most of the funds being redistributed come from the national tax revenue. Germany therefore claims direct political impact on the decisions made by, and the programmes undertaken by the European Commission. While this potent member state's general commitment to the pooling of sovereignty is apparent, there is little evidence of a willingness to delegate sovereignty to supranational bodies. German European leaders are obviously state-centric enough to maximize Germany's independent power and influence on European international processes.

For Germany to eventually support the position of the Commission and the French government, and to acknowledge the necessity of inner European redistribution of capital as one condition for the preservation of EMU, the threat of a fundamental cut in the relationship with France must have represented the key issue of systemic relevance.

Across the German political spectrum officials of all ranks, and parliamentarians of virtually all parties, against audible, critical voices of all kinds of intra-state groups, publicly stated, that Germany had benefitted greatly from the Euro, and linked the fate of EMU to the fate of the Union itself. Chancellor Angela Merkel claimed the creation of ESM to be "without alternative"[33]. Two-thirds of German exports, which in total make up 47% of GDP, go to EMU member states - markets that were likely to get lost if states were devaluating. But, most importantly, German geopolitical weight had been linked to European integration ever since the Treaty of Rome in 1952, and the prevention of renewed inner-Continental European competition among states, and concerns with enhanced political division as a consequence of economic inequality, had defined raison d'etat of European states and of Germany in particular, since 1945. For Germany the entire historical process of European integration had been "without

[33] Angela Merkel, Government note, May, 19, 2010, Deutscher Bundestag, http://www.youtube.com/watch?v=iehWNPPKaks

alternative", and especially with respect to the Treaty of Maastricht representing European neigbors' condition for an agreement to German unification.

According to the Spanish daily newspaper El Pais, Nicholas Sarkozy during a heated discussion with Angela Merkel in Brussels on May 9th, threatened to withdraw France from EMU, if Germany would not support inner European financial aid[34].

At a decision point like that, bearing political implications of such magnitude the decision to give in to the arguments of supranational agents and French officials, represented the most rational response, even if the French president's harsh position was more an act of Hungarian temperament rather than solid negotiation. In any case, it worked.

However German negotiators upheld national interest by ensuring direct impact on the activities of the new mechanism thereby calling for a continuation of the basic conflict in the future, when the new procedure is tested. The German government has controlled the initiation of a process, which will harmonize fiscal policy within Europe according to best practices in an intergovernmental setting. Being the economically most capable European member state, the "peer pressure" method, which profits from the essentiality of the over all conflict at hand, namely the end of EMU and potentially the EU, will enhance especially Germany's influence on other member states' fiscal policy. Wolfgang Schaeuble, the German minister of finance said, that as any crisis also the Euro crisis "bears an opportunity"[35], and although European integration appears to be taking an initially undesired leap, the German

[34] Giles Tremlett, Richard Wray and Nick Fletcher, „
Fears over Greek bailout send shares and euro tumbling", *The Guardian*, May 15, 2010, http://www.guardian.co.uk/business/2010/may/14/nicolas-sarkozy-threatened-euro-withdrawal

[35] Frank Bethmann, Christian Kirsch and Thomas Walde, *Ich, der Euro, eine Waehrung in der Krise*, 3sat Documentary, May 28, 2010

government seeks to control the future of this process, which *per se* is interpreted as being unavoidable and ultimately in German interest.

The French Position

France's interest in preserving the Euro as it is, is just as vital as Germany's interest in doing so. France's engagement in European integration, besides shared concerns about a perpetuation of inner-Continental European conflict after 1945, had historically been characterized by a desire to check potential German independent power.[36] The Deutsche Mark, in particluar was viewed as a "dictate"[37] (Theo Waigel) during the 80s, and the common currency represented a means to keep German economic and social policy linked to French economic and social policy.

Further, "In the case of France and Germany, one plus one is three", this statement by Nicholas Sarkozy during a Franco-German summit in Paris in 2008, gives a hint with respect to both nations' "functional interdependence" as much as "convergent interest" – both seek to maximize geopolitical weight.

However, the intitial controversy among France and Germany points to the fact, that France's decision to push alongside the Commission for a Greek bail out despite the likelihood of a lack of popularity among national voters, had been motivated by immediately pressing national interests.

France is the only European country that comprises within her national territory the vast economic imbalances, which set Southern European members apart from Northern European members. French investment in Greece is the most substantial

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[36] Micheal J. Baun, *The Masstricht Treaty as High Politics, France, and European Integration*, Political Science Quarterly, Vol. 110, no 4, The Academy of Political Science, 1995
[37] Frank Bethmann, Christian Kirsch and Thomas Walde, *Ich, der Euro, eine Waehrung in der Krise*, 3sat Documentary, May 28, 2010

compared to other European states, and her involvement in the Mediterranean region in general is crucial to French state power. Exposure of French banks to Greece is nearly 79 billion Euro (German banks have 43 billion Euro exposure to Greece)[38], and according to Dirk Hoffmann-Becking of Sanford C. Bernstein as quoted by the Wall Street Journal "French banks would be dealt a ‚severe' blow by a default on Greece's debt"[39], which potentially would have represented an existential threat to major institutes such as BNP Paribas or Societe General. The potential gravity of the consequences of a Greek default to the state of France possibly led French officials to identify the systemic relevance of Greece's debt crisis before the Germans did.

National Preferences

A repetitive theme of the press coverage on the issue is a perception of a rather new German assertion and confidence. After the seminal events during 2008, which after all served to fundamentally change the global economy, elites grew increasingly confident of the German system, the social market economy, which relies on liberal market rules, and yet provides for strong state regulation and a state-run cushion of social welfare. Further, the German historic trauma with inflation has determined the country's strict culture of economic stability, which had been the basis of the SGP. The consolidation of the fiscal budget, putting a stop to fiscal debt had been on the German agenda since 2005, and was amended to the basic law in 2009.Germany has great savings rates, and an enormous trade balance surplus. The myth of the "Swabian housewive", who saves and only spends money that she has got in her pocket was

[38] Jill Treanor, France and Switzerland most exposed to Greece's debt crisis, say analysts, www.guardian.co.uk, February 11, 2010, http://www.guardian.co.uk/business/2010/feb/11/greece-debt-france-switzerland
[39] William Launder, Jethro Mullen, „German, French Banks Vulnerable", *Wall Street Journal Online*, April 29, 2010, http://online.wsj.com/article/SB10001424052748704423504575212323413641634.html

promoted by officials across the aisle.[40]The experience with politically intricate, strict budget reduction policies during the former years on the one hand, and Germany's relative success in handling the crisis by promoting national joint efforts among employers, workers and government agencies using measures such as "Kurzarbeit" on the other, led to a decrease in political will to tolerate the inner European differences in fiscal spending policy, especially of virtually less competitive member states. The lessons learned from the financial crisis with respect to deregulation and fiscal budget deficits seemed to support the German position, and the reduction of fiscal deficit as much as the enhanced regulation of the banking sector in particular are now on the agenda of virtually all developed countries.

Differences in fiscal and economic culture serve to determine national preferences. There is evidence that these differences were also at the core of the Franco-German conflict over the future of EMU, and the scope of ESM.

Michel Godet, an economic advisor to the French government, who basically shared the initial German position, "that some countries should leave the Euro zone", and who could even envision "two Euro zones", held that "France has the same Mediterranean mindset as Greece and, like Greece, finances its growth through deficit spending".[41]

The following episode on France's proposition to deepen economic integration within the EU, during her presidency of the Council in the second half of 2008, will serve to further highlight the contrasting national preferences among France and Germany with respect to economic and fiscal policy.

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[40] Kathrin Bennhold, „In Greek Debt Crisis, a Window to the German Psyche“, *The New York Times*, May 4, 2010, New York edition

[41] Eleanor Beardsley, „Germans Resent Plans To Bail Out Greece“, *NPR morning edition*, April 29, 2010

France had called for a common "European economic government" already in 2008. Nicholas Sarkozy said to the European parliament on October 21, 2008, that "Europe has a common currency and a central bank, but no common policy", and that "Europe cannot continue without an economic government"[42]. About a month after the break down of Lehman Brothers in New York the French president called in Brussels for coordinated action of national state funds to buy up weakened European key industrial enterprises in anticipation of non-EU investors' potential take overs.
Pointing to state funds in Asia and the Middle East, Sarkozy, said: "I do not want European citizens to wake up in a couple of month to the fact, that European companies are owned by non-European capitals."[43]

However this call for more integration in 2008 was not heard by the German administration. German divergent economic interest became apparent in the statements of Germany's minister of economy at the time, Michael Glos, who said that "the French proposition to safe-guard European industries against foreign take over with state money, contradicts all the successful principles of our economic policy".[44]

Making this proposition, Sarkozy had particularly the European auto industry in mind and was demanding a European solution, while Germany preferred to bolster the auto industry through national programmes such as the German version of "cash for clunkers".

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[42] Thomas Gack, Corinna Visser, „Wir brauchen eine Wirtschaftsregierung", *Der Tagesspiegel Online*, October 21, 2008, http://www.tagesspiegel.de/wirtschaft/wir-brauchen-eine-wirtschaftsregierung/1353134.html

[43] Thomas Gack, Corinna Visser
[44] Thomas Gack, Corinna Visser

Apparently, for the German administration to understand and ultimately support a further integration of European economies, it took the existentiality of the threat of the Euro crisis expressed by a potential, fundamental break with France.

The "Pact for the Euro" after all represents a first real step towards a potentially truly integrated economic and fiscal policy in Europe, and Germany as the most competitive economy within the EU, and greatest potential contributor to CEB and ESM funding seeks to control the process.

The intergovernmental design of the "Pact for the Euro" and the "peer pressure" method is likely to provide for a continuation of inner-European conflict, especially among its key members France and Germany, since the integration of European economies still has to be realized, and a common economic and fiscal policy still has to be formulated in detail.

Incremental Endogenous Process

The steps leading to the creation of ESM, at first site, can certainly not be described as incremental, as neofunctionalism would suggest. Strategies to enhance the stability of the common currency, EU competitiveness, and to harmonize economic capability within EMU, as mentioned, have been on the agenda for over 10 years, however this particular and first meaningful step to accomplish that goal was made rather bluntly, and spontaneously.

Yet, the creation of the "Pact for the Euro" actually represents the beginning of an institutional process, which is supposed to eventually lead to an integrated economic and fiscal policy within the EU, and which therefore could be described as probably being of an incremental nature. But since we have no other choice than looking at the present institutional outcome, and since the creation of EFSF, ESM and the related "Pact for the Euro" represent the deflection on the dependent variable that can be observed, we have to acknowledge the relative haste in which these institutions were created and should postpone the question as to whether the *de facto* integration of European economic and fiscal policy may over all turn out to be indeed an incremental process.

Neofunctionalists, as pointed out, identify spillovers as a key automatism, that, once sparked by supranational agents causes states to continously delegate sovereignty in order to reduce transaction costs. Spillover is understood as a positive, organic process with a life of his own, somewhat independent from state interest per se, and capable of naturally and incrementally shifting authority from national governments to supranational institutions.

The institutional outcome of the process leading to the creation of the ESM can hardly be explained as the result of a spillover. This fact becomes especially evident with the acknowledgement of the notion, that transnational socio-economic synergies regarding this issue were virtually absent. While Euroscepticism of national electorates represents a constant feature of the process of European integration, and of EMU in particular, interests of relevant economic elites, which had originally promoted the common currency in opposition to mainstream public opinion across borders, changed position on EMU. Especially in Germany, the same economic elites, that intially were decisively involved in the transnational socio-economic activities leading to the creation of the Euro, came to change their minds, and began to promote solutions in favor of more national sovereignty. In addition, the heated debate on the issue makes it hard to identify an organic automatism, and the very limited delegation of sovereignty in the institutional outcome, which does not include *de facto* delegation of sovereignty to supranational bodies, underscores this point.

The more complicated and yet potentially more enlightening question with respect to the predictive value of neofunctionalism is the following: To what extent does the process leading to the creation of ESM, and this further step in the deepening of European economic integration, represent an endogenous process?

It is observable, that during the year 2010 endogenous sytemic problems were brought to light. Bank bail-outs, and recovery plans had caused virtually all member states to increase national debt, and those overindebted in the first place were crushed by the bursting bubble.

As mentioned, states of vastly differing productivity that share a common currency encounter distributive problems. Re-distribution of capital across national borders is a given necessity in such a monetary union, and by itself a most complicated matter for national politicians. Secondly, less productive European states had little incentive to implement politically costly, but efficient fiscal policy, since they were after all profitting from the strength of more competitive member states.

It is indeed a structural problem of EMU's design, that states of differing economic capability share a common currency without any mechanism in place to provide for an equivalent integration of core features of economic and fiscal policy. Due to the continous fragmentalisation of the political system, which is determined by sovereign member states' internal political processes, policies necessary to level out economic imbalances for the sake of monetary stability of EMU as a whole are most difficult to implement.

I repeat my point, that the step to create a mechanism that would allow for the re-distribution of capital within EMU on the one hand, and on the other the harmonization of European economic and fiscal policy maximizing member states' competitiveness, bears a certain endogenous logic, and to a great degree is a consequence of institutional insufficiencies immanent to the European system.

Greece's structural problems, and unsatisfactory economic performance had been of great significance in the debates accompanying Greece's entry into EMU in 2001. Greece was viewed as a potential risk to the stability of the Euro zone from the outset, however political considerations led member states' to agree unanimously on the acceptance of Greece. The inaccuracy of Greece's numbers had been suspected all along, and her fiscal spending outgrowing productivity could have been predicted.

Therefore, one could support the neofunctionalist perception of integration representing mostly an endogenous process, and note, that the creation of ESM had been anticipated by the incompleteness of the monetary union.

The evidence on the creation of ESM supports this analysis: As soon as the Greek crisis had become a European crisis, all state governments, and France and Germany as the most potent ones in particular, did exclude the abandonment of the Euro in its present form. They rather sought (even painful) compromise in order to preserve the current state of affairs and to push the process forward towards greater integration.Undoubtedly the Euro crisis and the creation of the new institution of the ESM have greatly been determined by endogenous systemic features.

<u>External Shocks And Events</u>

Liberal intergovernmentalist thought criticizes neofunctionalists' lack of sensitivity with respect to external factors pushing integration.

The steps taken in 2010, and ultimately the decision made in March 2011 to install a permanent, comprehensive mechanism to harmonize inner-European economic capability, would not have taken place without exogenous factors, or better external shocks and events demanding reactive decision.

The rhetoric of supranational agents as much as heads of state does indeed imply a reaction to exogenous factors:

The new Commissioner for Economic and Monetary Affairs Olli Rehn has celebrated the creation of ESM, by saying that Europe is doing "whatever it takes to defend the Euro"[45], and French president Nicholas Sarkozy held, that Europe was not going to "let undo others what generations have created"[31]. The head of BAFIN, Jochen Sanio had said, that there was a "war of aggression against the Euro zone"[46]presumably orchestrated by speculators in banks, hedge and pension funds around the world. Without getting into this conspiracy theory, I can provide supportive evidence for external events being key to the initiation of this new step in European integration: As mentioned, the creation of a permanent stability mechanism was not discussed before the systemic necessity became clear in the revised rating of Spain and Portugal by the major rating agencies in New York and London.

However, as outlined above, the French government's call for the deepening of European economic and fiscal integration, for a European "economic government" in 2008, had also represented a reaction to the consequences of the global economic and financial crisis, and was motivated by concerns about non-EU countries gaining control of weakened EU key industries. This French initiative failed due to especially German opposition. The German government obviously did not identify the necessity to integrate further as a reaction to the developments in the global economy after Lehman Brothers' bankruptcy, and preferred to provide national solutions.

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[45] Micheal Schuman, *Whatever It Takes to Save The Euro*, www.time.com, May 24, 2010, http://www.time.com/time/magazine/article/0,9171,1989056,00.html
[46] Reuters, Speculators are waging a fierce war against the Euro zone, www.reuters.com, May 5, 2010, http://www.reuters.com/article/2010/05/05/germany-bafin-idUSLDE64416020100505

This implies, that Germany did not see any reason to doubt the functionality of the present institutional framework of the EU as a reaction to international economic strife in 2008. That observation leads me to argue, that the suggested activity of external actors, of speculators betting against the Euro, shed light on existentially problematic issues immanent to the European system, and that this time exogenous factors may have facilitated the initiation of a probably incremental, endogenous process, which was essentially unavoidable within the logic of European integration.

CHAPTER 4
Conclusion

Introducing the conclusive chapter of my study, which aims to determine the predictive as much as the explanatory value of neofunctionalism and/or intergovernmentalism, of supranationalism and/or state-centrism as theoretic approaches to the creation of ESM and the "Pact for the Euro", I would have to note, that on the one hand there is process, and on the other institutional outcome. Data on both of these somewhat separated objects is needed to understand and explain European integration. Integration *per se* is a mobile phenomenon, and the institutional outcome represents the status of the process.

A theory's explanatory value becomes especially evident in the context of the outcome, yet its predictive value appears rather with respect to the process. State integration as an outcome is indicated by the actual level of delegation or of pooling of national sovereignty (or better sacrifice thereof) at a certain point in time. State integration as a process suggests a historical evaluation and classification of a particular outcome in order to then be able to speculate about the future process according to observed developments with respect to the delegation or pooling of sovereignty in the past.

Most reliable predictions about future process are possible, when the past process provides for linearity. The more non-linear the process the more complex and potentially uncertain the prediction.When a process prooves to be perfectly linear, prediction becomes explanation, since outcomes can be calculated precisely, rather than speculated upon. Explanatory theory therefore must provide for solidly linear logic in order to be valuable, and must deliver on the prediction of the precise outcome.

Process is measured by the observation of trend, and the mere existence of a positive trend confirming expectations represents the ultimate supportive evidence on the dependent variable, in this case state integration.

State integration as a process is normative, state integration as an outcome is descriptive, and in my view a fundamental misunderstanding among Haas and Moravcsik appears to be, that Haas is primarily refering to the normativity of the process, while Moravcsik is mainly concerned with the descriptiveness of the outcome.

European treaty work captures the descriptive as much as normative quality of European integration. Law in general, and international law in particular must provide for a harmonious balance among the two in order to be effective. Supranationalism embodies the normative element of the EU's institutional framework, while state-centrism represents the descriptive element.[47]

Moravcsik's theory holds that integration as an outcome represents the result of an occasional sequence, that starts with an intitiative of states following their respective interests, and which results in a delegation of sovereignty to supranational institutions as an affirmation of the credibility of commitments made after a process of intergovernmental bargaining on the basis of relative bargaining power. This precise linearity represents the explanatory mechanism of liberal intergovernmentalism. According to this model integration is the supranational outcome of an intergovernmental process. Supranational institutions serve as the measurement of integration, but are not part of the process, they rather represent the final outcome.

[47] Charlotte Ku and Paul F. Diehl, *International Law as Operating and Normative Systems: An Overview*, eds Charlotte Kuhl and Paul F Diehl, International Law: Classic and Contemporary Readings, 3rd edition, London: Lynne Rienner, 2009

I would like to introduce the test of liberal intergovernmentalism with this quite substantial, and central quote of Moravcsik's original text:

"European integration resulted from a series of rational choices made by national leaders who consistently pursued economic interests – primarily commercial interests of powerful economic producers and secondarily the macroeconomic preferences of ruling governmental coalitions – that evolved slowly in response to structural incentives in the global economy. When such interests converged integration advanced."[48]

Since liberal intergovernmentalism provides for such a precise linearity, and such a precise definition of outcome, its value in the context of the creation of ESM and the related "Pact for the Euro" should be tested according to the nature and origin of the initiative, the exclusive intergovernmentalism of the process, and delegation of sovereignty as the integrative outcome.

First, the initiative to pool member states' funds and to bail out Greece in the first place had been taken by the European Commission at a point when Germany and France were still making up their minds about the issue.

The following political process leading to the creation of ESM shows, that interests among member states regarding this issue were divergent rather than convergent. The decision to after all engage in a comprehensive process aiming to establish a *de facto* EMU was not characterized by convergent, issue-specific national preferences, and was also not followed by a *de facto* delegation of sovereignty to supranational bodies, but rather by a late, but apparently credible commitment of member states to pool and also delegate sovereignty in intergovernmental settings.

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[48] Andrew Moravcsik, ed. Donald J. Puchala, *Institutionalism, Intergovernmentalism and European Integration: A Review Article*, Journal of Common Market Studies, Vol 37, no 2, June 1999, p. 326

Furthermore, although external factors had a decisive impact on the recent developments within EMU and the EU, evidence does not support the notion, that national preferences were "developed as a consequence of exogenous changes in the nature of issue-specific functional interdependence."

The national preferences, which had characterized the process of intergovernmental bargaining, were not really a result of current exogenous changes. The political process leading to the creation of ESM and the "Pact for the Euro" as much as the institutional outcome reflect a traditional debate among monetarists and economists, which has been affiliated with the creation of EMU ever since the early stages of the process in the late 60s. Both French officials and Commissioners traditionally represent the monetarist camp, while Germany in alliance with neighboring Northern European states traditionally embodies the economist position. Just like during the late 1980s the monetarist alliance, which combines supranational and partial member state interest, was successful in promoting the immediate pursuit of further monetary integration without previous macroeconomic balancing. Yet the opposed economist camp, which in the case of Europe is obviously exclusive to member state interest was comparatively successful in promoting the integration of European economic and fiscal policy. Back in 1996 the introduction of the common currency (1999) was coupled with a mechanism that was supposed to provide for the convergence of national economic and fiscal policy, namely the SGP. The harmonization of economic and fiscal policy within EMU as an institutionalized function parallel to the creation of a common currency represented the compromise between monetarists and economists back in the 90s, and in fact this parallelity represents the compromise today. While ESM provides for a redistribution of funds of an unprecedented dimension across national borders for the sake of monetary stability, SGP sanctioning mechanisms have been made more automatic as a responsibility of the Commission to initiate measures early in the process, and in addition member states have made a commitment to realize the harmonization of European economic and fiscal policy on the basis of intergovernmental bargaining.

Liberal intergovernmentalism with respect to the creation of ESM, however captures correctly the fact, that institutional outcome reflects member states' national preferences. The problem is that integration occurred despite the virtual absence of convergent economic interests, and although *de facto* delegation of sovereignty to supranational institutions is minor. The authority to initiate the ESM lies with member states. Even the only additional delegation of sovereignty to the Commission, namely the right to initiate binding early sanctions, is after all subject to the Council's good will due to the "reverse majority mechanism".

The assertion of member states vis-a-vis the Commission is a phenomenon, that had characterized the post-Cold War process of deepening as much as widening and is reflected in the status of the institutional foundation of European integration, namely the Treaty of Lisbon. In the institutional outcome member states virtually sought to limit the delegation, or better sacrifices of national sovereignty by strengthening intergovernmental, rather than supranational elements. QMV procedures provide for intergovernmental efficiency and supranational institutions have become the less attractive alternative in order to reach an integrated outcome.

The delegation of sovereignty to supranational bodies has been minor, be it because supranational agents failed to sufficiently undermine national sovereignty, as neofunctionalism would assume, or because member states' commitment lacks credibility, as liberal intergovernmentalism suggests. Yet, a deflection on the dependent variable is observable, since member states' funds are continously being pooled, and member states have accepted factual and potential additional sacrifices of national autonomy in crucial policy areas.

Germany's reluctance to follow the Commission's recommendations, and France's all-out threat to quit EMU, first and foremost show, besides the divergence of national preferences, that functional interdependence was not issue-specific. The German decision to agree to the creation of ESM did not at all reflect the commercial interests of the German economic elite, which publicly promoted issue-specific functional independence suggesting alternative courses of action such as a division of the Euro zone. Yet, integration occurred and the institutional outcome reflects to a certain degree German as much as French macroeconomic preference.

I would like to argue, that the fact, that European states chose to continue to integrate rather than to disintegrate the monetary union was caused by general, geopolitical interdependence[49], rather than issue-specific economic convergent interest.

While this notion supports state-centrism as being the main determinator of the process as much as the outcome, it however reveals the weakness of liberal intergovernmentalist explanatory capacity. The linear precision of Moravcsik's model fails to capture the exact process as much as the precise institutional outcome. A theory, that fails to explain precise institutional outcome, may not necessarily fail to predict on process. Yet since Moravcsik emphasizes linear precision as the particular value of liberal intergovernmentalism and integration as an outcome rather than a process, one has to note, that with respect to explaining the creation of ESM and the "Pact for the Euro", the theory fails to live up to its promise, and leaves the student of European integration with a continous need for explanatory theory.

[49] Alan Milward, *The European Rescue of the Nation-State*, Los Angeles, University of California Press, 1992

Moravcsik notes with a certain cynicism, that every time European integration experiences a step in the process analysts hail neofunctionalism as being the superior theory despite explanatory insufficiencies. However, any piece of evidence, which supports the mere existence of a continous process of European integration despite controversy among member states, does indeed support the neofunctionalist assumptions of state integration being irreversible and some sort of an incremental automatic process beyond particular states' national interest *per se*.

However neofunctionalist explanatory mechanisms, just like liberal intergovernmentalist explanatory mechanisms fail to precisely account for the creation of ESM.

Neofunctionalism understands state integration as being much less of a linear process, than liberal intergovernmentalism does, and further understands supranational institutions as being an essential part of the process not only the outcome. Transnational socio-economic synergies, which, guided by supranational agency, serve to incrementally undermine national sovereignty via spillover make much more of a punctual/circular process, a spiral. Indeed the spiral lacks precision, and therefore explanatory value with respect to the institutional outcome is not only more complicated, but limited.

However if observable outcomes serve to confirm a perpetuation of the spiral nature of the process, the theory continues to hold certain predictive value.

Supranational agency did indeed represent a decisive determinator of the process, even though the institutional outcome, does not provide for evidence for a substantial increase in supranational authority.

Moravcsik continously criticizes supranational schools of thought on the grounds of a rejection of the perception, that supranational institutions are part of the process.

He states, that "controlled tests reveal that supranational intervention, far from being a necessary condition for efficient interstate negotiation in the EC, is generally late, redundant, futile and sometimes even counterproductive."[50]

However the findings of my research on the process of the creation of ESM and the "Pact for the Euro" suggest, that Moravcsik is wrong.

With respect to supranational institutions as part of state integration as a process in the case of the ESM, I realize, that especially in this case where controversy among states is as serious as it prooved to be, supranational agency is relevant, even if delegation of sovereignty to supranational bodies in the institutional outcome is minor. One can only speculate what the outcome of this process would have been, if the Commission was in the economist camp and would have supported the German, rather than the French position.

Most likely Greece would have left the EMU, and such a substantial pooling of funds would probably not have taken place. Presumably, there would not have been the political momentum to enhance the automatism of early sanctioning mechanisms of the SGP and to pursue the further integration of European economic policy, which after all has been a centerpiece of the Commission's agenda ever since the creation of EMU as we know it today.

The Commission, at this point in time may not have acquired complete authority with respect to the realization of the ever closer economic and monetary union, but her political mission to initiate the process has been achieved, and her conceptual contributions have been and are contiously appreciated.

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[50] Andrew Moravcsik, *A New Statecraft? Supranational Entrepreneurs and International Cooperation*, International Organization, Vol 53, no 2, MIT Press, 1999, p. 269

Although the precise institutional design of ESM does not display considerable delegation of sovereignty to supranational bodies, supranational agency has been a decisive factor in a process leading to the further pooling of sovereignty, and has successfully undermined independent national sovereignty.

I have to note, that with respect to the institutional outcome of the political process, that led to the creation of ESM in March 2011, the explanatory value of neofunctionalism as much as the explanatory value of intergovernmentalism are only modest at best. A pooling of funds and potential and factual sacrifices of national sovereignty have taken place, and supranational agency has been a decisive factor in this process just like intergovernmental bargaining. The agreement on the creation of ESM and the "Pact for the Euro" under the authority of intergovernmental bodies stands for the credibility of member states' commitment to engage in a contious process of intergovernmental bargaining, which is supposed to lead to an integration of European economic and fiscal policy without further delegation of sovereignty to supranational bodies.

In support of neofunctionalism, there is evidence, that this progress in European integration can partly be explained as an endogenous process. Member states' acknowledged, that decisions were needed in order to grant for the preservation of EMU and potentially the EU as a whole, and the fundamental systemic problem, as represented by the debate between monetarists and economists suggests the endogeneity of this deepening of European integration despite diametrical national preferences.

In support of liberal intergovernmentalism, on the other hand, it is however just as accurate to claim, that the agreement on a precise institutional outcome at this very point in time would not have taken place without the pressing impact of external events.

A neofunctionalist automatism based on transnational socio-economic synergies (spillover) was absent as much as indicators of states' recognition of issue-specific functional interdependence, as liberal intergovernmentalism would suggest. Rather member states' general geopolitical interdependence appears to provide for the common (rather than convergent) interest in preserving EMU and the EU as a whole which ultimately led to the institutional outcome. On the other hand divergent issue-specific interests with respect to how to accomplish that goal determine the precise institutional design.

Neofunctionalist predictive capacity, which relies on the notion, that assertive supranational agency is the initiator of an incremental process leading states to sacrifice national sovereignty, retains a certain value. If the creation of ESM and the "Pact for the Euro" is understood as a step on the long route to integrated economic and fiscal policy, which I think it should be, then neofunctionalism is correct in assuming the relevance of supranational institutions in the normative process of European integration. Further, the fact, that member states' final agreement was made under the existential pressure of the potential disintegration of EMU and the EU as a whole, not only supports the irreversibility and endogeneity of the process, but also the notion, that integration happens as a consequence of undesired effects of previous decisions.

Liberal intergovernmentalism on the other hand does provide for a certain explanatory value, but however fails to measure the dependent variable, since its focus on the institutional outcome limits its predictive capacity. While intergovernmental bargaining on the basis of relative bargaining power did indeed determine the process, the final commitment despite being evidently credible did not lead to an institutional design that would entrust the Commission with substantially increased authority. The prediction, that national preferences would be reflectd in the institutional outcome holds true, yet according to the precise standards of liberal intergovernmentalist analysis the creation of ESM and the Euro does not represent a step in European integration. The creation of the SGP *per se*, back in 1996, does precisely fit liberal intergovernmentalist assumptions, since its implementation had been assigned to the Commission after the agreement of bargaining member states. The ESM and the "Pact for the Euro" have been established to realize the integration of European economic and fiscal policy, just like the SGP, and although this new piece of legislation predominantly relies on intergovernmental settings as the institutional outcome, the process towards European integration has been advanced in the context of the SGP.

Max Pollack in a somewhat outdated, but however insightful article analysing the varying institutional settings and decision-making procedures across policy areas within the EU's supranational and intergovernmental framework, notes, that "the argument presented above neither accepts nor rejects the conflicting claims of neofunctionalist or intergovernmentalist theories;"[51] and I would like to add that my argument as presented above does neither.

In this context Pollack cites Lowi on pluralist and elitist theories:"One way to deal with the extraordinary degree of inconsistency among the prevailing schools of thought is to abandon all (of them)...Another way is to embrace them all and then try

[51] Mark A. Pollack, Creeping Competence: The Expanding Agenda of the European Community, *Journal of Public Policy*, Vol. 14, no 2, Cambridge University Press, 1994, p. 132

to find the limits of applicability of each...In short, once each puts an end to its claim to universality...it approaches the standards of scientific theory."[44]

I would therefore like to first identify the central common feature of both, which is the acknowledgement of the systemic relevance of socio-economic synergies across borders, and secondly condense the two theories to two central diametrical concepts of state integration: Supranationalism, and state-centrism. Further, I emphasize the distinction between integration as a process and integration as an outcome demanding evidence on the initiation and nature of the process on the one hand, and on the precise institutional design of a particular piece of legislation (such as the ESM) on the other.In any case explaining and predicting European integration will remain a puzzle, if not a riddle. My research on the process leading to the creation of ESM and the "Pact for the Euro" leads me to conclude, that the normativity of supranationalism was relevant to the process, but that the institutional outcome perpetuates the trend of an assertion of state-centrism with respect to future process.

The Future

The recent crisis had brought the European project of the common currency to a pivotal moment in its history, and if the integration of economic and fiscal policy fails in the established intergovernmental setting of the "Pact for the Euro", the future of EMU and the EU as a whole is indeed open.

In an article in the May/June 2011 edition of Foreign Affairs, which was apparently written before the creation of ESM and which focusses on the EFSF, authors Henry Farrell and John Quiggin state, that the rigid strategy to cut deficit spending in European states as a means to stability would not only bear grave economic, but most importantly grave political consequences. "Dogmatically anti-inflationary" monetary policy, as represented by the CEB and as demanded by the union’s greatest net contributor, Germany, would potentially lead to high unemployment, "more economic hardship", and ultimately "xenophobia"[52]. And indeed public opinion during the hot phase of the crisis in 2010 was characterized by *resentiments* in receiving as much as contributing states.

The political task at hand is undoubtedly challenging, and the Euro crisis forces states to act. This time bomb had been ticking for a while, and the explosion leaves the developed and comparatively wealthy states in Europe with the responsibility to after all provide for a meaningful political definition of European Union. Political processes in democratic states tend to be messy, however these fights have to be fought. Farrell and Quiggin predict, that if European integration continues to be associated with increasing economic hardship, then the project may fail politically due to intensified Euroscepticism among populations. It is in fact already observable, that in many of the European states, especially on the contributing side, such as France, the Netherlands, Finland or Austria, ultra-right wing parties, which traditionally campaign on Euroscepticism, have assumed parliamentary relevance and even enter governments in coalitions. On the other hand governments of receiving states continue to fail to implement austerity programmes, simply because they lose power, like in Portugal or Ireland.

Admittedly the situation is grim, and the future is uncertain. However Europe is not the only place, where the future is uncertain, and the political question is not only, whether the EMU member states will be able to compromise and provide for economic and monetary stability or if the EU will continue to exist, but also whether there is any politically feasible alternative.There are hardly any Western politicians or government officials left, who would not agree, that the welfare of a state is not

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[52] Henry Farrell and John Quiggin, How to Save the Euro – and the EU, *Foreign Affairs*, Vol. 90, no 3, 2011, pp. 98/99

sustainable without sustainable fiscal spending.I suggest, that developed countries in the past have neglected the fact, that changes in the political and economic structure of the world have had a negative impact on the functionality and sustainability of democratic systems.

Not only the governments of Euro zone states such as Germany, France, Spain, Portugal, Greece or Italy, but also the United Kingdom and the United States have identified consolidated fiscal budgets as being without alternative.

The internal political processes, that naturally come along with austerity programmes are a given democratic reality, and democracies should do, what they were designed to do, namely to facilitate a societal compromise, that ensures the stability of the system. It would not have made a difference to Greece with respect to economic hardship and internal political strife, if they would have left EMU and resorted to a restructuring of their debt (which they may in fact do soon) without a European mechanism in place – the internal political situation would have been comparable, probably even worse.

I argue, that fiscal debt does not only represent a challenge to European integration, it in fact represents an enormous challenge to the democratic state *per se.* I claim, that transnational socio-economic dynamics, global economic interests, have served to undermine the functionality of virtually all democratic states, and ultra-right wing groups, nationalism and isolationism have been on the rise in the US as much as in Europe since the events of 2008.

Beyond European integration theorists have identified a structural problem caused by the internationalization of the market economy. I quote the American scholar Robert Gilpin: "Whereas the science of economics emphasizes the efficient allocation of scarce resources and the absolute gains enjoyed by everyone from economic activities, state-centric scholars ... emphasize the distributive consequences of economic activities...."[53] Robert Gilpin further identifies a "clash between the evolving economic and technical interdependence of national societies and the continuing compartmentalization of the world political system into sovereign independent states,"which in his view leads to an "inevitable clash between the logic of the market and the logic of the state."[54]

The Global market economy will stay with us for a while to come, simply because the world's most powerful nations share an interest in upholding it. Democratic states' only option to solve the political problem arising with the clash between the logic of the transnational market, and the logic of the sovereign nation state, is to integrate.

The history of the European common currency is closely tied to the history of globalization, and European economic and monetary integration is now more than ever a political rather than an economic mission. The recent decision to save the Euro, which implicitly represents a decision to save the EU, was motivated politically rather than economically, and it is fully consistent with a state-centric approach to integration. As long as global economic competition continues to determine individual states' dependence and independence, European states will integrate as deeply as they must in order to preserve the democratic state system, while upholding open markets.

The process of European integration has not come to an end, despite countless moments of great turbulence, and internal strife. The year 2010 probably represented the most serious challenge to the European Union and the process of European integration since 1990, if not ever since its very beginning in the 1950s.The current institutional status of the highly turbulent process of economic and monetary

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[53] Robert Gilpin,*Global Political Economy*, Princeton University Press, 2001, p.78
[54] Gilpin, 2001, p.81

integration, namely the ESM and the "Pact for the Euro", will have to prove its utility, efficiency and legitimacy, but however stands for an expression of European states' strong political commitment to face the future together, rather than to allow economic inequality and consequential political division to cause a potential repetition of history, and to limit the continents potential.

Further, given the fact, that since 1992 member states have asserted their institutional position vis-a-vis the European Commission, which itself is increasingly losing room for political function, I claim, that the more European states come to understand their general functional interdependence as neighboring democratic states in an economically and politically competitive global environment, the less politicalsignificance supranational institutions will have in the process.

European integration has in fact already reached a degree, which demands new theory in order to predict on the future process. I believe this theory should be state-centric, and it should account for democratic states' interest in preserving the democratic state *per se* while upholding transnational markets.

I find this notion to be supported by the fact, that the past 15 years or so have shown, that European legislative procedures have been revised in favor of intergovernmental settings on the one hand, and democratically elected supranational officials on the other. The problem with the political executive function of the Commission, which had been essential to the creation of the EEC, the EC and the SEA, is, that officials are not elected, and is therefore unsustainable as soon as a certain degree of integration has been achieved.

The process of European integration may indeed have started out as an elitist enterprise led by powerful producers' commercial interests, but it has become much more than that. In my view it now represents an endeavour to save the democratic system and the balance of the enlightened European society, while competing economically with politically incompatible states. There is no doubt, that the further process will lead to political friction in all member states, and there will be considerable external interest in sabotaging the project. New societal compromises in Europe will fiercely be fought for in the streets and parliaments, and there will be more elected and non-elected officials as much as interested actors blackmailing each other in nightly sessions. Yet, I am confident, that European electorates will come to the conclusion, that European leaders have come to before and on March 25, 2011, namely, that the European future demands compromise in any case, and that integration is without alternative.

Here is a set of assumptions that provide for solid predictive as much as explanatory capacity:

Europeans want to live in peace and prosperity, they know, that it is not possible to pursue that on their own, and they will find whatever form is necessary to accomplish that, just because there is no alternative. In my view, it is that simple.Theory is one thing, practice another, and European political leaders, especially in France and Germany tend to be member state representatives and supranational agents at the same time.

I quote Wolfgang Schaeuble, the current German Minister of Finance, and one of the last surviving political grand figures deeply involved in the process of European integration: "If we would not have European integration already, we would have to invent it."

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Abbreviations

QMV - Qualified Majority Vote

EMU – Economic and Monetary Union

EU – European Union

EFSF – European Stability Facility

ESM – European Stability Mechanism

SGP – Stability and Growth Pact

CEB – Central European Bank

GDP – Gross Domestic Product

IMF – International Monetary Fund

ECJ – European Court of Justice

ECHR – European Court of Human Rights

EEC – European Economic Community

ECSC – European Coal and Steel Community

EAEC – European Atomic Energy Community

SEA – Single European Act

EMS – European Monetary System

EP – European Parliament

CFDP- Common Foreign and Defense Policy

EEAS – European External Action Service

EMCF – European Monetary Cooperation Fund

ECU – European Currency Unit

ERM – Exchange Rate Mechanism

CAC – Collective Action Clauses