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Liberal Intergovernmentalism and the

Establishment of the European Stability Mechanism

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Abstract

The European Union (EU) was both created by and developed through a combination of Treaties signed by participating nation states and supranational activity. This paper aims to use Liberal Intergovernmentalism (LI), an influential European integration theory to account for EU milestone developments and policy outcomes forged by intergovernmental negotiations among EU member states. The establishment of the European Stability Mechanism (ESM) — a permanent rescue mechanism purposely adopted to counter the Eurozone sovereign debt crisis — represents a typical case of crisis induced deepening of EU integration. Utilizing the research methods of congruence testing and process-tracing, this paper examines Liberal Intergovernmentalism's (LI) analytical and predictive power in explaining the creation of the ESM. The research results show that the three-phase LI model works well in accounting for the highly state-driven formation of the ESM. Based on the case study of the ESM, however and partially drawing on alternative theoretical approaches, new factors and causal mechanisms are proposed as additions to the LI model.

Keywords: *Liberal Intergovernmentalism; European Stability Mechanism; Euro crisis response*

Contents

1. Introduction[1,2,3]

The entire European Integration project was shaken to its core by the sovereign debt crisis in 2009[4]. Both the European Union (EU) and the European Economic and Monetary Union (EMU) suddenly faced severe challenges, which highlighted several problems with the direction of the European integration project. But most importantly the crisis showed the vulnerability of the single currency union without any kind of strict fiscal coordination. The EU has subsequently initiated a series of reforms and adopted measures to try and mitigate the effects of the sovereign debt crisis across the Eurozone countries.[5] Thus, the crisis provided a critical juncture to incentivise deeper financial integration as well as greater fiscal surveillance.

Yet, the EU faced the dual challenge of constructing a feasible crisis management mechanism within a short period of time, while at the same time ensuring that it did not violate the "no bailout" clause in the EU legal framework. Initially, the European Financial Stability Facility (EFSF) was created as a temporary solution to aid the debt-ridden countries. But, it was evident that a permanent solution was needed in case Eurozone countries faced future challenges in tapping into the financial markets. In 2012, as a successor to the EFSF, the European Stability Mechanism (ESM) was established to ensure that the Eurozone countries had a permanent crisis rescue mechanism. The ESM was to provide financial assistance to insolvent countries via different kinds of debt instruments.

The crisis and its subsequent management triggered another round of debate among the competing theories of integration. Over the last half century numerous theories based on empirical evidence have been developed to understand and account for the EU project and its process. Among them, Liberal Intergovernmentalism (LI) has gained popularity due to its focus on explaining the intergovernmental negotiations propelling EU developments.[6] LI was first developed and subsequently updated by Andrew Moravcsik. The theory is state centric whereby nation states are

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[1] This paper strongly draws on Pan (2015). It condenses, adapts and updates sections of this work focused on the explanatory power of different European integration theories -- including LI -- in the analysis of European monetary integration after the European sovereign debt crisis.

[2] We thank participants at the 7th International Euroacademia Conference 'The European Union and the Politicization of Europe', 25-26 January 2019 in Bruges, and notably Emanuel Crudu, for helpful comments and feedback on an earlier version of this paper.

[3] A deeper elaboration of the theoretical aspects of the paper, based on the empirical analysis provided here, is in preparation.

[4] For more details, see, for example, http://www.efsf.europa.eu/about/index.htm and http://www.esm.europa.eu/ .

[5] According to the European Commission, the EU's measures to counter the crisis are based on three distinctive approaches and rationales: (a) reinforcing economic governance with closer EU surveillance, (b) repairing the financial sector, and (c) safeguarding the stability of the euro area ("Economic Governance", European Commission). To create a permanent ESM obviously belongs to the third category.

[6] For a recent assessment of LI and a comparison with rival theoretical approaches, see Moravcsik (2018).

regarded as the principal drivers of integration. These states engage in three phases which lead to integration: national preference formation focused on economic gains, interstate bargaining whereby the results depend on power relations, and the institutional choice to ensure future compliance (also see Moravcsik and Schimmelfennig, 2009).

The purpose of this paper is to test Moravcsik's LI against the case study of the establishment of the ESM.[7] Schimmelfennig (2015) has applied LI to the overall Eurozone crisis response and management, and concluded that LI was successful in explaining the general responses, but also described some limitations to the theory This paper will focus solely on the creation of the ESM, and explore the causal chains that built up through the process. It therefore seeks to display how the LI model sheds light on understanding the formation of the ESM, whilst also testing LI against this recent EU evolution.[8] The case of the ESM was chosen due to its creation being a major step forward in the fiscal integration of the European Union. The establishment was hotly contested and required significant treaty changes which make it an important test case for LI. The paper will use the methodologies of congruence testing and process tracing to analyse the predictive power of LI against the ESM case. If there is any collapse of the causal mechanisms posited by LI, the reasons behind such failures will be explored, allowing for revisions of LI assumptions to further develop LI theory in the context of changing EU empirical evidence (George and Bennett 2005, 153 & 182 & 206; Panke 2012, 129). However, using LI as a theoretical framework does not imply that this approach alone can generate insights into the case to be explored. Our paper simply provides a test to see how well it can account for the establishment of the ESM as an example of a recent, major step in European economic and financial governance. The paper heavily relies on the roles of Germany and France in the negotiation process of the ESM. Since Germany and France both played the role of coalition leaders with opposing views that incorporated most if not all members of the Eurozone and therefore incorporates all views of the different MS bundled in the different coalitions, the main focus on Germany and France does not detract from the validity of the paper's argument.

The paper is structured as follows: section two describes the three-stage theoretical framework of LI, its main assumptions and outlines, and its predictions for the establishment of the ESM in the form of several hypotheses. Section three presents case study and hypotheses tests, examining the extent to which the LI model is effective in explaining the formation of the ESM. Section four briefly details the

[7] The predictive power of other theories of European integration, focusing on European monetary integration, is examined in Pan (2015).

[8] For an application of LI to different crises in the EU, see Schimmelfennig (2018). In the case of the Euro area crisis, the author finds LI as a static theory to insufficiently account for endogenous preferences which in fact can be a result of path dependence.

main propositions and suggested additions to LI theory. The final section summarises the main findings of the paper before coming to a set of conclusions.

1.1 Model and Hypotheses of Liberal Intergovernmentalism

Liberal Intergovernmentalism (LI) was originally developed by Moravcsik (1993, 1995) and it has undergone several phases of revision since its inception. This paper uses the LI model after its contemporary revisions offered by Moravcsik and Schimmelfennig (2009), in which the LI model is framed as shown in figure 1.

The LI general assumption consists of three sequential stages	
Stage 1: National preference formation	(1) Preference formation is "issue-specific", economic issue areas consist out of a balance of preferences among producers, taxpayers and other actors, while non-economic issue areas consist of geo-political and ideological preferences. (2) When national preferences are relatively certain and well defined they will be better represented during negotiations and have a higher likelihood of being accepted, as a result LI will have the best predictions when national preferences are clear.
Stage 2: Interstate bargains	(3) Bargaining power is decided by two factors: (3a) National asymmetrical interdependence, that is, the uneven distribution of the benefits of a specific agreement; (3b) national information acquiring of other actors' preferences and institutional mechanisms. (4) These two factors imply: (4a) Member states who economically benefit the most from EU integration tend to compromise the most on the margin to realise gains, whereas those who benefit the least tend to make hard bargains and impose conditions; (4b) The supranational EU institutions will influence national governments and enhance negotiations only when the transaction costs involved are high and they are armed with better information and expertise than national governments.

Stage 3: Institutional choice	(5) The purposes to establish supranational institutions are: (5a) to help governments reduce the transactions costs of future interstate negotiations on the same issue; (5b) to provide information for governments to estimate other actors' future preferences and behaviour; (5c) to set up rules to distribute gains, reduce coordination costs, monitor and sanction governmental non-compliance. (6) Three factors contribute to different institutional designs: (6a) the severity of distributional conflict and enforcement problems; (6b) uncertainty about the preferences of other actors; and (6c) the future states of the world. (7) The intention to establish institutions is to guarantee credible domestic commitments by pooling sovereignty at a supranational level. (8) National non-compliance will happen when an agreement leads to high costs for powerful domestic actors.

Figure 1. LI Model with Three Sequential Stages

Sources: Pan (2015), based on Moravcsik and Schimmelfennig (2009)

Based on this strategy, figure 2 illustrates the research design of this paper for the case of the establishment of the ESM. The LI approach will, therefore, explore the degree of validity of the LI model to account for current EU developments in a new context.

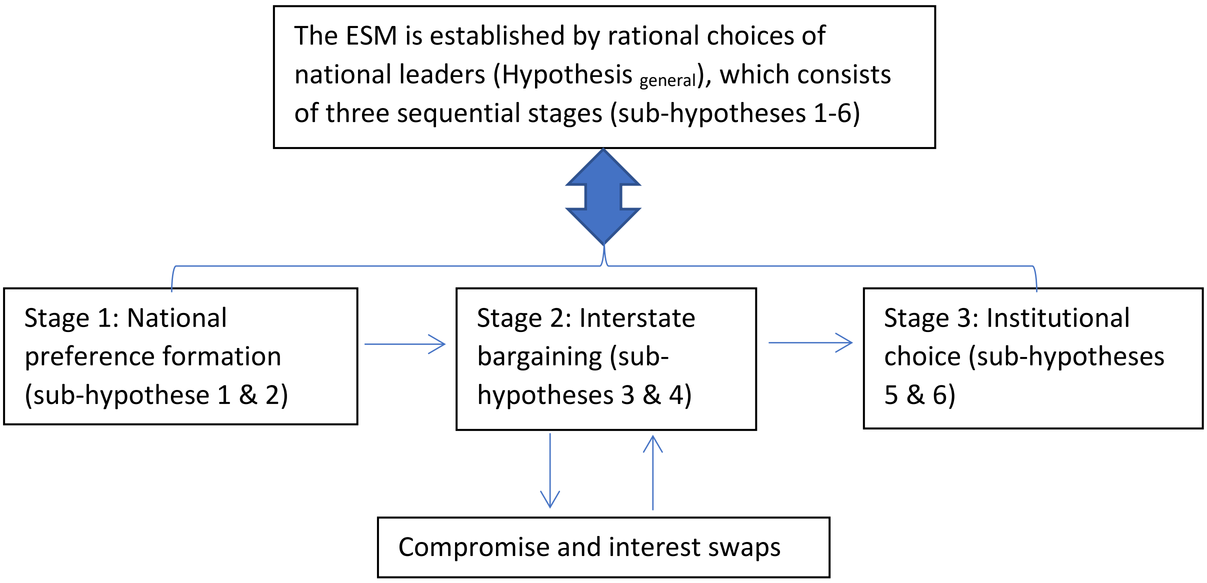


Figure 2. Research Design: A Road Map for the Analysis

The general core assumption of LI in the context of the establishment of the ESM can be framed as follows:

Hypothesis$_{general}$: The creation of the ESM is a rational choice made by national leaders, which is forged by three factors consecutively: national preference formation based on the economic interests of powerful domestic constituents, intergovernmental bargaining where asymmetrical interdependence decides the relative power of states, and institutional arrangements to guarantee the credibility of intergovernmental commitments.

This general hypothesis is further broken down into six sub-hypotheses that are based on the theoretical framework outlined in figure 1. The sub-hypotheses are framed as follows:

Stage 1: National preference formation

- Sub-hypothesis 1: The establishment of the ESM to address the Eurozone sovereign debt crisis reflects the economic interests of powerful domestic constituents.
- Sub-hypothesis 2: The stronger and better-organised (the weaker and more diffuse) representation of domestic societal interests is, the more (the less) predictable and more certain (uncertain) national preferences are, the better (worse) LI works. The clearer (unclear) preferences are, the better (worse) the bargaining position nations experience depending on whether they need flexibility or non-flexibility.

Stage 2: Interstate bargaining

- Sub-hypothesis 3: National asymmetrical dependence on the ESM determines the relative bargaining power of the nation states, so member states who economically benefit the most from the ESM tend to compromise the most on the margin to realise gains, whereas those who benefit the least tend to impose conditions and drive hard bargains.
- Sub-hypothesis 4: The ESM tends to reflect big countries' will rather than that of the EU institutions, because the latter rarely possess information or expertise unavailable to the member states.

Stage 3: Institutional choice

- Sub-hypothesis 5: During the creation of the ESM, nation states made institutional choices to delegate and pool sovereignty to EU supranational institutions so as to guarantee the credibility of intergovernmental commitments.
- Sub-hypothesis 6: National non-compliance will happen when an ESM agreement leads to high costs for powerful domestic actors which in turn pressure their national governments into non-compliance.

The sub-hypotheses will now be explored based on the case study of the establishment of the ESM.

2. Case Study: Establishment of the ESM

The major steps leading to the finalisation of the ESM are displayed in Figure 3. The following case studies and hypotheses tests are based on the processes illustrated in this figure.

Establishment of the ESM

The initiator of the ESM is Germany since a permanent rescue fund is a part of its interests

(1) to establish a permanent rescue fund, with an insolvency procedure involving the losses and risks sharing of private investors, that is, private-sector involvement (PSI);

(2) impose tougher budget rules and an automatic sanction mechanism charged by the Commission, rather than by the Council applying QMV (i.e. the status quo); Germany's demands for stricter rules are in line with the positions of the Commission and the European Parliament (EP).

↓ How to materialise those national interests?
Germany's strategy: forming a coalition with France, the 'number two' in the EU

France's preferences:

(1) a comparatively lenient fiscal sanction mechanism
(2) depriving the voting rights of the persistent deficit violators in the Council (a proposal attracting universal opposition and criticisms);
(3) the status quo of sanction decision-making by the Council

↓ The first round of interstate bargains: the bilateral Deauville Deal struck by Germany and France on 18 October 2010

↓ The second round of interstate bargains: various responses to the Deauville Deal, forming a rough line between small fiscally-restrained northern members who only face long-term threats from the crisis, lead by Germany (together with the Commission and the EP) and large, indebted southerners who face short-term threats, lead by France, critical towards the issue of a tougher and more-automatic sanction mechanism.

Germany's strategy: Germany caved in to France's demands of weakening articles on the risk sharing by the private creditor side, and in return, France agreed with a more automatic sanction process.

↓ The third round of interstate bargains: addressing the shortcomings of, as well as further strengthen, the EU's (particularly Eurozone) fiscal governance after the "six-pack"

Germany's strategy: Confronted with the UK's opposition, the Fiscal Stability Treaty was concluded as an Eurozone Treaty rather than an EU Treaty, excluding the "recalcitrant" governments; Germany bound the ESM and the Fiscal Stability Treaty together, and the Fiscal Stability Treaty was included in the ESM Treaty as a prerequisite for ESM member states to receive ESM assistance.

↓ The fourth round of interstate bargains: the formation of the ESM Treaty

On 11 July 2011, the 17 euro countries signed the ESM Treaty; later, on 21 July and 9 December 2011, decisions were made by the eurozone Heads of State and Government to increase the effectiveness of the ESM, such as introducing new financing tools and more flexible pricing; incorporating those decisions, the ESM Treaty was signed again on 2 February 2012. The ESM Treaty was subjected to national ratification of the euro countries, and the permanent ESM did not become operative until 8 October 2012.

After signing the ESM Treaty, interstate bargains and compromises still continued.

The fifth round of interstate bargains: Newly elected French president Hollande aims to have his growth pact adopted, a promise made to the French voters during his presidential campaign, to stimulate the French economy and claimed to complement Merkel's Fiscal Pact, which stressed austerity measures; before the EU summit on 29 June 2012, Merkel agreed to support Hollande's growth pact, and in return, Hollande agreed to sign off the unpopular fiscal pact championed by Merkel. Italy and Spain were emboldened by the French election and made demands for more flexibility.

Germany's strategy: Germany opposed the demands made by Italy and Spain, but it needed the allegiance and support of France for the Fiscal Compact; meanwhile, a growth pact was also needed by Merkel to placate her domestic opposition in exchange for their support for the ESM and the Fiscal Stability Treaty. Germany caved for French demands in return for assurances on the Fiscal Compact.

The sixth round of interstate bargains: responding to the German highest court's ruling of imposing two conditions for the ESM

The German Constitutional Court finally favored the ESM on 12 September 2012 but imposed two conditions: (a) the limited German liability of €190 billion and (b) the rights of the German parliament, the Bundestag, to obtain confidential information of the ESM; to meet the German highest court's requirements for ratification, the euro states quickly adopted an "interpretive declaration" issued on 27 September 2012 to clarify the court's concerns. Thus, the last obstacle for the operation of the ESM was removed.

Due to the uncertainties and new emerging situations/factors, the possibilities of interstate bargains and compromises on the operation of the ESM cannot be ruled out.

Figure 3. Processes Leading to the Establishment of the ESM

Sources: Pan (2015), based on Alexander (2011), Barysch (2010), BBC (2010), Chaffin and Spiegel (2010), Charlemagne (2011), Council of the European Union (2012a, 2012b), Deauville Declaration (2010), Eurogroup (2010), European Central Bank (2012), European Commission (2011), European Council (2010, 2012), Hipp (2012), Kaiser (2013), Kaiser and Rickens (2012), Kovacheva (2010), Miller (2012), Neuger (2013), Spiegel Online (2010a, 2010b, 2012a, 2012b, 2014), Wittrock (2012).

2.1 Economic interests and electoral cycles' role in national preference formation

Schimmelfennig (2015) argues that national preference formation during the crisis was strongly influenced by the interdependence among the euro area member states. They were all, due to mutual interdependence, vulnerable to the consequences of the crisis and as a result all preferred to protect the currency union. However, the states differed in how to achieve this goal. Sub-hypothesis 1 emphasises the influence of powerful domestic constituents in determining the course of the ESM. To understand the mechanism behind this, this section will examine the German and French motivations to initiate the ESM, and then consider the political backdrop against which this institution was created.

The German government's push for establishing a permanent rescue mechanism was based mainly on three considerations. Firstly, Germany was "the main bankroller" of the loan of €110 billion to Greece which was very costly for them and therefore they adamantly rejected the idea of endorsing another costly bail out. Secondly, the then available rescue mechanisms, the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM), were temporary backstops, and the German government wanted "something more substantial" to replace these temporary measures before they expired in order to create more political and market stability. Finally, the default mechanism proposed by Chancellor Angela Merkel meant that investors, rather than taxpayers alone, would also bear at least part of the losses of a state bankruptcy to avoid "a cascading panic in the markets" caused by sovereign defaults like that of Greece in the spring of 2010 (Phillips, 2010). Germany wanted to avoid any further damage to the currency system after the initial spill over from the Greek sovereign debt crisis. Therefore, the Merkel government supported a strict monitoring and sanctioning mechanism in the Stability and Growth Pact (SGP), "favour(ing) (the) highest possible degree of automatism" (Müller et al., 2010).

France, on the other hand, did not share the same urgency of creating automatism, but rather tended to side with the southern Europeans who opposed automatism as they had the highest chance of being the victim of automatic sanctions (Müller et al., 2010). This was unsurprising, given that the French economy was in a rather precarious state and the government itself ran the risk of debt defaults. The then French President, Nicolas Sarkozy was determined to "keep Greece on track", but reluctant to "make the banks foot more of the bill" through private risk sharing as he wanted to protect France's fragile financial sector (Alexander, 2011). So he supported Germany's idea of the ESM, but on a voluntary basis without automatism.

The German government faced different pressures from both its voters and domestic industrial giants such as ThyssenKrupp, Siemens and Daimler. German voters were opposed to another round of bailouts, while the big firms urged the German government to protect the single currency which meant keeping Greece in the currency union. Germany needed a permanent mechanism that would address financial and economic crises within the Eurozone, while at the same time limit its liabilities. The economic interests of powerful domestic entities had a strong sway on both the French and German governments' decision to initiate the ESM. Germany tried to appease the multinational industrial firms and France made efforts to protect its financial sector.

However, national preference formation transcends beyond pure economic interests. Both France and Germany faced domestic election cycles. Therefore, both had to take voters' attitudes on the ESM into account. In May 2012, Sarkozy was defeated by François Hollande in the French presidential elections, and the latter opposed Merkel's "inevitable" austerity measures to counter the crisis. Hollande also had to prioritise his election promises: to revive the French economy and to counter Germany's 'Fiscal Pact' with his own 'Growth Pact' centred around spending and investment (Poirier, 2012). The advent of the 'Growth Pact' encouraged the Italian Prime Minister, Mario Monti, together with his counterpart from Spain, Mariano Rajoy, to negotiate with Merkel. Domestic political pressure motivated both Monti and Rajoy; both had to push through unpopular reforms at home despite strong domestic resistance. They successfully forced Merkel to make concessions on the rules of governing the ESM bailout fund (Volkery, 2012). Therefore, the different political/electoral considerations of each nation, with regards to the ESM, were deeply embedded in their respective domestic political situations and electoral cycles. Consequently, political-electoral considerations are different in that they are time-sensitive. They are not only important during electoral cycles and they can both support or oppose the baseline of economic interests, depending on the electoral context.

The ESM case suggests a new preference formation mode to the LI model in Figure 1:

Proposition 1: In terms of issues directly related to the fate of the euro and/or the EU, national preference formation is not only based on economic interest calculations, but also encompasses political/electoral considerations.

Northern European nations led by Germany had clear national preferences: they sought to minimise the costs of a mechanism that would support weaker economies. Armingeon and Cranmer (2017) explain that this is because 'stronger nations' do not expect to experience austerity policies in the future, while indebted governments will oppose austerity even if it is inevitable because such vocal opposition will reduce future electoral costs. Due to this split in electoral preferences and economic preferences in Southern European nations it could be said that they had weaker national preferences and therefore had a weaker bargaining position. After the election of François Hollande there was a change, the election signaled a coalescing of the national preferences and led to a better negotiation position. Due to this change both Italy and Spain also felt emboldened to push through their demands and as a result they received major concessions from Germany in the fifth round of negotiations. As such, in general, national preference formation was therefore well-defined in the case of the ESM and thus, LI could be used efficiently to explain the process.

2.2 Germany's weaker than perceived position in interstate bargaining and the exclusion of non-affected EU powers leading to a multi-speed EU

Sub-hypothesis 3 claims that a nation states' relative bargaining power is determined by the extent to which it would benefit from the creation of the ESM. The more a country stands to gain, the more it will be willing to compromise for the ESM. To test this hypothesis, this section will examine the relative expected gains for the major players involved in constructing the ESM.

The Fiscal Compact, the core of the Treaty on Stability, Coordination and Governance (TSCG), was vetoed by the UK at the EU summit of December 2011. This confirms part of sub-hypothesis 2, as the UK, not being a eurozone member, would economically benefit the least from the agreement. However, despite the relative economic and political strength of the UK, Germany and France did not give in to the UK's demands. The TSCG containing the Fiscal Compact was meant to complement the ESM; thus, even without the UK, the TSCG can still function for the euro area countries. This example gives rise to a further consideration to be incorporated within the LI model: negotiating member states should be within the same block, or else the prediction made in sub-hypothesis 3 is untenable since the veto power of non-affected countries would proportionally be too high in comparison to affected nations with no room to use their veto power. As a result only affected states negotiate and exclude the over powerful non-affected states, so that interstate bargaining can proceed on a more equal footing. This is also because the euro block can progress with EMU affairs without consideration of non-euro area member states' opinions. Accordingly, a new scope condition for the LI model can be derived:

Proposition 2: The LI model's second stage (i.e. interstate bargains) works better when the negotiating parties belong to the same block in terms of the relevance of the agreement to them and therefore the absence of skewed power levels.

Sub-hypothesis 3 suggests that nations that are likely to gain the most from the creation of the ESM may experience a more precarious bargaining position. This paper argues that Germany had a more precarious bargaining position then earlier might have been thought. This runs counter to the proposal made by Schimmelfennig (2015) who claimed that Germany was in fact in a superior bargaining position because its economy was best able to withstand the crisis. He determines that Germany therefore drove a hard bargain when it came to integration decisions during the crisis. However, his line of reasoning somewhat understates the economic gains from, and therefore reliance on, the euro for Germany. A single common currency broadens the "domestic" market for the euro area states, whilst simultaneously facilitating greater interdependence among member states, particularly in the financial sectors. Germany, as an export-economy, benefits from the weakest members remaining in the euro as intra-Eurozone trade accounts for two-thirds of German exports (Sanati, 2011). A single currency has streamlined business, reduced transaction fees and guarded against foreign exchange risks, making German products more competitive globally (Sanati, 2011). It is estimated that the common currency helps Germany reduce labour costs by 15% compared with the average level of all euro countries (Porter, 2012). For the Eurozone countries, "[a]n artificially low euro in Germany means an artificially high euro in weaker countries like Spain and Greece", allowing these countries to afford German goods. (Sanati, 2011).

Germany therefore not only benefits from states staying in the Eurozone, but stands to lose greatly if members break away. If Greece, for example, broke away from the Eurozone, "it would cost around 20% to 25% of the country's GDP or 6,000 to 8,000 euros per German citizen"; in contrast, "if the Eurozone swallowed 50% of the debt of Greece, Ireland and Portugal it would cost a little over 1,000 euros per German" (Sanati, 2011). This is partially because of the interconnectedness of the financial sectors. The states plagued by the sovereign debt crisis are also financed by banks "headquartered in the core countries". Thus, although there was opposition to the Greek bailouts from the German taxpayers, letting Greece declare bankruptcy would be fatal to the whole German economy (Sanati, 2011).

Therefore, there is an asymmetrical benefit distribution from the single currency and, subsequently, the ESM agreement. In this sense, LI (sub-hypothesis 2) correctly predicts that national asymmetrical dependence on the ESM determines the relative bargaining power of the nation states. Germany, who economically benefits the most from the ESM, has compromised the most to realise its core interests. Meanwhile, those states that benefit least from strict accession to the ESM, for instance Italy and Spain whose bargaining position was strengthened due to the fact that their economies were too big to bailout, put forward strict conditions and made hard bargains (see the fifth round of interstate bargains in Figure 3). Although Germany's bargaining position was weaker than earlier suspected, the Eurozone sovereign debt crisis strengthened Germany's leading role while weakening France's political leverage in EMU affairs. Nevertheless, Germany had to form a coalition with France and compromise to secure its national interests, since it is not powerful enough to act alone and is heavily dependent on the currency union. Consequently, the new EMU policies and measures tend to start from and/or end at the merger and/or compromise of the propositions of the two core euro states, which normally are characterised by a German-French style of stricter vs. lessened fiscal rules and of budgetary cuts vs. spending growth emphases. Although Germany tends to make concessions to France's demands, the negotiation results tend to represent Germany's national interests more than France's due to asymmetrical national economic powers. All this demonstrates the explanatory and predictive power of the LI model. The validity of sub-hypothesis 3 in the case of the ESM also further supports the previous proposition 2.

Sub-hypothesis 4 claims that the ESM projects the interests of the most powerful states rather than being the result of the supranational EU institutions' policy making. A nation state's political leverage is closely related to its economic power and, post-2008, Germany held the pre-eminent position in this respect within the Eurozone. As discussed before, the Eurozone sovereign debt crisis strengthened Germany's leading role while weakening the political influence of all others on EMU affairs. It was Germany, and to a lesser extent France, rather than the EU institutions that shaped the course of the ESM, and therefore sub-hypothesis 4 is largely confirmed. Despite the national preferences being well-formulated, during LI stage 2 (i.e. sub-hypothesis 3 and 4) there were challenges as to how such preferences could be represented and coordinated at the EU level. EU leaders, the Commission, the ECB and other EU bodies have utilised their expertise and legitimacy to exert influence, such as making Treaty revisions to establish the legal basis for the creation of the ESM and the finalisation of Collective Action Clauses (CACs). However, in detailing the evolution of the ESM (see figure 3) one can see that national governments are the core actors and deciders of its formation, and German-French compromised positions created the framework for the agreement.

Moreover, Proposition 2 offers possible situations where not all member states participate in an interstate bargain (i.e. block-ins vs. block-outs). It recognises the different relevance and weight of the agreement to each member state as well as highlights the different integration speeds among EU member states (see sub-hypothesis 5modified). Puetter (2012) deemed this "deliberative intergovernmentalism" as a striking divergence from the Community Integration method, which focuses less on coordination via intergovernmental institutions such as the European Council. The creation of the ESM itself has primarily reflected the domestic interests of the big countries, while intervention of the Council and Commission was only seen in "exceptional cases" that were marked by high coordination and transaction costs. However, financial support mechanisms such as the ESM and EFSF, still require the legitimacy and framework of EU institutions to operate (Bauer and Becker, 2014). Therefore, intergovernmental frameworks do often rely on the European Council (and Commission's) executives, whose function has changed from that of entrepreneurship, to management of policies (Bauer and Becker, 2014). Accordingly, the ESM, which is part of the greater economic governance scheme, is still broadly under the monitoring of the Commission (Becker et al., 2016).

The road to the ESM comprised several rounds of interstate bargains, which challenge the unitary nature of "interstate bargains" proposed by the LI model. Germany's core interests and its baseline in negotiations reflected the German government's long term policy-orientations: a stable and credible currency, strict budgetary rules and low inflation rates. France's propositions also indicated a policy continuity in the French government: increasing governmental spending to stimulate economic growth and thus accepting higher government deficits with higher inflation rates.[9] Therefore, it was no surprise that Germany made strong demands for budgetary cuts with austerity measures for the southern debt-ridden countries. Whereas France suggested a growth pact as a counter to Germany's Fiscal Compact. Two new insights can be derived from this:

Proposition 3: Interstate bargaining is the result of multiple negotiation rounds during which national preferences and power relations can change as a result of external factors. During these multiple rounds of negotiations national core interests are the bottom line of interstate bargains, which tend to be unwavering while exhibiting national policy tradition over time.

2.3 France and Germany chose a mix of intergovernmental and supranational institutions for the ESM

Sub-hypothesis 5 states that institutional choices regarding the delegation and pooling of sovereignty to EU institutions during the inception of the ESM was primarily to ensure intergovernmental commitment toward the ESM. The LI model predicts that EU supranational institutions are set up to decrease transaction costs and ensure that the commitments are respected. Schimmelfennig (2015) asserts that the sovereign debt crisis highlighted there are significant enforcement problems regarding the EU rules. This led to more regulatory power being delegated to the EU supranational institutions (Kudrna, 2016). Laffan and Schlosser (2016) further stress that the Eurozone crisis was the main trigger that led to greater fiscal surveillance especially among the euro area member states. This new governance system allows for greater horizontal policy making at the EU level, and though there is no considerable EU fiscal control mechanism, the new EU regulatory power does have influence over national budgets. Scholten (2017) agrees that there is a growing influence of the EU on national direct enforcement strategies. The increasing number of fiscal councils across the EU also demonstrates this growing commitment to the supranational rules-based framework (Larch and Braendle, 2017).

[9] E.g. see Hosli (2005).

Member countries understand the need for creating respective institutions and accept a loss of sovereignty to protect the currency union. Germany sought to limit its financial commitment to the ESM by capping the lending capacity to €190bn, and the ESM was there to ensure that this commitment was upheld. ESM assistance also comes with a strict set of conditions that the indebted countries must adhere to. Therefore, sub-hypothesis 5 is valid but can be better construed after including proposition 2 which refers to the effects of negotiations taking place in the bloc of affected states:

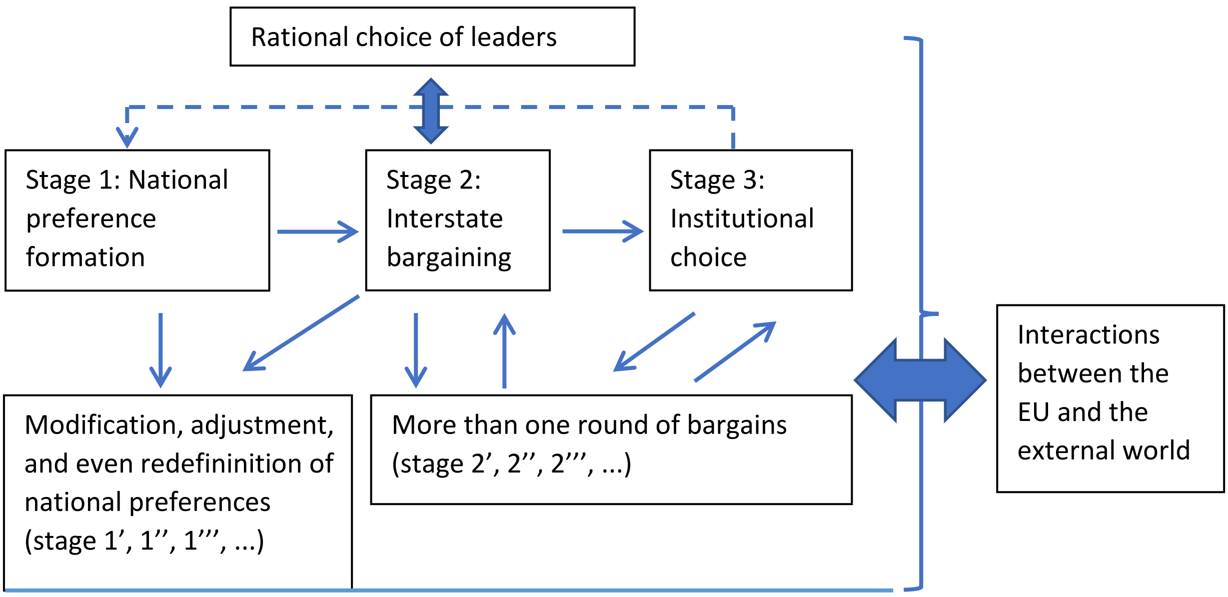
Sub-hypothesis $5_{modified}$: Nation states make institutional choices to delegate and pool sovereignty to EU supranational institutions and/or intergovernmental institutions to guarantee the credibility of intergovernmental commitments, and the latter may cause or strengthen earlier established differentiated integration speeds among EU member states.

Sub-hypothesis 6 concerns the non-compliance of states that is most likely to result from the high domestic costs of the ESM agreement. In December 2016, Greece announced a €617 million pre-Christmas bonus for pension holders living under €800 per month. The ESM immediately froze short-term debt relief measures. The Greek Prime Minister, Alexis Tsipras, facing significant domestic pressure argued that Greece had managed to go beyond its fiscal surplus target and thus could afford the expenditure. However, it was only after the Eurogroup had received an official letter from the Greek finance minister confirming the country's commitment to the programme, that the ESM measures were continued. Although this episode is not officially deemed as non-compliance, it shows that powerful domestic forces can induce national governments into not complying with the ESM conditions (Pan, 2015). Recently the possibility of non-compliance has been highest in the case of France and Italy which have faced the organization of powerful domestic constituencies that oppose the ESM; in the case of Italy, this even led to a governmental change (Borrelli, 2018; Ramnarayan & Ranasinghe, 2019). While both nations flirted with non-compliance, in both cases the ESM was respected after negotiations in the intergovernmental fora and between the different nation states and the responsible supranational institutions.

2.4 Analytical and Predictive Power of LI in Explaining the ESM

The aim of this paper was to test whether LI can adequately explain the establishment of the ESM as a response to the European sovereign debt crisis. It analysed the process leading up to the ESM according to the three stage LI model, and has determined that this mode of crisis management can be sufficiently explained by LI. This section will briefly examine some of the divergences between the model initially derived from LI theory (figure 2), and the evidence from the hypothesis tests, based on process tracing and congruence testing

Figure 4 suggests that interstate bargains concerning a specific issue may not be finalised in a single deal, rather it is more likely that they will undergo several rounds of negotiations before being concluded. Neither national preference formation nor institutional choice finalisations are static. Instead, they evolve over time and are modified, adjusted or redefined in response to new situations and challenges in the EU integration process. In periods of uncertainty, this elaborated LI three-stage model offers a useful theoretical tool to grasp, understand and unravel the policy outcomes forged by intergovernmental negotiations.



- The core national interests tend to be stable and are not easily changed throughout the negotiation processes
- Compromise, national interest swaps, and/or forming a coalition with other members are necessary during bargains to secure (core) interests

Figure 4. Elaborated Process of the LI Model

Source: Pan 2015

This adjusted model is somewhat different from the classical three-stage model that was derived in figure 2. It is a more dynamic process, because the terms of how the ESM functions are subject to change based on bargaining among the countries as well as the overall EU integration process. Especially notable in the changing dynamics of bargaining and preference formation is the inclusion of the time-sensitive political-electoral aspects (similar to Schimmelfennig's accounting for the effects of mass politicization and the observation that earlier integration modifies preference formation and with this, the bargaining space; Schimmelfennig 2015: 1580). Hence, endogenous changes feed back into the various stages that are core to the LI model. Furthermore, all three stages respond to exogenous changes to the EU (pressures from the rest of the world). However, despite this dynamic nature, core national interests are shown to remain unchanged. Other important insights from the ESM case were that forming coalitions was crucial in the interstate bargaining process, even for a powerful state like Germany and that the role of supranational EU institutions may have shifted, in this context, *from policy entrepreneurs to policy managers* that mainly deal with coordination issues. Another insight is that crises that only affect a part of the EU will lead to differentiated integration speeds due to the exclusion of overly powerful non-affected states in the negotiations of further integration and the need of the affected states to pursue deeper integration.

3. Conclusion

This paper has tested the three-stage LI model's explanatory and predictive power against a new EU development during the Eurozone sovereign debt crisis — the establishment of the ESM, seeking to assess the analytical power of this EU integration theory. LI emerged as a three-phase analytical framework to account for EU grand bargains and was modified and supplemented in 2009 by Moravcsik and Schimmelfennig. As the ESM was the result of several rounds of intergovernmental negotiations among the euro area member states, it proved a suitable case with which to explore the validity of LI.

The general hypothesis of this paper had three distinct parts, each of which corresponded to a state in the LI model. Firstly, national preference formation regarding the ESM was largely influenced by powerful domestic forces. Germany was under pressure from giant multinationals to back the Eurozone because its collapse would have meant significant economic losses. At the same time, German taxpayers were opposed to a bail out, and they had the capacity to punish the government through votes in the regional elections. France, on the other hand, was determined to protect its banks as they held a significant portion of the Greek debt. France's preference for more lenient terms in the ESM stemmed from its economic vulnerability. Secondly, the results of the interstate bargaining on the formation and terms of the ESM were determined by the asymmetrical interdependence of the states in the Eurozone. While each party stood to lose if the euro collapsed, some would be hit harder than others. For instance, Germany's exports depend on the Eurozone and thus it made concessions to initiate an insurance mechanism – the ESM. Conversely, Germany's relative economic power meant that it had enough influence to insert its core demands into the ESM. Finally, the ESM was established to ensure the credibility of intergovernmental commitment. The Eurozone crisis demonstrated the significant enforcement problems in the EU, and thus there was a need to pool sovereignty and transfer more power to the ESM.

The validity of LI to account for the ESM suggests the rigor of LI as an EU integration theory: from Moravcsik (1991, 1993, 1995 and 1998), to Moravcsik and Schimmelfennig (2009), to this paper as well as other LI studies, LI has been continuously developed and re-galvanised alongside the EU integration process. The LI study of the ESM case in this paper once again confirms the role of national interests and governments in propelling the EU project forward by intergovernmental approaches. The formation of the ESM also supports the intergovernmentalist proposition that the contemporary European integration project is "the result of deliberate state choice" (Moravcsik and Schimmelfennig 2009, 86) as well as national compromises. Nonetheless, our case study, based on congruence testing and process tracing, proposes additions to LI which notably encourage the integration of dynamic elements into core LI assumptions, mainly as regards the national preference formation and the intergovernmental bargaining stages. Our case study, however, corroborates some of the core insights of LI and provides another test into its validity when applied to recent developments in European integration.

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