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Integration in the Time of Crisis:

A historic case study on European economic integration 2010-2012

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Abstract

This thesis is a historical case study on the European integration between 2010-2012. The aim of the study is twofold. First it has a descriptive approach, focusing on the nature and extent of the integration. The second part is theory testing. By incorporating principal-agent theory in liberal intergovernmentalist theory and historical institutionalist theory I isolate their points on contention and limit the scope of the inquiry. By studying the relationship between the principals (Germany and France) and the agent (the ECB) in decisions of European integration I test the explanatory power of the integration theories. The materials used in this study is primarily second hand material from previous studies, as well as official documents from EU institutions and statements made to the press by policy makers.

The cases for the thesis is the SMP, the EFSF, the TSCG and the ESM. The SMP is a programme launched by the ECB to secure liquidity to countries hit by the financial crisis by purchasing public debt on secondary markets. The ESFS was a temporary stability facility providing emergency loans for countries in loosing access to financial markets. The TSCG is an intergovernmental regime launched by the EMU countries to increase control and monitoring of fiscal policy within the union. The ESM is a permanent crisis mechanism, aimed at providing emergency assistance to EMU countries. The conclusion of my study is that the historical institutionalist theory provides a better explanation for the the actions of the member states and the ECB during the integration process. The ECB has successfully lobbied for increased financial constraint and control and has been granted new powers that are far removed from the common practices of central banks.

Key words: Liberal Intergovernmentalism, Historical Institutionalism, Principal-agent theory, European integration, ECB
Words: 20 000

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1 Introduction

1.1 Introduction

The financial crisis of 2008 hit the European Union (EU below) like a sledgehammer. What started out as a mortgage crisis in the United States soon shook the confidence in the banking sector as a whole and the following world economic downfall has been described as the 'worst since the great depression' (Hodson 2015:176). The financial response of the EU to the crisis can been seen as lacklustre-, and this posed questions about the economic governance of Europe

The affected the countries within the EMU differently, but I hazard the claim that Greece was among hardest hit. The global financial markets were in turmoil[1]. The collapse of huge lending institutions such as Leeman brothers, and the the near collapse of Merrill Lynch, AIG and the Royal Bank of Scotland made investors vary of financial assets that had previously been considered 'safe'. Greece had previously been able to finance their deficit spending through the issuing of governments bonds, but as investors lost trust in the country the Greece had to pay higher and higher interest rates to maintain liquidity. This only exacerbated the problem. When market actors saw the desperation of the Greek government they started to question the tenability of Greece being able to repay at all. Since Greece had lost all trust by markets actors, it lost all access to financial markets and was on the brink of default. The crisis was no longer a problem for countries in the European periphery, it had hit the heart of the EU - the EMU. Investors began questioning the tenability of the EMU project, and started to re-evaluate the performance of other countries such as Ireland, Portugal and Spain. Something had to be done.

The response the the EMU was slow. At first there was bilateral loan agreement between Greece and EMU countries, providing emergency funding for the Greek government. But the emergency loans were only temporary measure, they didn't dress the root of the problem and didn't affect investor confidence. The first real mutual response of the EMU as a whole was from the European Central bank (ECB below). The ECB launched the Securities Markets Program (SMP below), a program where the bank wold start intervening in secondary bonds market by guaranteeing a 'lowest' price for sovereign debt (Sinn 2011:42,

[1] Guardian 2014

Salines, Glöckler & Trushlewski 2012:669). The program was controversial for two reasons. First it seemed to violate the 'no bailout clause' stipulated in the bank mission. The ECB was not allowed, under any circumstances, assume sovereign debt (Zimmerman 2015:71). The second reason was its effect on the financial markets in the rest of Europe. The ECB's mission was to promote price stability (Tuori 2013:145, Jones 2009:1093), it sterilised the debt purchases by selling of financial assets from other European countries that wasn't as affected by the crisis. So the PIGS countries received liquidity at the cost of financial stable counties, such as Germany (Sinn 2011:43).

The SMP programme was soon followed by the European Financial Stability Facility (EFSF below), a response by the EMU countries to pool debt obligations and increase investor confidence in the EMU. The programme was not successful in achieving this goal for two reasons. Its temporary nature showed a lack of commitment and its institutional design spread rather than contained financial risk among the EMU countries.

This didn't stop the EMU countries. Instead of withdrawing from common crisis solutions, the EMU countries increased their commitment to a mutual response. Following intense negotiations, the EMU countries launched the Treaty on Stability, Coordination in the Economic and Monetary Union (TSCG below), a common framework for fiscal policy and economic convergence. The negotiations of the TSCG included discussions of a permanent institution for handling the economic crisis for the EMU countries. They member states recognised the need for a steadfast commitment to secure the Euro in order to win back investor confidence and created the European Stability Mechanism (ESM below), which had its own capital and didn't rely exclusively on promises made by member countries.

These common responses saw a rise in power and influence of the ECB. Rather being exclusively concerned with monetary policy, promoting price stability through interest rates, it became part of setting fiscal policy in countries affected by the crisis (Schwarzer 2012:34). This a role far removed from its founding treatise, and is not something necessarily associated with central banks. (cf. Salines, Glöckler & Trushlewski 2012:677, Offe 2013:597, cf. Streeck 2015:370).

Why is this important? Central banks are unlike other political actors, which I will discuss briefly below.

1.2 Competing claims for Legitimacy

When studying central banks from a political perspective I pose that it's important to acknowledge their difference when it comes to rational and legitimacy in comparison to other government institutions.

Since the 1980's there has been a growing consensus that central banks need to be independent from political control (Quintyn 2009:269). Why is that? Why should a government institution not be subject to political control? The answer lies in the mission of the institution. Central banks largely, and the ECB particularly, have as a mission to maintain price stability (Tuori 2013:145, Hall 2008:58). But how does one attain price stability? The answer is trust. Money's value is inherently social. It has value because we trust in it (Hall 2008:55). In order to ensure the credibility of its currency a central bank must be seen as a legitimate actor by the market and the most important factors in winning this trust is through transparency and independence (Hall 2008:3). These factors could be won by instituting a monetary policy framework. If technocrats, rather than politicians, set policy to reach the pre-set goal of ensuring price stability the central bank is independent and transparent in its mission and is seen as a legitimate actor (cf. Hall 2008:138). What's important to note here is the constituency of the claim to legitimacy. The central bank doesn't have the citizens of a country as constituents, but rather the global financial market.

Democratic governments, however, base their legitimacy on very different grounds. Unfortunately, I don't have room for an elaborate discussion on democratic legitimacy but it's important to note that there's a much 'thicker' demand for legitimacy. Zaum (2013) provides a useful framework for understanding different types of legitimacy. He poses that we are interested in the output (efficiency), the input (the process through which a decision was made) and the appropriateness of of an institutions role in handling an issue (Zaum 2013:9). How we evaluate the need for these questions is not static and depends on the circumstances of a given situation, but it's important to note the the constituency is the citizens.

When evaluating the democratic legitimacy of institutions, we judge institutions by different standards. Pure "problem solving" institutions have traditionally been judged solely by their output since we don't really care how a problem is taken care of. This has generally been how we've reconciled the problem of central banking. Price stability has been seen as an objective best left to experts. Thus so long the inflationary goals legitimacy wasn't an issue (cf. Jones 2009:1098). However, if the nature of the mission of the ECB changes from a pure problem solving regime, the demands for legitimacy might no longer be reconcilable (cf. Majone 2010:172).

1.3 The 'puzzle' and the question

The economic crisis raised several questions about the state of European economic governance.

When the Euro was threatened, why did the member states of the EMU band together and propose increased integration rather than abandoning the crisis countries and the Euro?

What obligations did the member states of the EMU have vis-à-vi each other? Was Germany, driven by moral or self-interested reasons, when it assumed responsibility for the Greek deficits (cf. Offe 2015:57)?

What was the reason for the increased influence and actions of the ECB? Was the bank only acting according to the wishes of its creators or did it have an agenda of its own?

Was the European economic integration driven by the will of the member states or by European bureaucrats? In order to answer these questions my research question will be:

– How do we explain the actions of the member states and the ECB in the EMU's economic integration between 2010-2012?

In order to answer this question, I will break it down in parts. First I need to establish what actions were taken to further integrate the EMU. This is an empirical question and can be studied by simply looking at the content of the decisions taken. But in order to explain actions I need a theoretical approach. I've chosen to use liberal intergovernmentalist theory and liberal institutionalist theory in a theory testing approach. The theories share the assumptions of actors being rational and value maximising but disagree on what are the important actors when studying international relations. The liberal intergovernmentalist approach poses that states are the only relevant actors, while historical institutionalist theory states that international institutions may act in accordance to their own agenda and thus constraining the choices of the member states. In order to capture this difference between the theories I've employed the principal-agent theory, which I will discuss further below.

1.4 Historical Background

The origins of the EMU go back to a meeting of the European Economic Community (EEC) in 1969. The leaders of the EEC tasked Luxembourg's prime minister Pierre Werner with coming up with a plan for European countries in tackling the problem of currency fluctuation within the EEC caused by a faltering Bretton Woods.

The 'Werner plan' was adopted in 1971 but was cut short as the EEC countries battled the oil crisis of 1977. The idea of a fixed exchange rate and a common currency gained ground once more in the late '70's and the EEC countries created the 'ECU' a theoretical unit of account based on a basket of member states currencies (Scheller 2004:19). The idea of a common currency, and fixed prices across nations was part of the negotiations leading up to the Maastricht treaty and the creation of the EU (Hodson 2015:170). A common currency was a necessary and convenient measure as part of the new EU treaty was the free movement of capital within the union. Yet the so called 'Delors plan'[2] would not include a fiscal union . Each government was supposed to 'keep its house in order' and the treaty specified a 'no bailout clause' forbidding the new central bank of the EMU to bailout failing governments (Eurlex b, Salines, Glöckler & Trushlewski 2012:66). This was not a coincidence. The EU member states were apprehensive of giving new powers to an EU institution as they'd been surprised by the increasing power of EU institutions, especially the European Court of Justice, before (Heisenberg & Richmond 2002:204). Yet as part of the creation of the EMU, they needed a new central bank and the ECB was created in the model of the German Bundesbank in 1992 (Scheller 2004:21, Tuori 2013:144). The actions of the ECB were relatively uncontroversial until its involvement in the 'troika'[3], negotiating bilateral bailout loans for the Greek government during the beginning of the financial crisis (Commission B 2010:1, Offe 2013:597). I will discuss what happened during the crisis, the actions of the ECB and the member states, below.

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[2] Named after the European Commission's president Jaques Delors
[3] A colloquial term for the European Commission, the IMF and the ECB.

2 Theory & Methodology

2.1 Theory

In this part of the thesis I will discuss the use of theory. I will start by presenting the principal-agent theory, followed by theories of European integration where I argue for my choices of liberal intergovernmentalism and historical institutionalism. The last part of the theory section will be dedicated to integrating the principal-agent framework with my theories of European integration.

2.1.1 Principal-agent theory

In understanding the actions of the ECB I hold that it's useful to employ a principal-agent framework since it forces us to think about the relationship between the ECB and the EMU member states. The principal-agent theory is derived from economy and seeks to explain situation where a principal (in this case the EMU-countries) want to minimise cost and does so by employing and agent (in this case the ECB) to perform a task on the principal's behalf but yet retain some control over what the agent is doing (cf. Elgie 2012:187). The act of delegation might also provide an opportunity to displace responsibility for unpopular decisions (Kassim & Menon 2003:123). This is especially important for central banks since voters and politicians might be myopic when dealing with economic policy and prioritise short term gains over long term economic growth.

This has been the standard practice in liberal democracies since the 1980's when it comes to central banking (Quintyn 2009:269). A political assembly want to reap the benefits of increased economic expertise as well as having increased trust from market actors by setting up an independent agency responsible for monetary policy, which was also the case in the design of the ECB (cf. Heisenberg & Richmond 2011:208). There are two main problems in a principal-agent relationship for the principal (Waterman & Meier 1998:174). There is an assumed information asymmetry between the parties and thus the principal might run the risk of 'adverse selection' – the act choosing a less then optimal agent for the task since it can't properly evaluate the candidates.

The second problem is the 'moral hazard' where the agent might well have a different agenda than the principal. In the economic sphere this is mostly concerned with an agent wanting to maximise 'rent' from the principal without actually performing his task (cf. Majone 2010:155)[4]. This has two different facets: 'shirking' where the agent 'drifts' from the mission set by the principal and pursues his own agenda or 'slippage' where the decision-making process within an institution is devices of 'perverse incentives' that cause that aggregate decision output to go against the will of the principal (Elgie 2002:188, Pollack 1997:108).

In order to minimise the risks inherent in a principal-agent relationship the principal tries to construct a contract between himself and the agent in such a way that the mission is clear from the outset. In setting up the contract the 'rent' provided to the agent should be tied to performance in order to avoid the 'adverse selection' described above. This will only incentivise qualified agents to apply. Further, the principal may try to protect itself from 'moral hazards' by structuring the work of the agency, denominate its power and jurisdiction and what procedures it must follow (Calvert et al. 1989:604). This is called 'ex ante control' and is done to some degree with all government agencies.

But the 'ex ante controls' only sets the rules of the principal-agent relationship. in order to ensure compliance with the rules, the principal may employ what is called 'ex post controls'. These controls are focused on oversight (in order to control the agent) and sanctions (in order to punish the agent in case it breaks the rules of the agreement) (Elgie 2002:189).

But what can an economic theory say about the nature of government institutions such as the ECB? If we look at the history of the ECB we can see how this framework describes the design of the institution. The politicians (principals) had not been paying too much attention to the institutional design (the 'ex ante control') when setting up the European Court of Justice and has since been vary of the substantial effect this had on the court. There was a fear of a similar 'mission drift' (moral hazard) from a newly created ECB and thus the principals were diligent in making the banks mission limited and enumerated with a clear distinction of its jurisdiction and institutional mandate in order to minimise the risk of expansion ('shirking) (cf. Heisenberg & Richmond 2011:205-6).

The strong 'ex ante' control of the ECB might possibly be why there isn't really a strong framework of oversight and sanctions for the bank. There's a lack of a strong institutional framework for the principal(s) to exercise control over the bank. Since the ECB's role in the EU is enshrined within the treaty of Lisbon the threat of member states rolling back competences of the ECB is slim at best. The principals also can't overturn its policy through the European Council since the ECB is an independent agency and challenging the ECB before the European Court of Justice would likely not rule in favour of the countries since the ECBs role is set up to be independent in the treaty (Heisenberg & Richmond 2011:212-4).

The principal-agent theory admittedly comes with some intellectual baggage. Hailing from economics it presupposes the idea of rational choice which certainly isn't accepted by everyone in the field of political science (I will return to this below). Nevertheless, as I've shown above, I find it a useful tool in

[4] A classic example here would be a salesman on a fixed salary, working as little as possible

conceptualising the relationship between the member countries and the ECB as an institution.

2.1.2 Theories of European integration

The theories of European Union development are deeply divided between constructivists and rationalists and their view on how to understand European integration (Pollack 2015:23). In my study I've chosen to focus solely on the rationalist perspectives of (liberal) intergovernmentalism and (historical) institutionalism.

The reason for this is twofold: The focus of this study will be to explain actions in the short term, a constructivist approach where a diffusion of values is creating a European polity can simply not be observed over a period of a couple of years. The second reason is that of observability. Whether an action was taken as a consequence of a rational deliberation of a rent seeking individual or of that individual's ideas of appropriateness isn't really the point of this study. It would fit poorly in explaining whether an action was taken of the member states alone, or if EU institutions played a part in the decision making process. Below I will present the dominant theories of European integration and discuss their viability and relevance for my research question.

2.1.3 Neo-functionalism

The neo-functionalist approach claim that there has been, and will be a furthering of the power of EU-institutions if certain conditions are met. First developed by Haas in the 1950's the net-functionalist perspective was a hypothesis aimed to explain the development of the growing supranational tendencies of the European Coal and Steel Community.

Haas opposed that integration would deepen through 'spillover', both economic and political, when the current institutions would meet new problems and push for deeper integration (McGowan 2007:5-6). The supranational institutions created would possess the attributes necessary to make them agent of integration. Since they by necessity had been made to make, interpret and enforce rules (Sandholtz & Sweet 2012:19-20). Even though Haas himself gave up on the hypothesis after seing the lack of further integration under French president de Gaulle. The foundational attributes for neo-functionalist conditions (transnational activity and economic interdependence, European elites seeking regional solutions to mutual problems, supranational agent of rules and enforcement) certainly seem to apply to EU today (cf. Tortola 2015:138, Schmitter 2005:264-5, Sandholtz & Sweet 2012:20).

Despite this, I've chosen not include net-functionalism in my analysis for several reasons. The problems of the perspective is that it doesn't have a clear causality but rather is descriptive account on the European union and it doesn't provide anything that other theories lack. The European elites might well have been influential in creating an environment that made it beneficial for political leaders to support furthering of integration within the community/union, but this could be explained within a framework of liberal intergovernmentalism (below). The new agencies might well have "spillover" effects on new policy areas but this could be understood as an effect of institutional actors wanting to increase their power and that could be understood as 'shirking' in a principal-agent relationship as in historical institutionalism (below). The explanatory variables of the theory are simply put vague at best and doesn't offer us a clear causal story a how the European integration was furthered. Therefore, I don't find that this theoretical perspective has anything unique to offer in the study of European integration.

2.1.4 Constructivism

Constructivism did not begin as a theory about European Integration but was rather a 'metatheoretical' approach to social science that is seeking to explain human behaviour (Pollack 2015:20). The constructivist rose within the field of integration theory as a response to the different rational choice perspectives proposed by liberal intergovernmentalists and historical institutionalists (see below) by posing that their focus on actors and their preferences was myopic and failed to capture the intricacies of human relations within a social context. Rather than having a set of preferences given exogenously, the constructivists claimed that actors preferences was shaped by the very context they were in and thus didn't act according the maxim of value maximising at every instant (cf. Pollack 2015:21).

This invariably led to a new approach in the study of integration theory. Rather than studying the actors involved in the integration process, the scientist had to focus on the varying institutions involved. Constructivists posed that these institutions were they key to understanding actions within the policy process since the institutions through rules, and perhaps as important, informal norms led actors to take action in line with what they'd think 'appropriate' in a given situation (Pollack 2015:21). This method would would be especially advantageous when confronting policy issues with high 'issue complexity' (cf. Saurugger 2013:889). These would be issues were actors wouldn't necessarily have a clear, or even contradictory preference, where an actor places a larger emphasis on what would be considered appropriate given its context within an organisation (Saurugger 2013:889).

This has, for example, been used as a way to explain a lack of support for the furthering of European integration within the member states. Donnelley (2010) poses that the failure of the of the Draft Constitutional Treaty was caused by a lack of norms within the member countries supporting a more federal vision of

Europe. Rather than galvanising support for the EU by using the symbolic trappings of a state – e.g. a flag, an anthem and a written constitution, the citizens of the EU saw this as an encroachment on the 'appropriate' fora for these symbols i.e. the member states themselves (Donnelley 2010:4-6). This can be seen in contrast to where the EU has been more successful in establishing further integration. A look at a more successful example of EU integration would be the setting up of the common European currency. Since this was framed as a way of ensuring the common market, an idea vital for the EU since its inception, there wasn't the same struggle of whether it was appropriate for the union but was largely accepted as an inevitable consequence of the EU (cf. Saurugger 2013:898).

I hold that this effectively summarises the importance of the constructivist approach – the citizens of EU can be largely against something of little to no influence on their lives, yet readily accept something that will fundamentally change their way of economic governance because its considered the appropriate action for a given institution. One could argue that these examples would make a strong argument for the use of constructivism in the study of European integration, and I am want to agree to a certain extent. I would concede that the constructivist perspective provides a powerful framework for explaining the broad strokes of the integration if the EU over time. I do, however, think that it's poor in explaining the many small decisions leading up to a big change in policy. Given that the emphasis of my research is on a few decisions taken over a relatively short amount of time, I fail to see how the diffusion and interaction of norms would be able to be studied under these circumstances. Even though I might agree the 'appropriateness' plays and important role in shaping an actor's 'a priori' position on a policy, this wouldn't answer whether it was the member states or the EU institutions that were the drivers behind a specific policy change in practice. Therefore, I deem the constructivist approach 'inappropriate' for my study.

2.1.5 Liberal Intergovernmentalism

Liberal intergovernmentalism is perhaps best exemplified by the works of Moravcsik and his mission to construct a systematic theory of politics based on the assumptions of liberalism (1997). Moravcsik posed that liberal theory within social science had been acted on with a lack of rigour and sought to establish a framework for what should be considered a 'good' liberal theory of international relations (1997:515).

The first litmus test for a good theory would be whether it was "general and parsimonious" – meaning that it should be able to explain general rules for behaviour that can be derived from the core assumptions of the theory. When studying the works of neo-functionalists (above), Moravcsik has observed a constant 'ad hoc' approach to explaining the failures in particular cases of EU retrenchment whilst not being able to find any generalisable laws for international relations (cf. 1997:515, 1993:476), which he saw as lacking.

This would also fail his second test of rigour and coherence, where a theory had to be clearly outlined in its scope and applicability. Rather than coming up explanations for why a special case wouldn't follow the general rule, the researcher should come up with a better set of rules (cf. Moravcsik (1997:516).

The third test would be whether the theory stood up to empirical scrutiny in relation to other theories (Moravcsik 1997:516). Moravcsik had observed several failures of the neo-functionalist approach and argues that the liberal intergovernmentalist approach had a stronger explanatory power on these issues (1993:476).

The last test is that of multicausal consistency. Moravcsik was adamant that liberal theory should not be used as a second order theory in relation to realism or institutionalism. Rather, he posed, it should be the other way around (Moravcsik 1997:516). Liberalism should be the systemic explanatory theory where other theories should be applicable to solve certain situations within the theory but still being adherent to its overarching assumptions.

But what are the assumptions of liberalism? The first would be 'the Primacy of Societal Actors'. Liberalism poses that any change in society or policy must, by definition, have an actor behind it – driving that very change. Liberal intergovernmentalism also holds that any society, be it a society of states or within the confines of a state, is an aggregate of these individual actors (cf. Moravcsik 1997:516-517).

These actors are on average value maximising, rational and risk adverse and organise themselves to solve trade and collective action problems despite having conflicting values, variations of influence and facing material scarcity. This is perhaps the most fundamental assumption of liberalism and betrays its foundation in economic theory. The fundamental unit of investigation is always the individual actor who ranks their preferences in order to maximise value and have negotiation 'games' with other actors in order to pursue these preferences (Moravcsik 1997:517). This also outlines the clear conflict with constructivism (above) since the actor's preferences are taken as a given and is inherently unchangeable although their strategies for achieving these preferences may change given a change in their environment.

This also leads the second assumption – that states (or other political entities) represent a subset of the domestic society. The preferences of this subset in turn shapes the preferences of the state and the state will act purposively in order to pursue these interest (Moravcsik 1997:518).

As we can see the second assumption is in line with the first, if society is the same as an aggregate of actors, it follows that the society would pursue the aggregated interest.[5] This does not necessarily lead to states acting in what can be perceived as their 'objective self-interest' however, as the coalitions necessary for meeting the collective action problem of governance might lead the state to

[5] This, naturally, assumes a liberal democracy such as the EU member states. However, it doesn't exclude autocratic or fascist regimes since it allows for a difference in the influence of actors. In order to study these cases one must be more narrow in one's approach (Moravcsik 1993:518).

concede points on its international agenda in order to appease a coalition members domestic interests (cf. Moravcsik 1997:519).

The third and last assumption of liberal theory is that the configuration of interdependent state preferences determines its behaviour. This speaks to how states act in relation to other states on the international arena. Rather than seeing this a confrontational power play, liberal theorists argue that although there are situation where states coerce each other (where the dominant group in one country seeks to benefit at the loss of a dominant group in another country), in many situations a mutual cooperation and exchange might provide net benefits in both countries and will be solved through agreement rather than conflict (cf. Moravcsik 1997:520-521). But countries are not simply uninformed of other countries preferences and might therefore choose to pursue an agenda that isn't in line with its first choice in order to ensure that it might still reap some benefits from an international agreement if they evaluate their own relative power to be too weak to pursue its first. Thus liberal theorists claim to have a better explanation for international relations than realists. One cannot simply look at the actions of a state a say that it 'lost' or 'won' but one must look at the preferences of that state to see if a conflict would mean a bigger cost to the state than conceding a minor point and thus move further from its first preference (cf. Moravcsik 1997:523).

What does this mean for the study of European integration? Moravcsik applied these assumptions on the integration of EU through the theory of liberal intergovernmentalism where the 'liberal' describes the formation of state preference formation and the 'intergovernmental' describes the political bargaining between the actors. Here he views member states as the primary actors that facilitate the interests of societal coalitions that bargain amongst each other in order to meet their preferences by maximising utility and minimise cost (Moravcsik 19913:480-481).

2.1.6 Historical Institutionalism

Historical institutionalism started up as a response to two varied approaches on study of institutions. First it took a stand against the polarising perspective of rational-choice institutionalists and their unquestioning use of the principal-agent model in explaining the actions of institutions. Secondly it opposed the focus on informal modes of decisions and norms asserted by constructivist scholars

Rather than accepting any of these approaches it settled somewhere in the middle, agreeing with rational choice theory on the importance of the framework for an institution but also conceding to the constructivist point that institutions themselves should be a subject worthy of study (Pollack 2015:19). Historical institutionalist start with a fundamental criticism of the perspective that institutions as arbiters of the eternal will of their creators (Pierson 1996:131). Historical institutionalist would stipulate the function and logic of the principal-agent framework as the origin of any institution. The principals (state actors) seeks to win an advantage by lowering transaction cost and thus sets up an agent (institution) to facilitate their internal affairs. However, the historical institutionalist doesn’t see this as the end, rather its sees this as the birth of a new political actor (Pierson 1996:139). As Moe (1995:121) puts it:

> A new public agency is literally a new actor on the political scene. It has its own interests, which may diverge on those of its creators, and it typically has resources – expertise, delegated authority – to strike out on its own should the opportunity arise.

This has been especially problematic within the EU as member states has sought to create new institutions for long term cooperation were some amount of discretions have had to be left to the institutions themselves as they would face situations unfathomable for their creators (cf. Pierson 1996:137). The problem of these ‘unforeseen consequences’ has been exacerbated by the ever deepening of the union. Suddenly an old actor is presented with linkages to new EU institutions that all have their own mission and agenda. This ‘issue density' has been linked to two distinct problems for the institutions within the union. First the overload problem where member states are simply unable to keep up with the increasing complexity of European decision making. Secondly the problem of spillover, which I’ve discussed briefly above, where a new policy or institution demand a change in previous institutions in order to work (Pierson 1996:139). This has perhaps been most visible with the increasing power of the European Court Justice in relation to the member states. It also raises the problem of political ambivalence or change within the member countries. Although a certain government might have negotiated at the formation of an institution, the ‘societal coalition’[6] composing a states government might change over time while the institution remains. This might lead to a situation where a state is ‘stuck’ with a previous deal it no longer agrees with (cf. Pierson 1996:140). But given the uncertainty of domestic power coalitions, a state’s current government might well want to negotiate strong autonomy for their supranational institutions ‘locking them in’ and thus make it hard or impossible for their ideological opponents to change them. This argument holds especially true when taking into account the considerable sunk cost of EU decisions. Although the ‘nuclear option’ of a treaty revision or exit is always on option, a state might think long and hard about trying to wager such a bargain in face of opposition from other countries or the alternative cost of staying out of the union (cf. Pierson 1996:143-145). This also provide an explanation for ‘non-decisions’ by member countries in facing a changing institutional landscape as they would face steep cost in trying to change something previously agreed upon (Pierson 1996:146).

Thus an essential trait for the historical institutionalist perspective is the study of a phenomena over time. At their inception new institutions might well act in the interest of their principals, but over time there might well be instances of ‘shiriking’ or ‘slippage’.

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[6] Using the terminology of liberal intergovernmentalism

I think that this perspective certainly is applicable to the study of European integration and the ECB. Given the historical background of the ECB's inception *vis-à-vi* the European Court of Justice (se background above) I think it would provide an interesting test for the historical institutionalism to use it in the context of economic turmoil and conflict. I also hold that it's a good contrast to the perspective of liberal intergovernmentalism (see above). Rather than exclusively focusing on state actors, the historical institutionalist perspective hold that institutions might become actors themselves. Thus this approach will represent critics of European democracy claiming that integration is driven by a select elite rather than the peoples' representatives (cf. Moravcsik 1993:480-481).

2.1.7 Incorporating the principal-agent framework in integration theories

I've argued above that the theories of liberal intergovernmentalism and historical institutionalism are useful in answering who (the states or the ECB) was the driving force behind European economic integration during the period of study. I find that these theories provide a useful framework of mutually opposing views on the drivers of integration within international relations.

Yet I've chosen to supplement these theories with the principal-agent theory. Why is that, and how will I go about doing it? These are the questions I will seek to address in this section.

What is important to note is that the principal-agent framework is compatible with both of the integration theories I've presented above, at least as a heuristic device in conceptualising the relationship between the principals (states) and the international regimes (agents) they create in order to gain some sort of benefit (cf. Kassim & Menon 2003). Indeed, Moravcsik (1993:507) argues in line with a principal agent framework when he poses:

> Modern regime theory views international institutions as <u>deliberate</u> [my emphasis] instruments to improve the efficiency of bargaining between states [...] EU institutions strengthen the power of governments in two ways. First the increase the efficiency of interstate bargaining. The existence of a common negotiation forum [...] reduces the cost of identifying, making and keeping agreements (...)

Similarly, the historical institutionalist perspective rest on a foundational idea of an existing principal-agent framework, although they hold that one must question the idea of the instrumentality of the decisions within the framework.

> Member states may dominate decision making in these intergovernmental bargains, and actively pursue their interest, but they do so with constraints [...] created by their predecessors. [...] Studying process of policy and institutional change over time reveals that gaps may well be extensive, and the prospect of recapturing lost control are often quite limited. (Pierson 1996:148)

It's also important to note that both liberal intergovernmentalism and historical institutionalism share the basic assumptions of the principal agent theory. They both focus on the primacy of actors, and actions taken by these actors rather than norms. The disagreement lies in the question of who are the relevant actors to study? The liberal intergovernmentalist view is that the only relevant actors in the area of international relations are the states involved in interstate bargaining and that the actions relevant to study is the ends rather than the means of which states negotiate (Moravcsik 1993:481, Moravcsik 1997:522). The historical institutionalist perspective stipulates that states are important actors and are the fundamental source of power, resources and *raison d'être* for any international regime or institution and they form these regimes for their own purpose (Pierson 1996:157). Yet historical institutionalist hold that the regimes (or institutions) may over time acquire an agency and an 'actorness' of their own. Hence one cannot simply look at the actions and 'ends' of the principals but must also look at the actions of the institutions themselves in order to make an accurate interpretation of the actions taken in furthering European integration (Pierson 1996:158).

Both of the perspectives also fundamentally agree on the assumption that actors make rational choices albeit they disagree on the rationale behind the choices made. Whereas the liberal intergovernmentalist perspective would see problems within a principal-agent relationship as a contractual problem – where the agent seeks to maximise rent without providing the service for the principals (cf. Kassim & Menon 2003:127) the historical institutionalist perspective would hold that the agent might well develop an agency and agenda of their own, pursuing interest that are directly contrary to the will of their principals (Pierson 1996:132).

Now that I've established the shared assumptions (albeit with some differences) I would like to discuss the point where the historical institutionalism branches of from liberal intergovernmentalism – the important notion of time. The historical institutionalist perspective agrees with the liberal intergovernmentalists regarding the inception of an institution. As Pierson (1996:157) puts it:

> In principle, important aspects of historical institutionalism could be integrated with intergovernmentalism. Indeed, this article accepts the starting point of intergovernmentalism: member states are the central institution builders of the EC, and they do so to serve their own purposes.

Where the historical institutionalists disagree is the lack of temporal dimension within liberal intergovernmentalism. Whereas liberal intergovernmentalism focuses solely on the initial bargain between state actors (t0) when setting up a principal-agent relationship, the historical institutionalist poses that one must look at a policy process where the institution acts within the frame of its mission (t1) which changes the conditions for state actors when initiating a new grand bargain (t2) (Pierson 1996:148).

I hold that this point of disagreement speaks to the heart of my scientific inquiry. The framework of principal-agent is easily incorporated within both liberal intergovernmentalism and historical institutionalism and in using it in relation to these two theories we focus the inquiry on the drivers of economic integration within the EU – The member states or the ECB.

2.2 Material

There's an inherent problem when studying the problem of integration within the EMU. Much of the deliberations are done in summit behind closed doors, away from public view. Likewise, when looking at the ECB, its decision are taken in secret as is as such not subject to public scrutiny. A way forward could be conducting interviews with decision makers but I judged it improbable that they would provide me access. As such I've been left with analysing secondary sources.

The first form of secondary material has been previous research on the subject. A wealth of research has been done on the changing nature of European politics and integration. This has been useful as tool to establish political positions of various actors before, and in reaction to various polices. I've also looked extensively on speeches and interviews given by Jean Claude Trichet who was the president of the ECB during most of the time studied. These have been accessed from the website of the ECB. I've also looked at several news sources reporting on the politics of the EMU. The good thing about the summits has been that there's always been journalists asking the EU-leaders questions about their decisions, which have been useful in getting a sense of the countries positions. Here I've focused on the reporting done during the period of study rather than later interviews, in order to capture the feelings at the time rather than a (possibly) revisionist view. One might question the reliability of these sources, but the fact that they've painted a consistent picture should speak to their credibility

The problem of my material is obvious. In relying on second hand sources I've been forced to rely on someone else's interpretation and selection selection. It has also forced me to extrapolate what can be of interest for my study rather than being able to ask the precise questions myself. It may also be that people are lying, either to promote an agenda or protect themselves from criticism.

Yet, with one clear exception that I will discuss below, I think it's reasonable to assume that the actors have been stating their position accurately.

When discussing the content of a policy, I've looked at sources form the ECB, the European Commission, the EFSF and the ESM. I've no reason to question the veracity of these primary sources.

The extensive use of secondary material might seem unconventional but, given the limited access researches have to primary sources, it has become common in the study of European integration (e.g. Howarth & Quaglia 2013, Quintyn 2008, Gocaj & Meunier 2013, Jones 2009, Salines, Glöckner & Truschlewski 2012).

2.3 Methodology

This paper is a historical case study on the nature and causes of European economic integration (Yin 2009:11). As I've described above, the aim of this study is twofold. First it's a descriptive approach, I want to describe what happened and how it happened. This part of the study is relatively unproblematic. The main thrust, or claim of relevancy, of the study is not that it's unearthing any new or ground breaking material from the period but rather looking at the evidence we have at hand from a new perspective that can provide additional insight to a problem that is both interesting from a theoretical and a societal perspective. The second part of the study is that of *explaining the cause* of the integration. Here I employ a theory testing design (Yin 2009:37-38). By analysing the descriptive part of the study with the theoretical perspectives of liberal intergovernmentalism and historical institutionalism I hope to test their explanatory power.

The conclusions reached from this type of study may strengthen or weaken the theories claim to relevance (cf. Esaiasson et. al 2012:39). My goal has been to set up the analysis close to, if not actually, a best case scenario for both of the theories and as such provide them with every opportunity to succeed. Given that this is an 'ex post' study we already have the *explanandum* as a given from the descriptive part of the study, the thrust of the study will be to test to causal mechanism, or story, presented by the theories against reality. As I've argued above I will use the principal-agent framework in order to isolate this difference between the theories. I argue that this is useful in two ways. Firstly, it limits the scope of the inquiry. Since my scientific question concerns whether institutions play a role as actors in European economic integration, it follows that one must focus on areas where institutions might play a role in relation to its principals. Secondly it highlights the differences between the two theories. The liberal intergovernmentalist theory states that international regimes are created in order to gain benefits for the principals, and will act according to their will (Moravcsik 1993:507). In contrast the historical institutionalist perspective holds that institutional actors may over time develop agency and put constraints on their principals (Pierson 1996:132).

These two benefits are advantageous in that they allow me to focus on the areas of disagreement. When looking at the empirical reality *I will focus on the nature of the action in relation to the contract between the principal and the agent, and what actor(s) take that action* (Yin 2009:42).

It's important to note that the theories of liberal intergovernmentalism and historical institutionalism have different ontological claims. As I've noted above, liberal intergovernmentalism claim that states are *the only* actors relevant in the study of European integration. Historical institutionalist theory doesn't go quite as far. Its claim is that institutions *may under some circumstances put constraints* on states. Indeed, as I've noted above, historical institutionalist theory grants the basic assumption of intergovernmentalism, that state are the prime movers and created institutions to serve their purposes (Pierson 1996:157). As such they have different *burdens of proof.* Liberal intergovernmentalism must prove that states are the *only* actors relevant for international relations while historical institutionalism only must prove that institutions *sometimes or in some way* put constraints on states.

In operationalising the causal story of liberal intergovernmentalism, I will look for indicators of principal (state) control over the economic integration of the EU. To paraphrase Moravcsik – member states will only accept EU control if it strengthens control over domestic affairs (Moravcsik 1993:507). In operationalising the causal story of historical institutionalism, I will look for 'mission drift' or 'slippage' from the agent along with institutional constraints on the principals as positive indicators for the theory.

A problem remains, namely the number of principals involved in the creation of European institution. A more exhaustive study might be able to look at all of the principals but the scope of this paper will limit me to a select few. I've strategically chosen to focus on two state actors: Germany and France. These actors are chosen on the basis that they should be able to provide the best opportunity for the liberal intergovernmentalist theory to hold true.

Germanys chosen since it's had a unique role in shaping the economic institutions of the EU while being its biggest economy (Moravcsik 1993:501, Zimmerman 2015:71). The choice of France is twofold. It is one of the few countries that is close to Germany in influence (Naurin & Lindahl 2014:62), and it's been a country arguing that EU member countries should take a more active role in economic governance (Majone 2010:167). These countries represent the core of the EMU and have both been active in the creation and management of previous EU institutions.

Having established my choice of state actors I must also argue for my choice of ECB as the agent for the inquiry. I hold that the ECB is the perfect agent in this study, not only because it has such a central role in economic governance but also as it's used as a model for other agencies (cf. Quintyn 2009:275-276). Independent central banking is perhaps the truest political equivalent of principal-agent relationship in economics. The normative justification for placing such amount of power on central banks perfectly follows the principal-agent theory. Politicians are unable to set good economic policy, and be perceived as legitimate by the market, since they lack the skills of economic governance and are subject to electoral whims (Jones 2009:1085-1086, Hall 2008:138).

Further still, armed with the knowledge of the extensive 'ex ante' controls of bank (se above), we know that the ECB's mission as an agent is of a limited scope and should as such be more resistant to 'mission drift' or 'slippage'. One might disagree here and claim that the best agent to study would be the European commission since it's tasked with representing the common interest of the union. Although this certainly would be interesting, I hold that article 17[7] of the Lisbon treaty would make this hard. The vagueness of this article makes it hard to isolate

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[7] Article 17 states, in part, that 'The Commission shall promote the general interest of the Union and take appropriate initiatives to that end' (Eurlex b).

what would be considered 'mission drift' and what should be considered the appropriate actions of the commission in relation to its principals.

It should also be noted that this is a case study. Even though I'm interested in the economic integration during the whole period of 2010-2012, I have limited my investigation to a few strategic cases.

The cases I've chosen are the SMP (2010), the EFSF (2010), the TSCG (2012) and the ESM (2012). These cases are selected since I want to capture the entire spectrum of possible cases of interactions between the ECB and the member states. The SMP and the TSCG was chosen since they were cases that formally involved only one part of the principal-agent relationship. The SMP was programme launched by the ECB, while treaty changes are the domain of member states. The EFSF and the ESM was chosen since they involved both the principal and the agent. The EFSF and the ESM was also meant to fill very similar functions and should as such provide an opportunity to study the temporal aspect of policy making (Yin 2009:54-55).

I pose that in choosing these formative moments of action, one can capture the temporal aspect that is so crucial to the historical institutionalist perspective. Further, this provide that opportunity to capture important aspects of the agent vis-à-vi the principals. The plurality of regimes should provide opportunities for both issue density (as result of unintended consequences) and sunk cost constraints on principals (when the previous institutional arrangements are used as a starting points for something new) (cf. Pierson 1996:137, 144-145). I've chosen here not to include the European Financial Stability Mechanism as did included countries outside of the EMU and as such wouldn't isolate the relationship between the ECB and the member states of the monetary union.

Given the choice of principal actors (Germany and France), the agent (ECB), and the cases (SMP, EFSF, TSCG and ESM) I argue that both theories are given a fair chance of success which should strengthen this study's claim when evaluating the explanatory power of liberal intergovernmentalism and historical institutionalism.

Below I will evaluate each of the cases separately, but not unconnected. This means that I will analyse each case on its own, but where necessary and prudent make references to previous or later policy changes.

3 Analysis

This part of the thesis will be my empirical investigation of the two questions of my thesis ‘what was the scope of the change’ and ‘how can we explain the change. I will analyse each case on separately and chronologically, starting with the SMP and ending with the ESM. When looking at each case I will start by explaining the nature of the integration and how the change was made. This is to capture the extent of the change as well as how the actors were involved in the change. Following this will be a brief summation on who made the decision. Finally, I will analyse the change in each of the cases using the theories of liberal intergovernmentalism and historical institutionalism. This is done to test their explanatory power on the case analysed.

3.1 The Securities Markets Program

3.1.1 What happened and how did it happen?

On the 10th of May 2010 the ECB issued a somewhat surprising press release concerning a response to the economic crisis of Europe. The ECB proclaimed that it would start intervening in the *public* and private dept securities markets within the Eurozone.

Arguing for the move, the ECB referenced the ‘exceptional circumstances prevailing in the market’ and assured that it would not ‘affect the stance on monetary policy’ (ECB b). The ECB also took note of the Euro area governments[8] statement that they would ‘take all measures needed to meet [their] fiscal targets (…) and of additional commitments taken by some euro area governments to accelerate fiscal consolidation and ensure sustainability of their public finances’ (ECB b). Following this a decision was made to establish the Securities Markets Programme on the 14th of May (ECB a). This move was a surprising move by the bank as it included *public* dept. The acquisition of public dept had been expressly forbidden in Article 123 of the ECB’s governing treatise (Eurlex b):

[8] I would argue that this likely is referencing proposed austerity measures in the PIGS countries.

> “Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as ‘national central banks’) in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited [my emphasis], as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments.”

So was this move a case of ‘mission drift’ (cf. Elgie 2002:188, Pollack 1997:108)? It’s certainly an interesting question and doesn’t have a clear answer. As I’ve alluded to above, the primary mission of the ECB is maintaining price stability (Jones 2009:1093, Tuori 2013:145) and this shines thought when explaining the decision:

> (…) in view of the current exceptional circumstances in financial markets, characterised by severe tensions in certain market segments which are hampering the monetary policy transmission mechanism and thereby the effective conduct of monetary policy oriented towards price stability [My emphasis] in the medium term, a temporary securities markets programme (hereinafter the ‘programme’) should be initiated [….] The programme’s objective is to address the malfunctioning of securities markets and restore an appropriate monetary policy transmission mechanism. (ECB a)

In light of these exceptional circumstances the bank proposed the unprecedented action:

> Under the terms of this Decision, Eurosystem central banks may purchase the following: (a) on the secondary market [my emphasis], eligible marketable debt instruments issued by the central governments or public entities of the Member States whose currency is the euro; and (b) on the primary and secondary markets, eligible marketable debt instruments issued by private entities incorporated in the euro area.

This is undoubtedly an interesting argumentation by the bank. First it argues that because that a changing reality has forced it to undertake new action (they purchasing of public debt), but rather than purchasing it outright it would do it on the secondary market. Why is this important? I hold that it shows the agent (ECB) in following the will of the principals (the member states). Two aspects of its mission, the maintaining of price stability and ‘no bailout clause’ where at odds. The ECB must certainly have been conscious of the fact that it could be perceived as acting in violation of Article 123 and sought to alleviate this perception by limiting its purchases to the secondary market. In practice this would have limited effect as it allowed private actors to rid themselves of perceived toxic public debt on the secondary market. This caused the ECB to rack up debts government debt to the value of 211 billion Euro[9] in the first fifteen months of the SMP (Gloggnitzer & Lidner 2011:47). It should be noted however, that the ECB acted in accordance with its claim and sterilised the debt purchased by selling of other financial assets in order to avoid quantitative easing, and as such maintained the goal of price stability (Belke 2010:359).

Although this kind of exposure might seem out of place for the ECB, I would argue quite the opposite. I pose that this was a case of 'path dependency' where the ECB acted in line with its previous handling of the so called Target2 accounts (Pierson 2000:264). The Target2 accounts had been intended as a mean of effective transfer of capital within the euro zone as the countries adopted the Euro (Scheller 2006:100-101). But as the financial crisis of 2008 hit Europe the Target2 accounts came to be used as a transfer of capital from central banks in the rich part of Europe to the poor (Szécsényi 2015:342). Thus the rich countries of the Euro zone where already exposed to financial failure in the poor, and this had happened largely without complaint from the principals.

ECB's decision to start purchasing government debt on the secondary market had three big consequences for the principals. First it exposed them to a substantial amount of risk as a large portion of the ECB's stable assets where replaced by potentially toxic government bonds from countries in deep financial crisis. Since the ECB was a shared venture between the EMU countries, it effectively gambled the financial future of its principals on the financial stability of the PIGS countries. Should the ECB become insolvent it would certainly hurt the Euro (and in turn the principals) as the market would depreciate the value of the currency in anticipation of less stability oriented policy (cf. Bindseil, Manzanares & Weller 2004:27-30).

Secondly it provided a huge transfer of funds between the member countries as the alternative cost for purchasing the risky bonds (while sterilising the purchase through selling of safe bonds) is the indirect relative price hike of government bonds in richer countries. When choosing which countries bond to purchase it also had an indirect effect of subsidising certain rich principals over others as the rich countries were more or less exposed to the public debt of certain poor countries (Belke 2010:360-361).

The last, but not the least, consequence of the SMP bailout was the changing role of the ECB in relation to certain principals. As I've described above, when issuing the press release about the implementation of the SMP, the ECB alluded to the actions of the governments of Europe. During the crisis, and especially after the introduction of the SMP, the ECB became increasingly involved with fiscal, rather than monetary, policy and went to far as to comment on the policies of individual countries[10] (cf. Salines, Glöckner & Truschlewski 2012:669, Sester 2012:158). I argue that this, together with the fact that it took a (more or less)

[9] This figure would include Italian debt in addition to the PIGS countries
[10] E.g. a letter sent to the Irish finance minister threatening to withhold emergency liquidity funding unless certain policy changes were made (ECB d)

direct role in subsidising public debt in troubled countries must change the way we look at the ECB in relation to the principals (cf. Tuori 2013:159). When acting in relation to the debtor countries the ECB went far beyond the boundaries of what should be expected of an independent central bank. I will discuss the reasons for the decision below.

3.1.2 Who made it happen?

In setting up the SMP the ECB acted unilaterally in accordance with its treatise. Although there's speculation of political pressure on the ECB, the chairman of the bank vehemently denies that this played a part in the bank's decision. One must however look at the context of the decision. As I will describe in more detail below, the bank made its decision just days after a deal was struck between Germany and France to create the EFSF. Had the ECB no known that a deal was in place, and that there would be more liquidity reaching the PIGS countries soon, it's quite possible it wouldn't have launched the SMP.

3.1.3 How can we explain the actions of the relevant actors?

The introduction of the SMP is certainly interesting when looking at the principal-agent relationship of both the liberal intergovernmentalist and the historical institutionalist theory. Although the key decision of starting the programme was made by the ECB there has been speculation that there was pressure from the principals in enacting something of the same effect[11] (cf. Belke 2010:358, Sester 2012:157). When asked by Der Spiegel about this on May 5th, the president of the ECB – Jean-Claude Trichet denied the charge vigorously:

> That is ridiculous! We take our decisions completely independently and have a track record of taking positions contrary to those of the Heads of State and Government – in 2004 in refusing to decrease rates, in 2005 in increasing rates against their wishes, and throughout this period in fiercely defending the Stability and Growth Pact including defending it against the German Chancellor of the time? (…) Was I weak when I informed the Heads of State and Government in full independence that the situation was grave and that they had to live up to their responsibilities? We took our decision on Sunday in full independence. (ECB c)

[11] Reportedly, Merkel went to see Trichet on May 7th 2010 and said 'We have every confidence that you will do what you need to do' (Proissl 2010:30), while Sarkozy screamed 'Come on, stop hesitating!' (Barber 2010).

When asked about internal dispute leading up to the decision[12] Trichet answered:

> I never comment on the statements of other members of the ECB's Governing Council. I will only say this much: an overwhelming majority [My emphasis] were convinced that the decision was right under the circumstances. (ECB e)

What conclusions are we to draw from this? The first thing we can establish is that this was not a trivial move by the agent since the establishment of the SMP led to a significant and clear transfer of wealth, one cannot dismiss it as incomprehensible or incalculable (cf. Moravcsik 1993:494).

The ECB acted with purpose, yet was still (somewhat) bound by the contractual arrangement set up between it and its principals. Even though it took unprecedented action, it still framed that very action in terms of the reason of its agency, focusing on price stability rather than fiscal policy.

So are we to view this as an example of a blatant power grab by the ECB? Did it use its position as an independent agent, the information asymmetry and to put forth its own agenda (Pierson 1996:133)? I would argue no. The ECB was fundamentally opposed to using its resources in a way that involved direct participation in foreign debt markets (Walker, Forelle & Blackstone 2010). I would argue that the decision was rather against the banks interest rather than in line with it. If we view the terms of the principal-agent relationship this would constitute a lot of extra work and controversy for the ECB, thus decreasing its 'rent' (Kassim & Menon 2003:127). I think we can see this as well in the controversy within the ECB. German central bankers would not want to be associated with bailouts and fiscal imprudence.

However, I find it reasonable to conclude that there had been political pressure from the principals, and the agent acted accordingly in response. Armed with this knowledge launch of the SMP would be in line with the liberal intergovernmentalist perspective on a principal-agent relationship. The liberal intergovernmentalist perspective would hold that principal-agent relationships are the result of intrastate bargaining, where any change of the *status quo* would require all members to agree (Moravcsik 1993:501). The member states wish to change the *status quo* can be explained as an effect of the deepened economical interdependence of the Euro area, not the least as a result of the target2 program where German and French banks had significant exposure to the crisis countries (cf. Whelan 2013:498, Szécsényi 2015:342). The member states knew that the failure of acting in response to the crisis would come at a heavy cost for their domestic ruling coalitions. However, especially Germany saw that any departure from the 'no bailout clause' would be politically inconvenient, as it would be hard to explain to their constituents why fiscally responsible Germany should pay for the financial failures of Greece. As such it was convenient for Germany to frame

[12] E.g. The German Representative Axel Weber who had publicly voiced a strong opposition to the SMP and resigned in 2011

the issue as an intergovernmental issue, as to increase its legitimacy at home (Moravcsik 1993:515). The German government couldn't be held accountable for the actions of an independent agency of the EU.

How are we to view this form a historical institutionalist perspective? As I've argued above, I don't think that despite its controversial nature, the SMP should not be considered as the ECB acting in order to increase its influence. Rather I think the opposite. I thought the ECB was unable to withstand the pressure from its principals despite its independent nature. This is not to considered as evidence against the historical institutionalist perspective however as it recognises that states are the primary actors and that if they are steadfast in their policy the agent will have to bend to their will (Pierson 1993:142). The bank did however use its position as an independent agency in a more covert way to influence the member states. The ECB wanted monetary stability in the Eurozone and wanted to push policy makers to achieve it. As such, it waited to announce its decision of launching the SMP until after they knew that the EFSF (that I will discuss below) would be launched. It effectively used the information asymmetry and status as an independent agent to leverage its policy ambitions, effectively holding the member states' politicians hostage by not acting until they'd come up with a new common policy. As such, I see the ECB displaying certain sings of 'actorness', and could be considered an example of 'mission drift' (Pierson 1996:132, cf. Elgie 2002:188, Pollack 1997:108).

We can also see the SMP as a factor of path dependency. When launching the third stage of the EMU, the member states could hardly have anticipated that a the Target2 system (designed as a system for sending money between banks in the union (Scheller 2006:215) would be used for bailing out crashing economies (cf. Whelan 2013:498, Szécsényi 2015:342). The previous institutional relationships between the principals represented a 'sunk cost' and put constraint on the member states in handling the crisis, effectively limiting their options (Pierson 1996:146).

As we can see one can find empirical support for both of the theoretical approaches presented above, and I will expand on the relationship between the ECB and its principals below.

3.2 The European Financial Stability Facility

3.2.1 What happened and how did it happen?

As I've described above, there was a growing consciousness and concern about the effect the financial crisis would have within the union among European leaders. The only politically controlled framework for alleviating financial turmoil within Europe available before the crisis had been the Medium-Term Financial Assistance (MFTA). This facility had was regulated in Article 143 of the treaty of the function of the European union (Eurlex a) and provided the European Commission with the possibility of seeking mutual financing for loans to EU countries (Commission a).

During the first year of the crisis the MFTA successfully supported Latvia, Hungary and Romani, but it would it would prove ineffective dealing with the PIGS countries as they were member of the Eurozone and as such was forbidden to access the facility (Hodson 2015:177, Salines, Glöckner & Truchlewski 2012:675).

Given the the fact that Greece was rapidly facing default, and unable to to help save it during current regimes, the Euro countries helped finance Greece through *ad hoc* solutions such as bilateral loan agreements involving Eurogroup countries, and the International Monetary Fund (IMF), an agreement taken in concert with the European Commission and the ECB (Commission b). However, the Greek loan facility proved ineffectual and there was a need for EU leaders to take action. But what action was to be taken?

There had been a long standing disagreement between Germany and France concerning role of political control over financial governance of Europe (cf. Friend 2001:74-75), particularly the ECB, and this cleavage was once again evident in the negotiation for a new financial regime.

France initially proposed a bailout plan for the Euro countries without outsider influence, fearing that the reaching out to the IMF (dominated by the USA) would decrease European prestige and autonomy. Merkel refused this as she recognised that Germany would be expected to be the largest contributor of foundering for the new stability facility, as well as fearing domestic legal challenges against any deal that could be considered too onerous (Hodson 2015:177, Barber 2010).

Several options were discussed for dealing with the crisis. An extension and expansion of the bilateral loans was ruled out since the national cost for any loaner country would prove too costly. There was a discussion of a European monetary fund or European debt agency but it was decided that this would require a treaty change in order to not violate the 'no bailout clause' (Gocaj & Meunier 2013:242). The European Commission proposed that it would back at EU facility that would sell bonds backed by member states. This gained support by France but got rejected by Germany (Gocaj & Meunier 2013:243, Charlemagne 2010). The final options, and the one that eventually one, favour was to create a so called 'special purpose vehicle', a legal entity for a narrow and specific cause. As such the principals could avoid losing direct control to the agents Gocaj & Meunier 2013:243).

A deal between the countries was finally reached on the 9th of May 2010. Germany would agree to the creation of a mutual European financial support regime for Euro countries, while France would accept the involvement of foreign help from the IMF (Hodson 2015:177).

The EFSF was created as a limited liability company incorporated in Luxembourg with the 16 Euro countries as shareholders. The scope of the EFSF was broad. In addition to to providing direct loans to financially troubled countries by the issuing of bonds, it was to intervene in primary and secondary debt markets and support recapitalisation of financial institutions (EFSF a). It's important to note though, that despite the EFSF's curious status as a corporation, the EFFS's board of directors was not limited to the Eurozone countries but included the European commission and the ECB (EFSF b). The announcement of the EFSF also portrayed the significance of this:

> For the purposes of this support, the euro area Member States entrust the Commission, where appropriate in liaison [my emphasis] with the ECB, with the task of:
> (i) negotiating and signing on their behalf after their approval the memoranda of understanding related to this support;
> (ii) providing proposals to them on the loan facility agreements to be signed with the beneficiary Member State(s);
> (iii) assessing the fulfilment of the conditionality laid down in the memoranda of understanding;
> (iv) providing input, together with the EIB, to further discussions and decisions in the Eurogroup on EFSF related matters and, in a transitional phase, in which the EFSF is not yet fully operational, on building up its administrative and operational capacities. (Council a)

Although not having any voting rights, I hold that the addition of the ECB among the board of directors is of some importance. The wording 'in liaison' has some significance that reaches further than ECB's usual role as a consult (cf. Sester 2012:170-171). As such it would help evaluate request for financial assistance and advice on terms for the loans given by the EFSF. That would include matters of financial, rather than monetary policy and should be considered to fall outside the scope of the ECB's mission.

The ECB was anxious to see the the EFSF up and running. The SMP had already started melting away the at ECB's and Trichet as early as July Trichet pushed for the EFSF to start buying bonds and thus decreasing the cost for the ECB's SMP (Gocaj & Meunier 2013:247). Yet the EFSF did not become fully functional until August 2010. By this time nearly all of the promised assets had been confirmed by the member states and the EFSF had control over 440 billion Euro (Gocaj & Meunier 2013:246). The contributions to the EFSF had been made to correlate with the Euro countries share in the ECB (EFSF a). A country could apply for assistance by the EFSF when had no possibility of gaining access to capital markets or 'has to pay excessively high interest rates', but in order to receive financial aid there would be a negotiation with the between the debtor, the European Commission, The ECB and the IMF regarding the terms of the loan. Having negotiated this, the loan had to meet final approval by the finance ministers of the Euro group (Gocaj & Meunier 2013:246).

The EFSF however was not successful in stabilising European markets. The fund was initially targeted nearly twice its size, but the nominal amount was decreased in order to secure a AAA credit rating (cf. Peel & Atkin 2010, Gocaj & Meunier 2013:247). As the relatively small size of the fund together with the EFSF's temporary mission did not win the confidence of the markets (Atkins

2010) and thus began the new negotiations leading up to the ESM that I will describe below.

3.2.2 Who made it happen?

Although the ECB had strongly urged the member states to take some form of comprehensive action (cf. Barber 2010), the decision to launch the EFSF was certainly taken by the principals themselves as they sought to alleviate the crisis within the Eurozone. Recognising that the ECB couldn't sustain the economy of Europe through the SMP the member states negotiated a common response to the debt crisis.

3.2.3 How can we explain the actions of the relevant actors?

As we can see there was a great build up learning to the creation of the EFSF. The initial Greek bailout had failed to stop the country from plummeting even further towards financial ruin and the bond markets for Ireland and Portugal was looking weak. There was an emergency meeting for the EU finance ministers in Brussels the 9th of May, and taking part in the meeting was ECB president Trichet.

If we look at this meeting from a liberal intergovernmentalist perspective, we can identify several key factors. Since both Germany and France shared a currency with Greece as part of the EMU, any Greek default would surely have a disastrous effect on both countries. This kind of effect, where a policy (or lack thereof) in one country create costs in another is called 'international policy externality', is a main factor for political cooperation according to liberal intergovernmentalism (cf. Moravcsik 1993:485). But what action was to be taken? As I've described above, there was initially a great deal of distance between the positions of Germany and France. France wanted a stronger EU control over fiscal policy while Germany wanted to limit its liability. However, as actors are perceived to be rational, any bargain that was to be made had to fall within the 'winset' of both actors as both had a *de facto* veto over any action taken. This drives the agreement to the lowest common denominator – being a 'special purpose vehicle', which required no further treaty change (cf. Gocaj & Meunier 2013:243), Moravcsik 1993:501).

The fact that the EU was the forum for the negotiations, could be explained by the fact that their familiarity increased the efficiency of bargaining. As could the new role of the ECB in the EFSF. If you already have a principal it's unnecessary to create a new one *ad hoc* (cf. Moravcsik 1993:508).

Using a historical intergovernmentalist approach we see different patterns in the decision making. The ECB's role before, and during the negotiations certainly seems like an actor rather than an agent. Trichet had been advocating stronger fiscal discipline within the Euro countries, and did not reveal the start of the SMP until after he knew of the principals agree on a new bailout programme (Barber

2010). As I've discussed above, the ECB was able to effectively hold the Euro countries hostage (cf. Pierson 1996:139).

The ECB also increased its influence on fiscal policy as a result of the EFSF. In the SMP programme it only had the ability to withhold liquidity by refusing to buy public debt on the secondary market. Under the EFSF the ECB would be responsible for negotiating the bailout deals with all countries applying for assistance, and as such gained a much more active role in shaping European policy (Schwarzer 2012:34). This could also be considered 'spillover' from the ECB's role in the previous Greek bailout as well as MFTA (Pierson 1996:139).

The EFSF was an interesting, albeit short lived regime in European economic integration. I hold that the creation of the EFSF must be seen in relation to the SMP and that these two programmes must be seen in relation to one another. The SMP would likely not have been launched without had the ECB not been assured that the member states would try to stabilise the bond market shortly thereafter. Once the SMP was launched, the member states had to follow through with the EFSF (and later ESM) as they couldn't accept loosing total control over fiscal policy in the EMU to an agent, nor having the ECB become insolvent. Once the ball was rolling there was simply too much sunk-cost to withdraw from the plan (cf. Pierson 1996:145).

Below I will discuss how the EFSF stopped being and evolved into the ESM, and how European economic integration grew even closer.

3.3 The Treaty on Stability, Coordination, and Governance in the Economic and Monetary Union

3.3.1 What happened and how did it happen?

Following the failure of the EFSF to stymie the economic crisis in the PIGS countries the European leadership was in flux. Even though the union and its agencies had taken hitherto unprecedented steps through the SMP and the EFSF, making the 'no bailout' policy more a suggestion than a rule (cf. Zimmerman 2015:71, Streeck 2015:370), there was a continuing downward spiral for the European economy (Varoufakis 2013:61-62).

The ECB had proposed a more unified fiscal policy and was part of shaping this unification through its work with the 'troika' in crisis countries (ECB F). This work however was done on an *ad hoc* basis and was limited to the countries seeking financial aid. There was a sense that a more comprehensive approach was needed (Schwarzer 2012:36). When asked about whether more integration was necessary to avoid future crisis on July 8th 2010 Trichet was certain:

> We must, in particular, be able to go as far as possible, without necessarily changing immediately the Treaty, notably with regard to very early surveillance, almost automatic sanctions, and the strengthening and extension of sanctions so that the euro area has the equivalent of what we would have if we were in a fiscal federation. (ECB f)

What we can see here is that Trichet is somewhat hesitant to go all the way and call for a treaty revision, yet is clearly in favour of political change. This hesitation is understandable as the member states had yet to make up their mind.

The discussion of stronger political control over a fiscal union was already happening among the member states. This was not a new debate. As I've alluded to above, France had been a long-time proponent of a more centralised approach to European fiscal governance. However, the roadblock to change had always been Germany (Friend 2001:74-75).

Ever since the creation of the EMU, there had been questions raised whether a monetary union would be possible without a financial union (Alvater 2015:36).

However, Germany had always been sceptical to such a proposal. The country had traditionally been concerned with handing over too much power and responsibility to the EU, as it sensed that this could lead to a *moral hazard* where countries no longer felt obligated to control their finances (Dullien & Guérot 2012:3-4, Howard & Quaglia 2013:111). However, the financial crisis has caused a shift in German thinking (Dullien & Guérot 2012:5-6). The was a recognition that the Euro couldn't be saved without increased political convergence and control. At the same time Germany didn't want to assume unlimited responsibility for the public debt of the other EMU countries. The leaders of France and Germany met to discuss a new deal in Paris in the fall of 2010 and a compromise was made. France agreed to drop a proposal of mutual Eurobonds and support Germany's proposed change to the EU treatise. In return, Germany would allow the setup of a permanent bond buying programme under the EU (The ESM, which I will discuss below), as well as its demand that breaches against the fiscal goals of the Stability and Growth Pact would be sanctioned under the European Court of Justice (Charlemagne 2011).

The deal was presented to the rest of the EU shortly thereafter at a summit meeting. The proposal was strongly criticised by the ECB president Trichet as he saw it as step backward from a stricter proposal from the European Commission (Emmanouilidis 2010:1). In a speech given to a month later Trichet commented on the deal:

> Finally, let me state clearly – also on behalf of the Governing Council of the ECB – that we are not completely satisfied of the proposals put forward by the Commission and the European Council Task Force that should aim at strengthening the system of economic governance in Europe. These proposals in our view do not yet represent the quantum leap in economic governance that is needed to be fully commensurate with the monetary union we have created (…) It is my opinion that in order to pursue these lines of reform we need to give the Commissioner [charged with surveilling compliance with fiscal policy] himself and the Commission services charged with conducting macroeconomic and fiscal surveillance for the euro area the highest degree of independence possible within the Commission, ideally supported by a body of "wise persons" providing external assessments [My emphasis]. (ECB g)

I hold that this speech gives a clear view on the position on the agent vis-à-vi the principal. First it shows how bold the ECB had become in relation to the member states. The mention of "wise persons" is reasonably in reference to the ECB itself being already so involved with monitoring fiscal policy of the member states. This could be seen as an effort to advance its own interest (cf. Pierson 1996:133). Nevertheless, the ECB did not find support for its position.

The passing of the TSCG however was stopped. Since the TSCG had such wide reaching implications, all countries of the EU would have to accept the treaty under EU-law (Article 48 Eurlex B). Britain, fearing for negative consequences for the city of London vetoed the proposal, and the TSCG could therefore not ascend to EU law (Li 2014:47). As such the TSCG was adopted as an intergovernmental treaty among the EMU member states[13] (Li 2014:45).

This did not mean that the treaty had no effect on European integration, or European financial governance. Starting in 2011, there was a strengthening of the rules for economic transparency. The Stability and Growth Pact was amended to require stricter economic goals as well as imposing financial sanctions on member states failing to meet the goals (Schwarzer 2012:36-37).

A ratification of the TSCG was also made a requirement for any country seeking financial assistance from the newly created permanent lending regime ESM (that i will discuss below) (ESM 2014 a).

[13] As well as other, voluntary signatories.

3.3.2 Who made it happen?

The prime movers behind the TSCG was undoubtedly France and Germany. The foundation for the proposal was laid down during bilateral talks between the two countries (Charlemagne 2011), and was later introduced to the other members of the EU (Emmanouilidis 2010:1). Since the decision to make it into EU law was blocked by the British veto the TSCG was established as an intergovernmental treaty[14] for the EMU countries.

3.3.3 How can we explain the actions of the relevant actors?

The establishment of the TSCG was clearly a result of changing preferences among the principals. This falls squarely in line with liberal intergovernmentalist theory.
In a speech given on new year's eve 2010 Merkel and Sarkozy affirmed their position on the importance of the common fiscal policy of Europe:

> Do not believe, my dear compatriots, those who propose that we leave the euro. e isolation of France would be folly. e end of the euro would be the end of Europe. I will oppose with all my might any step back that ignores 60 years of European construction, which brought peace and brotherhood in our continent... Europe is essential to our future, our identity and our values. (Sarkozy cited in Bishop 2011:6)

> Europe has faced a big test in recent months. We have to strengthen the euro. It is not just about our money. The Euro is much more than a currency. Fortunately, we Europeans are unified. A united Europe is the guarantor of peace and freedom. The euro forms the basis for our prosperity. Germany needs Europe and our common currency, for our own well-being and also in order to overcome big challenges worldwide. (Merkel cited in Bishop 2011:6)

Where there previously had been a lack of support for any form of fiscal union within Germany, the new economic situation in Europe had created a shift in preferences in the country (cf. Moravcsik 1993:484).

This shift made it possible for Germany to engage in negations with France in order to create a new cooperation mechanism for fiscal control of the EU. Even though neither country got its preferred solution, the fact that the TSCG was implemented reflects that the actors thought that the treaty was better than the absence of any new rules of economic governance (cf. Moravcsik 1997:523, Moravcsik 1993:501). The TSCG certainly included provisions that both countries had been striving for for a long time (cf. Moravcsik 1993:507). It's interesting as

[14] It should be noted however, that the TSCG is referencing several EU institutions and rely on them for its function. Whether this could be a breach of EU law is uncertain, but the institutions are complying with the ESCG in practice (Li 2014:73-74).

well to note the dual nature of the TSCG both inside and outside the EU framework. The cost for France and Germany to negotiate a deal that would be acceptable to Britain was too high, and as such they chose to have the TSCG as an intergovernmental agreement amongst the EMU countries and creating another layer of difference within the union (cf. Moravcsik 1993:503). Despite this they felt comfortable enough with their position vis-à-vi any potential protest to keep using the EU's common institutions for the TSCG and thus avoiding the cost of setting up any new supervisory function (Moravcsik 1993:507).

The decision of the principals to ignore the objection of the ECB to the treaty shouldn't come as a surprise either. According to the liberal intergovernmentalist perspective, the ECB was merely a forum for interstate cooperation of monetary policy.

Looking at TSCG from the historical institutionalist perspective, we draw many of the same conclusions. The fact that the ECB disapproved of the final proposal doesn't mean that the principals would have to take its objections to heart. While it's true that the need for something akin to the TSCG could be considered an unanticipated consequence of the SMP and the EFSF, the ECB wasn't, and wouldn't be, a party responsible managing a fiscal union (Pierson 1996:136).

The main disagreement between the ECB and the principals wasn't concerning the direction of policy but the extent, thus didn't have the organisational capacity to limit any decision (Pierson 1996:142). The claim of historical institutionalism is not that institutions have absolute power over its principals, only that they under certain circumstances can constrain them. These would not be one of those circumstances. The principals had such an invested interest in the policy change that they tried to make the TSCG into a EU treaty revision.

Finally, a lesson I think is important to note for from the implementation on the TSCG is the reaction of the ECB in relation to the decision. The core of the complaint was concerning the strictness of and sanctions of fiscal policy within the member countries. The ECB, having prior been privy to negotiating deals under the MFTA and the EFSF, kept pushing for more control control over public spending. I argue that this can be an effect of the 'perverse incentives' in the setup of the ECB. Since the ECB's core function had been the maintenance of price stability, and this is how it evaluated policy proposals (Schwarzer 2012:35). This had not been a problem had the ECB not increasingly taken a role in setting *fiscal* policy. When serving in this role the actions of the ECB might have been contrary to the interest of the principals (cf. Elgie 2002:188, Pollack 1997:108).

3.4 The European Stability Mechanism

3.4.1 What happened and how did it happen?

As I've described above, the fall of 2010 saw a grand bargain made between the leaders of France and Germany on the future of the economic governance of Europe (Charlemagne 2011). The deal included a provision of an amendment to the EU-treaty, to more explicitly allow for a permanent institution to help deal with financial crisis in Europe.

This was important for Germany, as it already had a case in its supreme court challenging the existence of the ESFS on the basis that it violated EU-law (in particular Article 125 of the EU treaty (Barysch 2010:2, Eurlex b). This part of the agreement was welcomed by Trichet and he described it as 'enormously appreciated' to have more clear outline on how a bailout mechanism might work (Taylor 2010). This was in line with the ECB's position of supporting the EFSF rather than taking a more active role in the governance of debt itself (cf. Wyplosz 2011:14). The ECB had been pushing for changes for the EFSF as early as July 2010 ECB president Trichet had pushed to expand its scope as well as lowering the interest rates on loans, which was impossible under the the current institution (Gocaj & Meunier 2013: 247). Even thought there was an agreement among France and Germany concerning the creation of the ESM, there was a substantial roadblock. There had been severe pushback from the EU member states in the creation of the Treaty of Lisbon, and during times of economic crisis and substantial political cleavages between member states there was a fear that any mayor treaty revision would be impossible. A compromise was necessary. Rather than pushing for a new treaty of the European Union, the countries sought to amend Article 136 of the treaty of the functioning of the European union (cf. de Witte 2011:6). This was new line of reform had been made possible by the new procedures for treaty amendment included in the Lisbon treaty (see Article 48 Eurlex B). Since the treaty didn't increase the power of the EU, it didn't need to meet full approval of all member states. The amendment was approved by the European council in late 2010, and was ratified by the European Parliament in March the following year (Council b 2010, European Parliament 2011). But the treaty only enabled the countries to create the ESM. The countries wouldn't be able to enforce it within the framework of the EU, as this would have given the EU increased power and require a new treaty of the European union. Given this, the countries chose to make an intergovernmental treaty (much like the EFSF above) in order to secure compliance with the ESM rules. This intergovernmental treaty was signed in the the summer of 2011 by the EMU countries and established the ESM as an intergovernmental organisation outside of the EU framework (ESM a 2012:3, 54). It would however take some time for ESM to come into effect. In order for the ESM the member countries would have to provide capital for the new venture.

At the same time the president Trichet of the ECB had started to put a lot of pressure on the Euro governments to come up with a more effective means of debt alleviation (Sester 2012:169):

> Of course, what we expect is that the EFSF, which will have the capacity to intervene in the secondary markets, will be effective and efficient in its interventions. That would permit us not to have to intervene to help restore more appropriate monetary policy transmission. (ECB h)

This move proved successful as such a provision was implemented in the EFSF as well as the ESM (ESFS e). The ESM began its operations in in the October 2012 and is operated alongside the ESFS as the EFSF is still receiving loan payments (ESM b, ESFS c). Since the ESM was set to replace the ESFS, the EFS stopped its lending operations in July 2013 (ESFS d). There are also provisions in the ESM for assuming the obligations of the ESFS (ESM a. 2012:53).

But what is new about the ESM in relation to EFSF? The most notably difference is off course its permanency. While the EFSF was set up as an emergency measure, the ESM is supposed to support its member countries indefinitely. The second issue is the assets. The EFSF was essentially backed by the guarantees from member states. As such, EFSF bonds could deprecate in an event of financial turmoil among its backers. As I've described above, the ESM didn't become functional until it had raised capital of its own. The ESM has considerable capital of as well as callable capital from the EMU countries (ESM c 2013:9). Part of what made the EFSF so volatile was its guarantee structure. Under the ESFS all EMU countries participated as loaners (related to their GDP) until they became a borrower country and stepping out. This became problematic as countries started applying for loans. Every new country borrower country put increased pressure on the remaining loaner countries as their exposure was increased, causing a ripple effect (Varoufakis 2013:59-60, Wyplosz 2011:12). Under the ESM all countries are permanent members. The ESM is also has preferred creditor status where the EFSF's claims are *pari passu* (ESM c 2013:9).

The institutional structure of the ESM largely follows that of the EFSF. The board of governors are comprised of all the ESM member countries as well non-voting participants from the European Commission and the ECB. Though it is of note that the ECB has a considerably expanded role in the function of the ESM. In line with the TSCG that I've discussed above, the ESM members has to comply with increased fiscal scrutiny from the ECB (ESB i 2011:75).

In the case of a request for financial assistance by a member state, the ECB would be involved directly by conducting a risk assessment for the country and the Euro. Should the ECB find that there was sufficient risk, the bank will negotiate a deal for fiscal reform – a 'Memorandum of understanding'. The new position grants the ECB the final say on the whether a member county has taken acceptable steps and should be granted assistance (Sester 2012:171). This puts the bank in a very prominent position when it comes to European fiscal policy.

The ECB welcomed the decision to create the ESM and immediately started supporting it. The new ECB president Mario Draghi that central bank would support any country that agreed to an adjustment program under ESM by unlimited support through its new Outright Monetary Transfer program, set to replace the SMP (Whelan 2013:496).

3.4.2 Who made it happen?

The decision to create the ESM was part of the TSCG deal between France and Germany. The deal required a treaty amendment in the EU, as well as an intergovernmental treaty among the EMU countries. It is of note that the ECB was active in pursuing the ESM, and promoted the idea while simultaneously lobbied successfully for an expansion of the ESFS.

3.4.3 How can we explain the actions of the relevant actors?

The setup of the ESM gives a perspective of the negotiations among the principals. France would have wanted to see a stronger mutual common commitment to debt, while Germany was worried about a to expansive regime without strong institutional support for a fiscal responsibility (cf. Howarth & Quaglia 2013:111). The agreement fell somewhere in between.

Looking at the creation of the ESM from a liberal intergovernmentalist perspective we can see a clear case of bargaining both among the principals and in relation to the other EU countries. Both Germany and France recognised that something had to be done to the failing EFSF. The setup of the ESFS had resulted in severe problems for the Euro countries, rather than stemming the financial crisis, it could be argued that it deepened it and spread it (cf. Gocaj & Meunier 2013:243, Varoufakis 2013:52).

The German and French position had to be reconciled in order for a permanent crisis control mechanism to be established. France was under considerable pressure from its domestic banks investment and needed a mutual pooling of the risk to withstand further economic uncertainty (Howarth & Quaglia 2013:11. This created a situation of power asymmetry were the Germans could propose stricter control measures and harsher penalties for offenders (cf. Moravcsik 1993:499).

Once the agreement was reached, there was more negotiations ahead. Britain was opposed to any treaty change as it didn't see any gain but had strong domestic opposition against any deepening of the EU (Moravcsik 1993:487). As such, France and Germany had to create an alternative coalition that could be done outside the framework of the EU, as was the case of the intergovernmental part of the ESM (cf. Moravcsik 1993:502-503).

The increased use of the ECB in relation to the ESM could contributed to the fact that the actors saw the need for a competent agent in the supervision of the treaty. As such it was only convenient to use an already known and functional facility as the ECB (Moravcsik 1993:507).

The ESM was also a convenient way for the German government to overcome domestic dissent over European bailouts. Merkel could present the ESM as hard fought compromise and thus increasing its legitimacy (Moravcsik 1993:515).

Studying the ESM from a historical institutionalist perspective would give much the same explanations for the negotiations between the governments, but would add a layer of complexity how the governments came to form those preferences. In particular, we must examine the issue of 'sunk cost'. Since France and Germany already had participated in the EFSF, there was a fear that any lack of continuation along the same lines could spell the end of financial markets in southern Europe. This led to a situation where the France and Germany had saw an increasing cost in non-integration (cf. Pierson 1996:145).

The most interesting part however is the real winner of the ESM, the ECB. The ECB was active during the negotiations and design of the ESM. The central bank had pushed for a stronger intergovernmental response in securing failing markets since the beginning of the financial crisis. Even the expanded role of the EFSF in secondary bond markets had proved unsuccessful and the ECB thought that stronger fiscal control mechanism were necessary for the markets to regain trust in the European economy. The ECB hadn't liked its own SMP program from the start and didn't want to be involved in direct *de facto* bailouts on the debt market. A new fiscal regime would allow the ECB to focus on its core mission of monetary policy.

Yet the ECB didn't want to give up its influence in the setting of monetary policy in the European Union. The ECB saw the lack of fiscal discipline as the core reason for the European economic crisis, and didn't trust that member states governments could meet this challenge. The ESM gave the ECB almost exactly what it had wanted. In the framework of the ESM the ECB would be the deciding actor in granting loan applications from member countries and could conditions these loans on stringent austerity measures. At the same time the ESM would be responsible for any financial measures needed to assure liquidity, allowing the ECB to face out the SMP. From a historical institutionalist perspective, the certainly seems to fall in line with the agency of intergovernmental actors (cf. Pierson 1996:132). At the same time, it was almost inevitable, since the ECB had been active in all the aspects of crisis management and was as such uniquely qualified in dealing with the issues at hand. This should fall in line with the historical institutionalist claim of path dependency (Pierson 1996:145).

Looking at the in the framework of principal-agent theory we can once again identity the problem of 'perverse incentives'. The ECB saw the direct participation in financial markets with the SMP as an unnecessary cost and wanted to get rid of it (cf. Majone 2010:155). At the same time, it had somewhat 'perverse incentives' (Elgie 2002:188, Pollack 1997:108). Knowing that it would be evaluated on its goal of price stability, the ECB lobbied for increased control of fiscal arrangements within member countries that would help it meet this goal. I hazard to claim that having the ECB setting fiscal policy might not always be in the best interest of the principals as they might have other preferences than price stability.

4 Results

In this part of the of the essay i will present the results of the analysis done above. I will start by presenting the nature and extent of the European economic integration during the period of study. I will then present provide an analysis of this integration using the theories of liberal intergovernmentalism and historical institutionalism and explain why I think that one provides a better explanation for the process of economic integration. Finally, I will discuss the the consequences of my study, both in terms of the study of international relations and what it means for the wider public.

4.1 The nature and extent of integration in the EMU 2010-2012

Europe was hit badly by the 2008 financial crisis. While the first countries facing default was in the periphery of the EU, real economic challenges soon faced the heart of the EU when the extent of Greek economic mismanagement surfaced. As the markets lost trust in the European economy several countries within the EMU started experiencing a loss of access to financial markets.

The first response by EU policy makers was sluggish and uncoordinated. Instead of providing a comprehensive strategy for dealing with the PIGS economies, any involvement of the EU was done on an *ad hoc* basis with the signing of small and and bilateral loan agreements (Gocaj & Meunier 2013:241).

The euro countries faced a problem. The EMU had only been set up as a monetary union, and provided no means of fiscal coordination or structure between the member countries. This was something that had been criticised since its inception (Issing 2016:17). Policy makers and academics alike questioned the wisdom and feasibility of having a common currency without political convergence and integration. The reason behind this was a long standing feud between Germany and France. France had wanted a stronger union with more political control over the economy. Germany on the other hand feared that anything more involved would expose German citizens to the perceived irresponsibility of other EU member states. The German economy was going strong and it attributed this to the strong and independent *Bundesbank* as well as its constitutional requirements of balanced budgets and economic restraint. As such Germany could only accept further integration on the condition that it would be overseen on the European level and not be subject to political negotiations. Given the uncompromising stance of the two nations not further action was taken (Friend 2001:74-75).

The untenability of this arrangement became apparent as the bilateral emergency loans to Greece failed to stabilise the economy. Europe wouldn't win the trust of the markets unless its leaders made a show of force. Fearing the wrath of domestic opinion Sarkozy and Merkel tried to pressure the ECB to take stronger action (Proissl 2010:30). This was controversial as any involvement in markets by the bank could be considered a break from its treaty obligation under the 'no bailout clause'. The ECB however seemed unwilling and didn't intervene until it knew that a rescue package was on the way (Walker, Forelle & Blackstone 2010).

In launching the SMP the ECB took an unprecedented role in the European political landscape. The ECB became a *de facto* stakeholder of sovereign debt in the PIGS countries (Tuori 2013:159). However, the SMP was controversial in another way. The rules of SMP interventions were vague and in supporting some markets were one country were more exposed than another it effectively created winners and losers in the economy. This fact was exacerbated by the fact that the ECB, in line with its goal of price stability, sterilised the purchases by dumping bonds from stable countries and thus drying up liquidity in successful economies (Belke 2010:359). The SMP also raised the stakes for the EMU, since a financial collapse in the supported markets would affect the value of the ECB's assets and as such creating mistrust for the euro leading to a depreciation.

Once the die was cast with the SMP, the EMU countries basically had to intervene to save the failing economies or risk a weaker Euro. The initial response, the ESFS was lacklustre. Although it integrated the European economies by pooling risk, the institutional design of the framework caused it to put more rather than less pressure on the economies as the crisis continued (Varoufakis 2013:59-60, Wyplosz 2011:12). The EFSF also institutionalised the fact that the ECB would be part of negotiating economic bailouts to debtor countries, having the bank taking a more active approach in shaping European fiscal policy.

2011 saw a massive political effort to create a more comprehensive European response to the financial crisis. France suffered severe exposure to the financial markets of the PIGS countries through its domestic banking institutions which caused it to be inclined to make a deal with harsher fiscal constraints (Howarth & Quaglia 2013:111). This opened up an opportunity for a grand bargain on European Economic governance with amendments to the Stability and Growth pact and monitoring as well as a convergence on fiscal policy. Part of the negotiations on the deal was also the creation of a permanent institution for crisis control (Li 2014:50). This was an idea heavily championed by the ECB as it wanted to eliminate its direct participation in financial markets and end the SMP (cf. Sister 2012:163). The institutional design of the ESM was another step in the integration of fiscal policy in Europe. All signatories would have to agree to a common framework for economic governance. It also created a common institution with its own financial assets that didn't need to rely totally on membership participation. The ESM didn't automatic sanctions proposed by the ECB but it lent the central bank a more prominent position in setting European fiscal policy. The ECB would, together with the European commission, make risk assessments of countries applying for assistance. Having established a need, the ECB would have final say in loan applications, basing their decision on a ‘Memorandum of Understanding’. The ‘Memorandum of Understanding’ would be comprised of a set of fiscal policies designed to increase competitiveness and stop public deficit spending Howarth & Quaglia 2013:110).

In summation, the European economy was integrated in three ways. It increased the countries liabilities to each other’s economies by pooling risk under the SMP, EFSF and ESM. It converged fiscal policy through the TSCG and the rules under the ESM. Finally, it empowered a common institution, the ECB, to have a more active role in shaping fiscal policy.

4.2 Explaining the integration of the EMU

The liberal institutionalist theory explains international regimes as a result of two factors, demand and supply. The demand side is based on the preference formation of the state. If the ruling societal coalitions in countries want something they shape their states preferences for international regime. The supply side concerns the interstate bargaining, and explains how asymmetric interest and power relations shape the regimes created by those preferences (Moravcsik 1993:482).

Applying this to the economic integration of Europe during 2010-2012 we find apple support for the theory. The liberal intergovernmentalist theory see international regimes as the result of negations between the state principals. States create international institutions to decrease cost of bargaining, and increase efficiency in carrying out common task. This is the classical assumption of the principal-agent theory. Where we could find support for this view is the creation of the SMP by the ECB. The principals wanted such a programme and made their agent create it. Since the governments faced domestic opposition to and ‘bailout fatigue’ they could use the international nature of the ECB to increase legitimacy and externalise political animosity (cf. Moravcsik 1993:515).

We can also see this in the creation of the ESFS. The financial crisis caused international policy externalities in France and Germany, causing a shift in preferences for a common solution (Moravcsik 1993:485). The cost of continuing *ad hoc* solutions in where increasing and as such there was a mutual desire for a more comprehensive solution (Moravcsik 1993:509).

Similarly, the TSCG can be explained in terms of interstate bargaining between France and Germany. France wanted a stronger European framework for mutual fiscal policy and in the light of the dysfunctional economy Germany was provided to accept such a deal provided that it specified the responsibilities of the countries and provided monitoring (Moravcsik 1993:510-511). The existence of the new rules for fiscal discipline was also be seen as a side payment by France to Germany in order to accept their participation in ESM, the new framework for pooling financial risk and provide assistance for Euro countries (cf. Moravcsik 1993:505-506).

The problem with the liberal intergovernmentalist perspective is that it fails to account for the role of the ECB during 2010-2012. The ECB seemed to act contrary to the will of the principals during spring of 2010, only launching the SMP after having learnt of the coming EFSF. Further liberal institutionalism poses that '[EU institutions] is acceptable only insofar as [they] strengthen rather than weakens, their control over domestic affairs' (Moravcsik 1993:507). I claim that the new role of the ECB in evaluating and approving assistance to countries under the ESM should be considered a substantial political risk to the involved countries while the benefits of such an arrangement, in relation to member state control, is negligible.

Although somewhat convincing, and partly true, I pose that the liberal intergovernmentalist perspective lacks some of the nuance provided by historical institutionalist theory. The historical institutional theory provides a framework for explaining the actions of agents in relation to their principals, and the constraint put on principals by their prior decisions (Pierson 1996:148).

If we start by looking at the context of the crisis, we can see that the actors were already heavily involved with each other's economies. The EMU provided an unprecedented link making it impossible for the member states to adopt divergent monetary policy fitting each country. I claim that the SMP, the EFSF and the ESM was the result of path dependency. The countries were already so exposed to one another that there was an exorbitant alternative cost to letting a country fail as this was threaten the whole EMU (Pierson 1996:144-145). The common policy framework was simply the next great bargain between the EMU countries as the recognised the need for greater coherence in fiscal policy in order to sustain the common currency (Pierson 1996:148).

The historical institutionalist perspective also provides a richer perspective of the role of ECB in relations to its principals. The historical institutionalist perspective claims that institutions do have agency of their own (Pierson 1996:132). Yet the ECB did get involved in secondary debt markets, against its apparent wishes. Wouldn't this be contrary to the historical institutionalist perspective? I hold that it isn't as the ECB obviously has some sense of self preservation, and wouldn't be acting directly against the will of the principals (cf. Pierson 1993:142). But the ECB used its autonomy to put pressure on the member states to come up with a solution that was more in line with the ECB's wishes. I don't think it's plausible that Trichet announced the SMP, without telling the principals beforehand *after* the summit deciding on the creation of the EFSF. The argument that the ECB acted of its own volition gains further credence when looking at how the bank acted during the integration process. Constantly pushing for increased powers of the EFSF and the ESM while increasing its own power and promoting its own agenda (Pierson 1996:142). I claim that the ECB was successful in doing so as it had a considerable information advantage in relation to its principals and, because of its involvement in the various institutions as an expert, was constantly considered the natural choice for further institutions (cf. Pierson 1996:137).

But how can we explain the ECB's preferences, why did the ECB push for a more active role in shaping European fiscal policy? I pose that this is fundamentally a problem in principal-agent relationship between the ECB and its principals. The ECB's didn't want to participate directly in markets as this could be considered less strenuous and thus decreased the banks 'rent' (cf. Majone 2010:155). The bank's willingness to take part in fiscal policy can be understood as a 'perverse incentive' for the bank (Elgie 2002:188, Pollack 1997:108). The ECB main mission is securing price stability within the euro zone. As such it knew that that it would be evaluated by its ability to achieve this. In setting fiscal policy the bank could help promote fiscal restraint which would lower inflation and promote price stability.

This gives us a contractual problem in the principal-agent relationship. The ECB contract is set up for an institution exclusively to promote interest in monetary policy and in using the ECB outside this context it will naturally 'drift' from the will of the principals.

I think that there are two main points of contention between a liberal intergovernmentalist and a historical institutionalist perspective on the events that transpired in the economic integration of the EMU 2010-2012. The first is whether the ECB acted in the best interest of its principals in delaying their announcement of the SMP, and by doing this were pushing an agenda of their own. The second is whether the increased role of the ECB in the EFSF and ESM is that of a neutral arbiter providing control for the principals or is a case of path dependency and 'issue coupling' where the ECB a role in setting fiscal policy (Moravcsik 1993, 510-511, Pierson 1996:137).

Given my analysis above, I conclude that the historical institutionalist theory provides a more reasonable interpretation of events.

4.3 Concluding remarks

This thesis has investigated the role of the ECB vis-à-vi the member states but speaks to general issue of political control over common institutions. If the conclusions of me thesis holds true, even institutions designed with exceptionally strong 'ex ante' controls may subject their principals to constraints in setting policy. The ultimate test for the ECB's ability to constrain its principals will be the when the next financial crisis hit Europe. Under the ESM the ECB has exceptional power in relation to countries seeking assistance. Given these new powers a situation could arise where a more powerful principal (e.g. France) was forced to accept financial austerity measures by bankers rather than politicians. Should the ECB be successful in implementing its fiscal policy during such circumstances, I think it would provide strong argument for the historical institutionalist perspective.

European integration and economic convergence might be interesting for political scientist and economists but the most important part of these issues concern the citizens of Europe. The austerity measures of the 'troika' is a lived reality in Portugal, Ireland, Greece and Spain. There's important differences between fiscal and monetary policy. Although somewhat contested, it is the general consensus that independent central banks provide better economic output when looking at price stability (Quintyn 2008:271, Tuori 2013:150). If we agree that this is the only goal of monetary policy, the 'Faustian bargain' of relinquishing political control over monetary policy might well be worth it. Yet, if we extent this logic to fiscal policy we're effectively undermining the the idea of democratic control. Fiscal policy is about the collection and distribution of wealth, something at the core of political debate.

The new role of the ECB reminds me of the story of the scorpion and the frog: A scorpion asks a frog to help it cross a river. The frog hesitates, being afraid of the scorpion's sting. The scorpion assures the frog by stating that they'd both die if the scorpion stung the frog while crossing. Midway across the scorpions stings the frog, dooming them both. When the frog asks the scorpion why it answers 'because it's in my nature'.

The institutional setup of the ECB makes it focus on price stability, and this is how it derives legitimacy from market actors. As such, we cannot be surprised when it evaluates programmes on this basis – it's 'in its nature'. This is why the ECB is such a poor choice of actor in an institutional framework focusing on fiscal policy. The "Memoranda of Understanding" forced upon countries in crisis doesn't only sound 'Orwellian', they are. I argue that the countries of the EMU must rein in the ECB and take responsibility for the fiscal policy within the EU. Granted, there can't be a 'Blanco cheque' written to countries lacking fiscal discipline, but the decision to approve or deny help in times of crisis has to been a political decision subject to public scrutiny and debate. The EU institutions that have the *biggest* effect on the European public can't reasonably be subject to the *least* democratic control.

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