Liberal Intergovernmentalism and the Establishment of the European Stability Mechanism

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Abstract

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

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

1. Introduction[1]

The entire European Integration project was shaken to its core by the sovereign debt crisis in 2009[2]. Both the European Union (EU) and the European Economic and Monetary Union (EMU) suddenly faced severe challenges, which highlighted several problems with the direction of the European integration project. But most importantly the crisis showed the vulnerability of the single currency union without any kind of strict fiscal coordination. The EU has subsequently initiated a series of reforms and adopted measures to try and mitigate the effects of the sovereign debt crisis across the Eurozone countries.[3] Thus, the crisis provided a critical juncture to incentivise deeper financial integration as well as greater fiscal surveillance.

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

Compared with other EU measures to address the crisis, the ESM has two distinctive features. First, the introduction of the ESM required amendments to EU Treaties via national ratification, as there was no legal basis provided by the Lisbon Treaty to create such a permanent rescue mechanism. Second, the ESM is an intergovernmental institution, which means that it

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

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

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

was negotiated, financed and established by the euro member states in the interests of both the Eurozone and the wider EU community. As with any other international Treaty among the EU member states, the ESM became operational only after national parliamentary approval by each euro state.

The crisis and its subsequent management triggered another round of debate among the competing theories of integration. Over the last half century numerous theories based on empirical evidence have been developed to understand and account for the EU project and its process. Among them, Liberal Intergovernmentalism (LI) has gained popularity due to its focus on explaining the intergovernmental negotiations propelling EU developments.[4] LI is a later variant of classical, state-centric intergovernmentalism, privileging the role of nation states and governments in promoting the European integration process (e.g. Cini 2010, 87; Hix 1999, 15). Moravcsik (1991, 1993, 1995, 1998) is generally regarded as the founder of the three-phase LI model, consisting of: national preferences formation, interstate bargains and institutional choice.[5] Moravcsik's LI is distinct from other EU integration theories and approaches in that it can explain and predict both national government behaviour, as well as the negotiated results during Treaty conclusions. Thus, LI appears to be a suitable European integration theory to account for the ESM.

The purpose of this paper is to assess the explanatory and predictive power of Moravcsik's LI model in relation to the establishment of the ESM.[6] Schimmelfennig (2015) has applied LI to the overall Eurozone crisis response and management, and concluded that LI was successful in explaining the general responses. However, this paper will focus solely on the creation of the ESM, and explore the causal chains that built up through the process. It therefore seeks to display how the LI model sheds light on understanding the formation of the ESM, whilst also testing LI against this recent EU evolution, thus developing LI theory further.[7]

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

[5] For a recent overview of LI and its applicability to European integration, see Kleine and Pollack (2018).

[6] The predictive power of other theories of European integration, focusing on the ESM as one of the case studies, is examined in Pan (2014).

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

However, using LI as a theoretical framework does not imply that this approach alone can generate insights into the case to be explored. Our paper simply provides a test to see how well it can account for the establishment of the ESM as an example of a recent, major step in European economic and financial governance.

We will combine the congruence method and process-tracing techniques to examine the validity of the three-stage LI model proposed by Moravcsik in accounting for the establishment of the ESM. If there is any collapse of the causal mechanisms posited by LI, the reasons behind such failures will be explored, allowing for revisions of LI assumptions to further develop LI theory in the context of changing EU empirical evidence.

The paper is structured as follows: section two describes the revised three-stage theoretical framework of LI, its main assumptions and outlines, and its predictions for the establishment of the ESM in the form of several hypotheses. Section three explains the methodology with which the LI model is tested with reference to the ESM. Section four presents case studies and hypotheses tests, examining the extent to which the LI model is effective in explaining the formation of the ESM. Section five briefly details the main propositions and suggested additions to LI theory. The final section summarises the main findings of the paper before coming to a set of conclusions.

2. Revised LI Model and Hypotheses

LI, rooted in neo-liberalism and traditional intergovernmentalism, was developed by Moravcsik (1993, 1995) and it has undergone several phases of revision since its inception. This paper uses this updated theory of LI offered by Moravcsik and Schimmelfennig (2009), in which the LI model is framed as shown in figure 1.

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

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

This general hypothesis is further broken down into eight sub-hypotheses that are based on the theoretical framework outlined in figure 1. The first six are directly linked to the model while the last two sub-hypotheses correspond to the limitations of LI stated in (8) and (9). The sub-hypotheses are framed as follows:

Sub-hypothesis 1: The establishment of the ESM to address the Eurozone sovereign debt crisis reflects the economic interests of powerful domestic constituents.

Sub-hypothesis 2: National asymmetrical interdependence on the ESM determines the relative bargaining power of the nation states, so member states who economically benefit the most from the ESM tend to compromise the most on the margin to realise gains, whereas those who benefit the least tend to impose conditions and drive hard bargains.

Sub-hypothesis 3: The ESM tends to reflect big countries' will rather than supranational entrepreneurship, because EU entrepreneurs rarely possess information or expertise unavailable to the member states.

Sub-hypothesis 4: During the creation of the ESM, nation states make institutional choices to delegate and pool sovereignty to EU supranational institutions so as to guarantee the credibility of intergovernmental commitments towards the ESM.

Sub-hypothesis 5: Member states' credible commitments can be guaranteed and realised via strengthening the national executive, the national judicial branch and/or the very domestic groups that support the policy in the first place vis-à-vis other domestic forces favouring non-compliance.

Sub-hypothesis 6: National non-compliance will happen when an ESM agreement leads to high costs for powerful domestic actors.

Sub-hypothesis 7: The stronger and better-organised (the weaker and more diffuse) representation of domestic societal interests is, the more (the less) predictable and more certain (uncertain) national preferences are, and the better (worse) LI works.

Sub-hypothesis 8: During the creation of the ESM, the Commission and European Council President Van Rompuy exerted influence only because the transaction costs involved were high, domestic interests poorly coordinated and represented, and/or national governments lacked *critical information, expertise, bargaining skills, or legitimacy that the Commission and Van Rompuy could provide.*

Figure 2 illustrates how the constructed LI model will be tested using the case of the ESM. An LI approach will also ascertain the degree of validity of the LI model to account for current EU developments in a new environment. The general LI theory expects the ESM to be a rational choice made by the European leaders, also reflecting the preferences of their country. The commitments and conditions are determined via interstate bargaining which comprises of compromises and interest swaps. The model also predicts that the ESM was established to ensure the commitment of each country, be it a solvent donor country or an indebted one. Furthermore, non-compliance will occur when the costs of complying are high for powerful domestic agents.

3. Methodology

Our paper will use the congruence method and process-tracing to test the validity of LI in explaining the creation of the ESM. The congruence method tests whether a theory is consistent with the outcome of a case, while process-tracing aims at uncovering the casual mechanisms posited by a theory (George and Bennett 2005, 153). A salient feature of the congruence method is that it "does not have to trace the causal process that leads from the independent variable to the case outcome" (George and Bennett 2005, 182). Thus, it is necessary to combine the congruence method with process-tracing, which "attempts to identify the intervening causal process between an independent variable (or variables) and the outcome of the dependent variable" (George and Bennett 2005, 206). Process-tracing provides explanations for the changes in the dependent variable(s) caused by the independent variable(s) (Panke 2012, 129).

4. Case Study of the ESM

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

4.1. Evidence for Sub-hypothesis 1: National preference formation (LI Stage 1)

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

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

France, on the other hand, did not share the same urgency of creating automatism, but rather "tended to side with the southern Europeans who tend to see Germany's demands for strict stability criteria as a nuisance" (Müller et al., 2010). This was unsurprising, given that the French economy was in a rather precarious state and the government itself ran the risk of debt defaults. The then French President, Nicolas Sarkozy was determined to "keep Greece on track" and reluctant to "make the banks foot more of the bill", suggesting a voluntary agreement instead (Alexander, 2011).

The German government faced different pressures from both its voters and domestic industrial giants such as ThyssenKrupp, Siemens and Daimler. German voters were opposed to another round of bailouts, while the big firms urged the German government to protect the single currency which meant keeping Greece in the currency union. Germany needed a permanent mechanism that would address financial and economic crises within the Eurozone, while at the same time limit its liabilities. In support of sub-hypothesis 1, the economic interests of powerful domestic entities had a strong sway on both the French and German governments' decision to initiate the ESM. Germany tried to appease the multinational industrial firms and France made efforts to protect its financial sector.

However, national preference formation transcends beyond pure economic interests. Merkel's Christian Democratic Union (CDU), faced regional elections while Sarkozy was running for presidential re-election. Therefore both had to take voters' attitudes on the ESM into account. In May 2012, Sarkozy was defeated by François Hollande in the French presidential elections, and the latter opposed Merkel's "inevitable" austerity measures to counter the crisis. Hollande also had to prioritise his election promises: to revive the French economy and to counter Germany's 'Fiscal Pact' with his own 'Growth Pact' centred around spending and investment (Poirier, 2012). The advent of the 'Growth Pact' encouraged the Italian Prime Minister, Mario Monti, together with his counterpart from Spain, Mariano Rajoy, to negotiate with Merkel. Domestic political pressure motivated both Monti and Rajoy; both had to push through unpopular reforms at home despite strong domestic resistance. They successfully forced Merkel to make concessions on the rules of governing the ESM bailout fund (Volkery, 2012). Therefore, the national preference formation of each nation, with regards the ESM, was deeply embedded in their respective, domestic, political situations and electoral cycles.

The ESM case suggests a new preference formation mode, exhibiting a mixed feature of both Modes 1 and 2, which can be added as (1c) Mode 3 to the LI model in Figure 1:
Proposition 1: In terms of issues directly related to the fate of the euro and/or the EU, national preference formation is not only based on economic interest calculations, but also carries political considerations on securing the political project which enshrines more than half a century's efforts. ((1c) Mode 3)*

4.2. Evidence for Sub-hypotheses 2 and 3: Interstate bargains (LI Stage 2)

Sub-hypothesis 2 claims that a nation states' relative bargaining power is determined by the extent to which it would benefit from the creation of the ESM. The more a country stands to gain, the more it will be willing to compromise for the ESM. To test this hypothesis, this section will examine the relative expected gains for the major players involved in constructing the ESM.

The Fiscal Compact, the core of the Treaty on Stability, Coordination and Governance (TSCG), was vetoed by the UK at the EU summit of December 2011. This confirms part of Sub-hypothesis 2, as the UK, not being a eurozone member, would economically benefit the least from the agreement. However, despite the relative economic and political strength of the UK, Germany and France did not give in to their demands. The TSCG containing the Fiscal

Compact was meant to complement the ESM; thus, even without the UK, the TSCG can still function for the euro countries. This example gives rise to a further consideration to be incorporated within the LI model: negotiating member states should be within the same block, or else the prediction made in Sub-hypothesis 2 is untenable. This is because the euro block can progress with EMU affairs without consideration of non-euro member states' opinions. Accordingly, a new scope condition for the LI model can be derived:

*Proposition 2: The LI model's second stage (i.e. interstate bargains) works better when the negotiating parties belong to the same block in terms of the relevance of the agreement to them. ((14)**

Sub-hypothesis 2 suggests that nations that are likely to gain the most from the creation of the ESM may experience a more precarious bargaining position. This article argues that Germany was in such a position. This runs counter to the proposal made by Schimmelfennig (2015) who claimed that Germany was in fact in a superior bargaining position because its economy was best able to withstand the crisis. He determines that Germany therefore drove a hard bargain when it came to integration decisions during the crisis. However, his line of reasoning somewhat understates the economic gains from, and therefore reliance on, the euro for Germany. A single common currency broadens the "domestic" market for the euro states, whilst simultaneously facilitating greater interdependence among member states, particularly in the financial sectors. Germany, as an export-economy, benefits from the weakest members remaining in the euro as intra-Eurozone trade accounts for two-thirds of German exports (Sanati, 2011). A single currency has streamlined business, reduced transaction fees and guarded against foreign exchange risks, making German products more competitive globally (Sanati, 2011). It is estimated that the common currency helps Germany reduce labour costs by 15% compared with the average level of all euro countries (Porter, 2012). For the Eurozone countries, "[a]n artificially low euro in Germany means an artificially high euro in weaker countries like Spain and Greece"; allowing these countries to afford German goods. (Sanati, 2011).

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

Therefore, there is an asymmetrical benefit distribution from the single currency and, subsequently, the ESM agreement. In this sense, LI (Sub-hypothesis 2) correctly predicts that national asymmetrical interdependence to the ESM determines the relative bargaining power of the nation states. Germany, who economically benefits the most from the ESM, has compromised the most to realise its core interests. Meanwhile, those states that benefit least from strict accession to the ESM, for instance Italy and Spain, put forward strict conditions and made hard bargains (see the fifth round of interstate bargains in Figure 3). All this proves the explanatory and predictive power of the LI model. The validity of Sub-hypothesis 2 in the case of the ESM also further supports the previous Proposition 2.

Sub-hypothesis 3 claims that the ESM projects the interests of the most powerful states rather than being the result of supranational entrepreneurship. A nation state's political leverage is closely related to its economic power and, post-2008, Germany held the pre-eminent position in this respect within the Eurozone. Arguably, the Eurozone sovereign debt crisis strengthened Germany's leading role while weakening the political influence of all others on EMU affairs. It was Germany, and to a lesser extent France, rather than the EU institutions that shaped the course of the ESM, and therefore sub-hypothesis 3 is confirmed.

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

Proposition 3: National core interests are the bottom line of interstate bargains, which tend to be unwavering during negotiations while exhibiting national policy tradition over time.

Proposition 4: The Eurozone sovereign debt crisis further strengthened Germany's leading role while weakening France's political leverage in EMU affairs. Nevertheless, Germany must form a coalition with France to secure its national interests. Consequently, the new EMU policies and measures tend to start from and/or end at the merger and/or compromise of the *propositions of the two core euro states, which normally are characterised by a German-French style of stricter vs. lessened fiscal rules and of budgetary cuts vs. spending growth emphases. Although, Germany tends to make concessions to France's demands, the negotiation results tend to represent Germany's national interests more than France's due to asymmetrical national economic powers.*

4.3. Evidence for Sub-hypotheses 4, 5, and 6: Institutional choice (LI Stage 3)

Sub-hypothesis 4 states that institutional choices regarding the delegation and pooling of sovereignty to EU institutions during the inception of the ESM was primarily to ensure intergovernmental commitment toward the ESM. The LI model predicts that EU supranational institutions are set up to decrease transaction costs and ensure that the commitments are respected. Schimmelfennig (2015) asserts that the sovereign debt crisis highlighted that there are significant enforcement problems regarding the EU rules. This led to more regulatory power being delegated to the EU supranational institutions (Kudrna, 2016). Laffan and Schlosser (2016) further stress that the Eurozone crisis was the main trigger that led to greater fiscal surveillance especially among the euro member states. This new governance system allows for greater horizontal policy making at the EU level, and though there is no considerable EU fiscal control mechanism, the new EU regulatory power does have influence over national budgets. Scholten (2017) agrees that there is a growing influence of the EU on national direct enforcement strategies. The increasing number of fiscal councils across the EU also demonstrates this growing commitment to the supranational rules-based framework (Larch and Braendle, 2017). Member countries understand the need for creating an institution. They accept a loss of sovereignty to protect the currency union. Germany sought to limit its financial commitment to the ESM by capping the lending capacity to €190bn, but the ESM was there to ensure that this commitment was upheld. ESM assistance also comes with a strict set of conditions that the indebted countries must adhere to.Therefore, sub-hypothesis 4 is valid but can be better construed as:

Sub-hypothesis $4_{modified}$: Nation states make institutional choices to delegate and pool sovereignty to EU supranational institutions and/or intergovernmental institutions to guarantee the credibility of intergovernmental commitments, and the latter may cause differentiated integration speeds among EU member states.

Sub-hypothesis 5 focuses on how credible commitments by nations can be guaranteed and realised. While the case study shows sub-hypothesis 5 to be valid, it also highlights the importance of the role of national parliaments. During the establishment of the ESM, national parliaments both acted as guarantors of domestic commitments and power checkers for national executives. Therefore, a new element is added to sub-hypothesis 5 - securing credible national commitments via strengthening national parliaments. This is vividly illustrated by the German Parliament's two conditions for its approval of the ESM and TSCG (see Figure 3). Sub-hypothesis 5 can be extended as follows:

Sub-hypothesis $5_{extended}$: Member states' credible commitments can be guaranteed and realised via strengthening the national executive, the national judicial branch, the national parliament and/or the very domestic groups that support the policy in the first place vis-à-vis other domestic forces favouring non-compliance.

Sub-hypothesis 6 concerns the non-compliance of states that it is most likely to result from the high domestic costs of the ESM agreement. In December 2016, Greece announced a €617m pre-Christmas bonus for pension holders living under €800 per month. The ESM immediately froze short-term debt relief measures. The Greek Prime Minister, Alexis Tsipras, facing significant domestic pressure argued that Greece had managed to go beyond its fiscal surplus target and thus could afford the expenditure. However, it was only after the Eurogroup had received an official letter from the Greek finance minister confirming the country's commitment to the programme, that the ESM measures were continued. Although this episode is not officially deemed as non-compliance, it shows that powerful domestic forces can induce national governments into not complying with the ESM conditions.

4.4. Evidence for Sub-hypotheses 7 and 8: Two limitations to the LI Model

LI's predictive power is limited in economic areas where the policy outcomes are rather uncertain such as fiscal and monetary policy. The ESM is by nature an economic institution where, arguably, the benefits and costs are unevenly distributed and uncertain. However, the focus of sub-hypothesis 7 is on how well domestic societal interests are organised and represented, and this determines the predictive power of LI. Through testing sub-hypothesis 1 and 2, we know that the national preferences of powerful initiators such as France and Germany were very clear. Northern states, including Germany, sought to minimise the costs of a mechanism that would support weaker economies. Armingeon and Cranmer (2017) explain that this is because stronger nations do not expect to experience austerity policies in the future, while indebted governments will oppose austerity even if it is inevitable because such vocal opposition will reduce future electoral costs. National preference formation was therefore well-defined in the case of the ESM and thus, LI could be used efficiently to explain the process.

Despite the national preferences being well-formulated, during LI stage 2 (i.e. sub-hypothesis 3 and 4) there were challenges as to how such preferences could be represented and coordinated at the EU level. EU leaders, the Commission, the ECB and other EU bodies have utilised their expertise and legitimacy to exert influence, such as making Treaty revisions to establish the legal basis for the creation of the ESM and the finalisation of Collective Action Clauses (CACs). However, in detailing the evolution of the ESM (see figure 3) one can see that national governments are the core actors and deciders of its formation, and German-French compromised positions created the framework for the agreement. Moreover, Proposition 2 offers possible situations where not all member states participate in an interstate bargain (i.e. block-ins vs. block outs). It recognises the different relevance and weight of the agreement to each member state as well as highlighting the different integration speeds among EU member states (see Sub-hypothesis 4_{modified}).

The ESM is one of the main crisis responses from the European nations, and the lack of EU supranational entrepreneurship shows the increased level of intergovernmentalism in the bloc's economic governance. Puetter (2012) deemed this "deliberate intergovernmentalism" as a striking divergence from the Community Integration method, which focuses more on coordination via intergovernmental institutions such as the European Council. The creation of the ESM itself has primarily reflected the domestic interests of the big countries, while intervention of the Council and Commission was only seen in "exceptional cases" that were marked by high coordination and transaction costs. However, in concordance with sub-hypothesis 8, financial support mechanisms such as the ESM and EFSF, still require the legitimacy and framework of EU institutions to operate (Bauer and Becker, 2014). Therefore, intergovernmental frameworks do often rely on the European Council and Commission's executives, whose function has changed from that of entrepreneurship, to management of policies (Bauer and Becker, 2014). Accordingly, the ESM, which is part of the greater economic governance scheme, is still broadly under the monitoring of the Commission (Becker et al., 2016).

4.5. Analytical and Predictive Power of LI in Explaining the ESM

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

Figure 4 suggests that interstate bargains concerning a specific issue may not be finalised in a single deal, rather it is more likely that they will undergo several rounds of negotiations before being concluded. Both national preference formation and institutional choice finalisations are not static. Instead, they evolve over time and are modified, adjusted or redefined in response to new situations and challenges in the EU integration process. In periods of uncertainty, this elaborated LI three-stage model offers a useful theoretical tool to grasp, understand and unravel the policy outcomes forged by intergovernmental negotiations.

This adjusted model is somewhat different from the classical three stage model that was derived in figure 2. It is a more dynamic process, because the terms of how the ESM functions are subject to change based on bargaining among the countries as well as the overall EU integration process. Furthermore, all three stages respond to exogenous changes to the EU from the rest of the world. However, despite this dynamic nature, core national interests are shown to remain unchanged. Another important insight from the ESM case was that forming coalitions was crucial in the interstate bargaining process, even for a powerful state like Germany.

5. Conclusion

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

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

The validity of LI to account for the ESM suggests the rigor of LI as an EU integration theory: from Moravcsik (1991, 1993, 1995 and 1998), to Moravcsik and Schimmelfennig (2009), to this paper as well as other LI studies, LI has been continuously developed and re-galvanised alongside the EU integration process. The LI study of the ESM case in this paper once again confirms the role of national interests and governments in propelling the EU project forward by intergovernmental approaches. The formation of the ESM also supports the intergovernmentalist proposition that the contemporary European integration project is "the result of deliberate state choice" (Moravcsik and Schimmelfennig 2009, 86) as well as national compromises. Thus, the establishment of the ESM is both well predicted and explained by the three stage LI model.

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The LI general assumption consists of three sequential stages	
National preference formation (Stage 1)	(1) Preference formation is "issue-specific", and is divided into two different modes: (1a) Mode 1: Economic issue areas: A balance of preferences among producers, taxpayers and other actors who are interested in regulation, mainly to meet the challenges brought by globalisation; (1b) Mode 2: Non-economic issue areas: Preference formation derives other concerns, such as geo-politics and ideology.
Interstate bargains (Stage 2)	(2) Bargaining power is decided by two factors: (2a) national asymmetrical interdependence, that is, the uneven distribution of the benefits of a specific agreement; (2b) national information acquiring of other actors' preferences and institutional mechanisms. (3) These two factors imply: (3a) member states who economically benefit the most from EU integration tend to compromise the most on the margin to realise gains, whereas those who benefit the least tend to make hard bargains and impose conditions; (3b) Ideational entrepreneurs of supranational institutions will influence national governments and enhance negotiations only when the transaction costs involved are high and they are armed with better information and expertise than national governments.
Institutional choice (Stage 3)	(4) The purposes to establish supranational institutions are: (4a) to help governments to reduce the transactions costs of future interstate negotiations on the same issue; (4b) to provide information for governments to estimate other actors' future preferences and behaviour; and (4c) by setting up rules to distribute gains, reduce coordination costs, monitor and sanction governmental non-compliance. (5) Three factors contribute to different institutional designs: (5a) the severity of distributional conflict and enforcement problems; (5b) uncertainty about the preferences of other actors; and (5c) the future states of the world. (6) The intention to establish institutions is to guarantee credible domestic commitments by strengthening: (6a) the national executive; or (6b) the national judicial branch; or (6c) the very domestic groups that support the policy in the first place vis-à-vis other domestic forces favouring non-compliance so as to help nation states to cope with globalisation. (7) National non-compliance will happen when an agreement leads to high costs for powerful domestic actors.
There are two limitations attached to applying the LI theory	
Two limitations to the application of LI	(8) LI best explains policy-making in issue areas where social preferences are relatively certain and well defined. (9) Supranational entrepreneurs will only intervene when states face severe problems with domestic coordination and interest representation, and if they lack critical information, expertise, bargaining skills.

Figure 1. LI Model with Three Sequential Stages

Sources: Pan (2015), on the basis of Moravcsik and Schimmelfennig (2009)

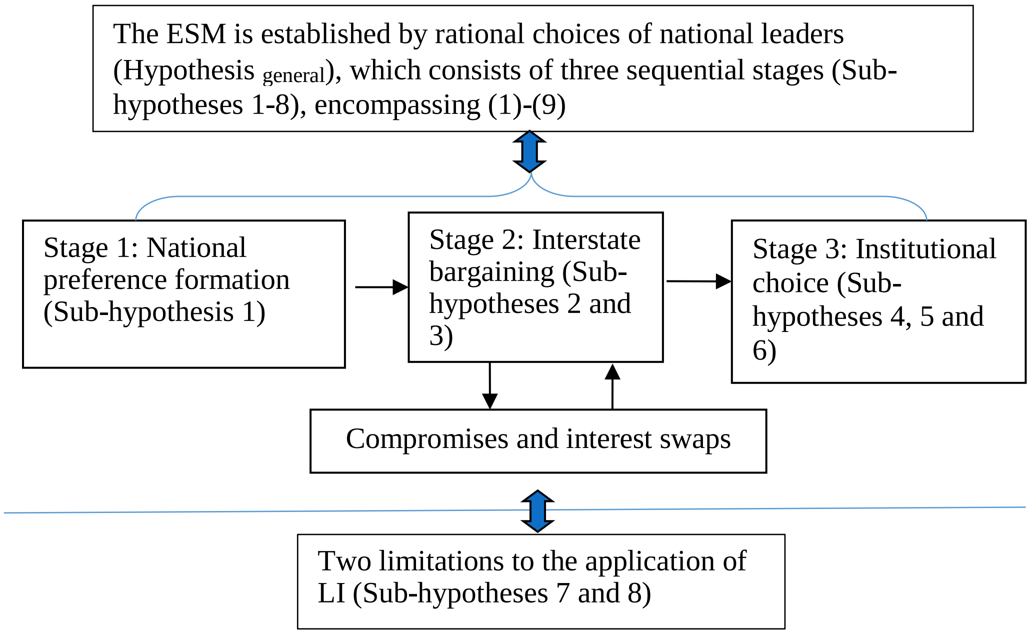

Figure 2: A Model Structure of Testing LI Hypotheses on the ESM

The initiator of the ESM: Germany

Germany’s preferences:

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

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

How to materialise those national interests?

Germany’s strategy: forming a coalition with France, the number two in EMU and the EU

France’s preferences:

(1) a comparatively lenient fiscal sanction mechanism (a strong ally for the southern European states while opposition is coming from the Northern states who have better fiscal records);

(2) depriving the voting rights of the persistent deficit violators in the Council (a proposal attracting universal opposition and criticisms);

(3) the status quo of sanction decision-making by the Council (opposition from EU institutions and Northern euro states).

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

The second round of interstate bargains: various responses to the Deauville Deal, forming a rough line between small fiscally-restrained northern members (together with the Commission and the EP) and large indebted southerners on the issue of a tougher and more-automatic sanction mechanism.

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

The third round of interstate bargains: addressing the shortcomings of, as well as further strengthening, the EU’s (particularly Eurozone) fiscal governance after the “six-pack”

Germany’s strategy: Confronted with the UK’s opposition, the TSCG was concluded as an intergovernmental Treaty rather than an EU Treaty, excluding the “recalcitrant” governments; Germany bound the ESM and the TSCG together, and the TSCG was included in the ESM Treaty as a prerequisite for ESM member states to receive ESM assistance.

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

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

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

The fifth round of interstate bargains: Newly elected French president Hollande wanted to get his growth pact to be adopted, a promise he made to the French voters during his presidential campaign to stimulate the French economy and claimed to complement Merkel's Fiscal Pact which stressed austerity measures; before the EU summit on 29 June 2012, Merkel agreed to support Hollande's growth pact, and in return, Hollande agreed to sign off the unpopular fiscal pact championed by Merkel.

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

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

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

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

Figure 3. Processes Leading to the Establishment of the ESM

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

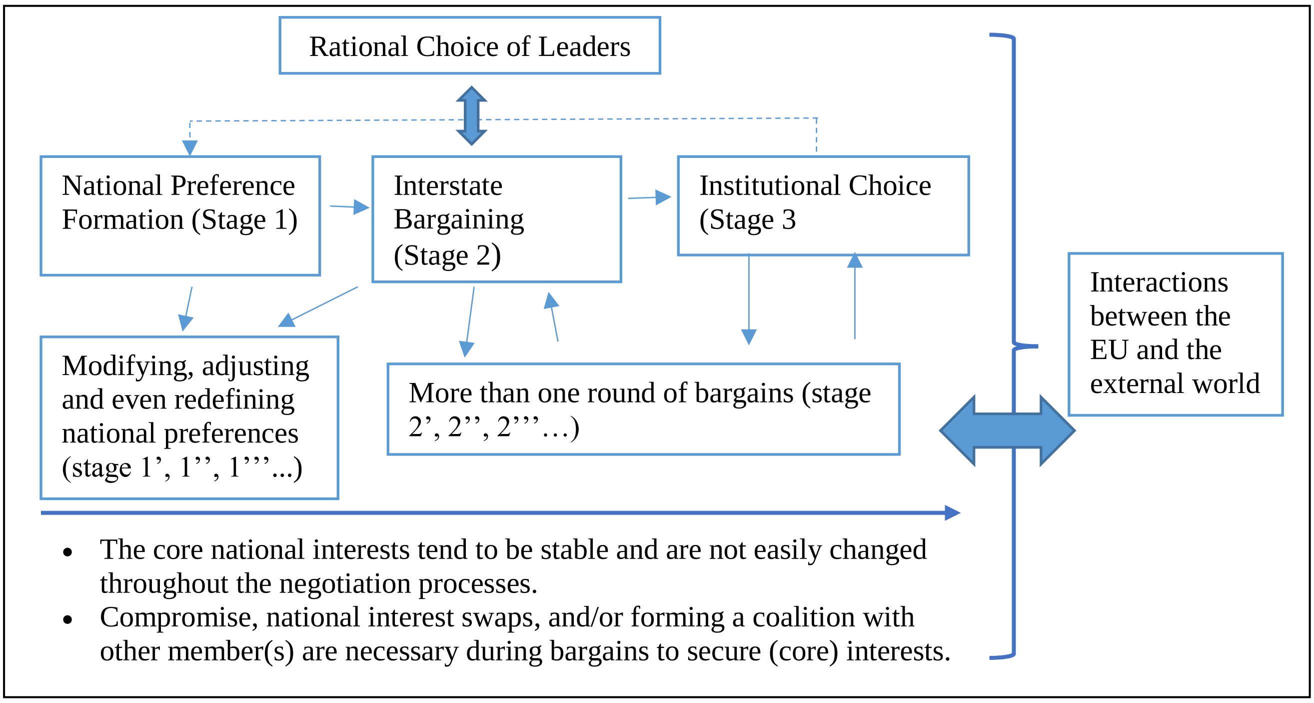

Figure 4. Elaborated process of the LI Model

Source: Pan (2015)