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The Politics of Eurozone Reforms

Edited by
Zdenek Kudrna, Sonja Puntsher Riekman,
and Fabio Wasserfallen

ecpr PRESS

ROWMAN &
LITTLEFIELD

London • New York

Published by Rowman & Littlefield

In partnership with the European Consortium for Political Research, Harbour House, 6-8
Hythe Quay, Colchester, CO2 8JF, United Kingdom

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electronic or mechanical means, including information storage and retrieval systems,
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British Library Cataloguing in Publication Data

Library of Congress Cataloging-in-Publication Data

Names: Wasserfallen, Fabio, 1983- editor. | Puntscher Riekmann, Sonja, editor. |
Kudrna, Zdenek, 1977- editor.

Title: The politics of Eurozone reforms / edited by Zdenek Kudrna, Sonja Puntscher
Riekmann, and Fabio Wasserfallen.

Description: New York ; London : ECPR Press | Rowman & Littlefield, [2021] |
Includes bibliographical references and index.

Identifiers: LCCN 2021015921 (print) | LCCN 2021015922 (ebook) |
ISBN 9781538151532 (Cloth : acid-free paper) | ISBN 9781538151556 (ePub)

Subjects: LCSH: European Union countries—Economic policy. | European Union
countries—Economic conditions. | European Union countries—Politics and
government.

Classification: LCC HC240 .P59385 2021 (print) | LCC HC240 (ebook) |
DDC 330.94—dc23

LC record available at <https://lcn.loc.gov/2021015921>

LC ebook record available at <https://lcn.loc.gov/2021015922>

∞™ The paper used in this publication meets the minimum requirements of American
National Standard for Information Sciences—Permanence of Paper for Printed Library
Materials, ANSI/NISO Z39.48-1992.

Printed in the United States of America

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Chapter 1

The Politics of the Eurozone

Analyses of New Data from Multiple Methodological and Theoretical Perspectives

Zdenek Kudrna, Sonja Puntscher Riekmann,
and Fabio Wasserfallen

1.1 INTRODUCTION

The euro has survived, and against all odds, no member state has left the Eurozone. When the wicked financial and fiscal crisis engulfed the monetary union in the aftermath of the collapse of Lehman Brothers in 2008, many economists predicted dangers and doom for the euro. Yet, despite the vulnerabilities of the monetary union, which includes a diverse set of economies, the Eurozone has not disintegrated, but deepened.

The creators of the euro sought to forestall some asymmetries and macroeconomic imbalances by treaty clauses on debt, deficit and no bailout as well as the rules enshrined in the Stability and Growth Pact, combined with repeated commitments to structural reforms and support for economic convergence. This stance was qualified as the result of 'a gargantuan misreading of the laws of economics' (Marsh 2011, 7). When member states came to realise the weakness of their toolbox, they sharpened them considerably and added new rules and institutions to supervise their implementation. In emergency circumstances, member states agreed on rescue funds, such as the European Stability Mechanism (ESM), fiscal discipline legislation, such as the Two- and Six-Pack, and banking regulations that were previously beyond reach. Despite different initial interpretations of the causes and consequences of the crisis, decision-makers from the member states and EU institutions eventually took collective action to rescue the euro and reduce risk for national financial sectors.

The contributions to this book summarise the main findings of the Horizon 2020 project *EMU Choices*, which started in the wake of the reform process and lasted from 2015 to 2019. The consortium of political scientists and legal scholars analysed manifold measures that were enacted between 2010 and 2015 to refine our understanding of the reform processes and to identify insights into future reforms. While recent reforms of the Economic and Monetary Union (EMU) mark the most profound deepening of European integration since Maastricht, important elements of a sustainable architecture for a single currency are still missing. Therefore, a refined understanding of political and legal constraints on EMU reform politics remains an important prerequisite for future progress.

This book puts member states' preferences, positions and strategies front and centre of our research, while not neglecting the role of supranational agents such as the Commission, the European Council, the ECOFIN, the Eurogroup or the European Central Bank (ECB). Our research questions are, *first*, how preferences of EU member states on EMU reforms were formed, and, *second*, how the European decision-making produced the reform outcomes that were enacted during the Eurozone Crisis.

To answer these questions, we have built four new datasets based on the analysis of more than 5,000 documents, 200 expert interviews and the review of constitutional court cases in all 28 EU countries. First, the *EMU Positions* dataset collects comprehensive and systematic data on the bargaining positions of each EU member state and six EU institutions during all Eurozone reforms enacted between 2010 and 2015. Second, the *EMU Historical* dataset provides a long-term perspective of these positions. Third, the *EMU Formation* dataset codes which actors were most influential in the domestic formation of member state positions. Finally, the *EMU Legal Index* maps the procedural hurdles imposed by national and EU legal systems on the process of EMU-induced constitutional change or treaty change, respectively. Relying on these unique datasets, we were able to analyse our questions systematically and comprehensively.

While most chapters of this book present research exploring these datasets, we maintain methodological pluralism throughout the book. Some contributions focus on the quantitative analysis of preference formation and EU-level bargaining; others develop comparative case studies or employ systematic legal analysis. Moreover, we build on and advance different theoretical approaches to EU decision-making and preference formation. The organisation of the broader *EMU Choices* research project follows the two-stage model of European integration, which dissects EU policymaking into, first, preference formation at the national level and, second, interstate bargaining at the European level (Moravcsik 1993, 2018). We use this two-stage model as a structuring framework. Accordingly, our research focuses on the study of

how preferences are formed and how political conflicts among member states on the European level shape the reform outcomes. In the spirit of academic pluralism, the various strands of our research project extend several analytical accounts (see chapter 6), typically evaluating theoretical conjectures with rigorous empirical testing using the new data gathered in the project.

The relentless focus on data collection combined with methodological pluralism defines the main contribution of this book and served as the baseline on which all scholars of the *EMU Choices* project collaborated. The wealth of new data enables us to refine and evaluate insights into the reform politics of the Eurozone. Unlike earlier literature, we are not limited to a handful of policy issues and the analysis of major member states. Rather, we provide a comprehensive account of dozens of policy issues, all member states and key EU institutions. Indeed, some of our key findings, such as the single-dimensional structure of the policy conflict or the dominant role of financial stability concerns in preference formation, cannot be established without access to comprehensive datasets. Moreover, the systematic empirical analysis also supported the choices of key topics for case studies that provide more detailed insights into the dynamics of preference formation, EU-level bargaining or the role of constitutional courts. The comparative chapters on major EU economies and Southern member states complement and challenge key findings of existing empirical analyses. They also shape our contribution to multiple stands of EU-focused literature.

The EMU is the topic of abundant and rather specialised economic literature focusing on efficient system design. Studies in this tradition analyse existing Eurozone arrangements in relation to economic models and make proposals for reforms from an economic perspective (Sinn 2014; de Grauwe 2016; Cardinale et al. 2017; Schelkle 2017). This strand of research provides important baseline knowledge on the economics of a monetary union on which the *EMU Choices* project and book rely. At the same time, we complement this discussion with a systematic mapping of political and legal constraints that often prevent the adoption of its recommendations. Our data and insights guide reform proposals that are more compatible with dominant constraints and improve the odds of securing political compromise on their adoption and implementation.

Our focus on policy conflicts among political actors on national and European levels is based, among others, on the extensive political economy literature on the Eurozone Crisis. We work from studies showing how imbalances in competitiveness and in current accounts shape political conflicts (Copelovitch et al. 2016; Armingeon and Cranmer 2018). Important points of our orientation came from Brunnermeier et al. (2016), who stress the power of economic ideas and underlying economic philosophies in shaping policy preferences. Our focus, however, is on actors and institutions. Furthermore,

our conclusions advance earlier accounts of the Eurozone Crisis, discussed in Caporaso and Rhodes (2016), as we provide more systematic insights on political and legal constraints to their observations of economic and political dynamics among key member states.

Apart from that, our analysis of the Eurozone crisis also speaks to a larger literature that explores how the various crises of European integration shaped the process of integration from the empty-chair crisis in the mid-1960s to the immigration crisis and Brexit. At the time of the final editing of this book, politics in the EU and all member states are entirely focused on the COVID-19 crisis. The distributional conflicts on the European level in this crisis are very similar to the conflicts analysed in this book. Again, Southern member states call for solidarity and burden sharing, while Northern member states, like the Netherlands and Austria, oppose unconditional financial support. Unfortunately, we had no time, given the publication timeline of this book, to incorporate these current developments more fully. The only two things we can state at the time of finalising this book are that our analyses of Eurozone reform politics explain, to a large extent, the current political divides and that the next crisis – which may lead to further common action – has already hit Europe.

In this broader context of integration through crises, the Eurozone Crisis is one instance in a series of crises that have often led to increased integration. By exploring its political dimension, we also hope to contribute to this broader understanding of how crises shape European integration (Majone 2014; Fabbrini 2015; Matthijs and Blyth 2015; Dinan et al. 2017; Caporaso 2018; Schlosser 2019). Particularly important in that respect is Jones et al. (2016) and the special issue edited by Ioannou et al. (2015), which connect the Eurozone Crisis to other crises and situate this case in the broader debate on the drivers of integration.

In sum, by presenting a comprehensive analysis of the politics of Eurozone reform, we engage with a large set of literature. The individual chapters of this book summarise and synthesise findings of more than 80 research papers and reports written in the context of the *EMU Choices* research project. Each chapter connects to different literatures in more detail. For example, chapter 3 engages with findings on the question of leadership in the Eurozone (Schoeller 2019; Howarth and Quaglia 2016) and chapter 5 furthers the existing analyses of legal impacts of EMU reforms on national legal systems and vice versa (Beukers et al. 2017; Woźniakowski 2018). The theoretical lenses of individual chapters – contrasted and summarised in chapter 6 – build on the state-of-the-art scholarship explaining EU policy and decision-making (Hix and Høyland 2011; Cini and Pérez-Solórzano Borrágán 2016) as well as specialised studies of EU legislative politics (Thomson 2011) and high politics of intergovernmental conferences (Moravcsik 1998; König and Hug 2006).

Last but not least, this book derives implications for the policy debates on the future reforms of the Eurozone. We summarise proposals from Presidents' Reports, discuss their feasibility under prevailing political and legal constraints and reconcile them with a survey of expectations conducted at national representations in Brussels. In the concluding chapter, we also outline two reform scenarios and map them on to recent reform experience, which is going to shape the outlook for the new Commission, headed by Ursula von der Leyen.

1.2 MAIN FINDINGS

The comprehensive and data-driven analyses allow us to evaluate and refine some common wisdom about Eurozone politics established in academic literature as well as media discourses on the Eurozone Crisis. Our findings confirm the North–South divide, while also providing novel insights on the positions of individual member states on specific policy issues. Similarly, we can confirm the important role of Germany and France, while also pointing out that no member state was able to dominate legislative politics in Brussels. The prominent role of concerns about the stability of the banking sector in the decisions of national government is also well known. Yet, we add systematic evidence that it dominated the position taking of governments in Eurozone politics. The role of the German constitutional court in shaping some EMU reform decisions is also often listed as common wisdom, corroborated by the ruling on PSPP of 5 May 2020; however, we provide an overview of constitutional cases in all member states and also derive some implications for future reforms, taking all other EU member states into account. In short, while the headline features of Eurozone politics will be familiar to informed readers, their empirically substantiated refinements are new and important for the discussion of future EMU reforms.

The shock unleashed by the global financial crisis hit the divergent economies of the Eurozone unequally. They were also differently prepared to cope with the consequences (another parallel to the COVID-19 crisis of 2020). When constructing the Eurozone, member state representatives were well aware of their economic diversity, but – against the warning of numerous economists (see Feldstein 2012; Krugman 2013) – preferred to rely on the deficit and debt regime and the no-bailout clause, rather than put more emphasis on automatic stabilisers or risk-sharing. Hence, in the crisis, the lack of stabilisation mechanisms was the key problem underlying the institutional structure of the Eurozone.

The asymmetry of the impact of the economic crisis gave rise to the most obvious feature of Eurozone politics, typically referred to as the North–South

divide. Inevitably, it is a simplifying metaphor that is neither geographically correct nor fully congruent with the distribution of policy preferences. As chapter 2 demonstrates in detail, the preferences of some Eurozone countries clearly cluster at opposite camps across all policy issues, while the rest of the EU is closer to the median position than either extreme as their preferences vary on specific issues. Nonetheless, the North–South categorisation became a major point of reference for Eurozone politics because, indeed, the political divide was most acute between the Northern Eurozone core and the Mediterranean periphery.

The less obvious aspect of the North–South divide is the question of what forced both sides to agree on the EMU reforms. After all, governments from both sides agreed on handing out loans and credits through provisional mechanisms and, later, the permanent ESM as well as the Banking Union with new supervision and resolution mechanisms. In chapter 2, Bailer, Tallberg and Wasserfallen conclude that exposure to financial markets was a major explanatory factor for variation in member states' approaches and positions with respect to euro rescue operations. A major reason why member states tolerated the ECB's non-standard measures, such as Mario Draghi's announcement of OMT, the execution of QE and the zero-bound interest rate policy, was that the alternative – the dissolution of the euro – would have had detrimental consequences, not only in the Southern economies but also in the financial sectors of the Eurozone core member states.

Dramatic pronouncements, such as German chancellor Angela Merkel's famous dictum 'if the euro fails, Europe fails',¹ were an important part of the story. However, the detailed analysis of preferences indicates that the exposure to other Eurozone banking sectors (Târlea et al. 2019) brought countries together. Also, stabilisation funding came with strings attached. The credits for ailing countries were disbursed on austerity conditions, which is in line with the Maastricht narrative of no-bailout and strict rules for national deficit and debt. This approach was defined in the Memoranda of Understanding between the Troika composed of the Commission, ECB and IMF and the recipient state. Common debt management was ruled out to stifle moral hazard. Solidarity and austerity became twin arguments fuelling deep resentments on both sides and thus further enhancing the polarisation of decision-making on EMU reforms. Our findings are in line with the argument that solidarity is a 'by-product' of self-interest rather than of normative considerations (Schelkle 2017, 12).

The quantitative analysis of member states preferences summarised in chapter 2 also reveals unusual single-dimensionality of the North–South divide. In a nutshell, a coalition of predominantly Southern member states prefers fiscal transfers against the opposition of Northern member states, who support fiscal discipline. This is distinct to most other cases of EU politics,

as there is no discernible evidence of other dimensions, such as the left–right ideological orientation of governments or their general preference for more or less integration (Marks and Steenbergen 2002). The absence of additional dimensions precludes a formulation of package deals, whereby member governments are prepared to make concessions on EMU reforms as long as they are aligned with their political orientation or in exchange for benefits in other policy domains. The conflict constellation in Eurozone politics requires mutual concessions between the North and South coalitions.

Our empirical findings also refine the common wisdom about the German or Franco–German dominance of the EMU reform process. While the two countries are central to the respective coalitions and, in some important cases, were able to set the agenda by excluding measures such as Eurobonds or a common deposit insurance (Degner and Leuffen 2019), overall, they were not disproportionately successful in achieving their policy preferences (Lundgren et al. 2019). Germany was neither capable of pursuing its primary goal of highly conditional engagement (‘member states have to do their homework before receiving help’) nor of imposing its policy preferences on the rest of the EU. When EMU reform proposals entered the EU legislative process – mostly via the ordinary legislative procedure – the success in achieving policy preference was broadly comparable across all member states. Balanced legislative compromises indicate that the decisions taken to resolve the crisis left no states as unequivocal winners or losers of EU legislative bargaining. At the same time, however, the economic consequences of the crisis were very unevenly distributed, as the Southern member states were much more affected by the Euro Crisis with deep economic and social disruptions.

Moving to the domestic level, the analyses of the preference formation reveal strong centralisation as national governments and EU institutions were by far the most influential actors in all member states (Kudrna et al. 2019). The EMU Formation data indicates that national parliaments played some balancing role in some member states, but media, public opinion or business actors had very limited influence in shaping government preference. Chapter 3 by Saurugger et al. refines this observation with a more detailed, comparative analysis of Germany, France and the UK. They confirm a strong centralisation of preference formation and subsequent decision-making in the hands of a narrow political elite dominated by the offices of the heads of government and treasuries. At the same time, they also unveil differences between France and the UK, on the one hand, and Germany, on the other. The German case is marked by differences between the ministries of finance and economy, and by a greater role of the Bundestag in preference formation. Moreover, German politicians need to develop preferences and positions in the shadow of the Federal Constitutional Court, which has repeatedly ruled on the implications of EMU reform for German democracy and the budgetary

autonomy of the Bundestag. Chapter 3 also identifies the circular preference formation between France and Germany, whereby the administrations of both countries internalise each other's red lines. This is also facilitated by a longstanding and ongoing informal conversation between ministerial actors. The UK case is special in the sense that the British administration was keen to participate in this conversation to safeguard its interests as a non-euro member and cooperated accordingly in the elaboration of the Banking Union.

In chapter 4, Morlino and Sottilotto provide a comparative analysis of the Southern member states during the crisis. They challenge the view that shared preferences on EMU reforms were rooted in similar political and economic constellations. With the exception of Malta, Southern member states were deeply affected by the crisis, but for quite different reasons. Spain and Cyprus had low public debt before the crisis, contrary to Greece, Portugal and Italy. While Italy had been plagued by high public debt for decades, it also had a good reputation for debt management. Moreover, in the negotiations on measures to combat the crisis effects, Southern member states only gradually came to accept the main thrust of solidarity-cum-austerity measures. To avoid EU rescue operations, Italy, in particular, opted for internalising structural reforms to maintain its refinancing capacity on financial markets. Others manifested oscillating positions between imputing responsibilities for national woes to the respective governments and eventual support for multi-lateral aid to avoid contagion. While Southern member states chose different approaches to accept austerity conditions, they agreed to EU decisions based on their preference to stay in the Eurozone.

Chapter 5 by Elisabeth Lentsch points out the common wisdom that recent Eurozone reforms increased the activity of national constitutional courts. She refines this observation by a systematic overview of all relevant cases, arguing that rulings provide important information on relevant constitutional options, limits and obstacles that constrain any further transfers of competences to the supranational level. She finds marginal progress in recent changes to the EU treaties as well as secondary legislation as an 'embryonic' fiscal union, which emphasise the view of the euro area as a 'single and distinct entity'. Chapter 5 complements the findings from recent constitutional case law with a systematic analysis of procedural requirements on both EU treaty change and EU-induced constitutional amendments. The latter are presented in the form of the *EMU Legal Index* dataset. The data of this index reinforces the expectation that a treaty change is an unlikely option for reform. The member states do not seem to be prepared to sacrifice constitutional principles. Rather, they remain capable of accepting some modifications. As in the last crisis, further reforms are likely to be based on existing treaty elements.

As mentioned, the *EMU Choices* project used liberal intergovernmentalism as a baseline theory structuring the data collection process, and much of the

subsequent analysis of E(M)U decision-making. However, the methodological pluralism of the project led to challenges and refinements of this approach and some of its key assumptions. Chapter 6 by Leuffen and Puetter discusses our theoretical and methodological choices by reviewing the most pertinent publications of the *EMU Choices* project. They show that the diverse approaches generated more encompassing perspectives on the politics of EMU reform by inviting controversial debates and helping to identify the scope of conditions under which different theories perform best.

As also argued in chapters 3 and 4, preferences and positions, as key analytical variables, need a wider and more differentiated perspective. Another important question concerns the stability of preferences tackled by various scholars of the project. Most concluded that stability may vary, but also that it is important to clarify when, why and how preferences and subsequent positions are likely to change. Other questions address the role of EU-level discussions as input into national preference formation and its 'destabilising' force of previously formed preferences. In that respect, our project research shows that in the iterative nested bargaining games, which became so frequent during the financial and fiscal crisis, the independence assumption between the two levels of integration is an assumption with clear limitations.

1.3 THE FUTURE OF EUROZONE REFORMS

The last chapter by Kudrna and Puntischer Riekmann summarises key policy-relevant findings of this book (see table 7.2), reconciles them with the current reform agenda and develops a gradual outlook for further EMU reforms. The common wisdom of the North–South divide, refined with the insight of the single-dimensional policy conflict, presents the most important stumbling block for future reforms. However, the dominant role of financial stability concerns in the preference formation provides an opening for preference convergence on further reforms. During the crisis, this concern helped to forge crucial compromises across the North–South divide, while currently, it motivates Northern governments to delay reforms until the legacy losses in Southern financial sectors are resolved. Nonetheless, as the latter makes progress in reducing these risks, the former will have fewer reasons to oppose reforms, and their preferences may gradually converge into viable compromises.

As chapter 7 documents, there is some evidence of very gradual convergence, such as agreements on the fiscal backstop for the Single Resolution Fund or the development of the Budgetary Instrument for Convergence and Competitiveness. While these steps tap into existing risk-sharing mechanisms – the ESM and EU budget, respectively – they still demonstrate a willingness

to develop the missing parts of the Eurozone architecture. If nothing else, they can be scaled up quickly in crisis circumstances.

The very limited progress until the end of 2019, combined with the results of our survey of expectations conducted at national representations in Brussels, indicates that the horizon for gradualist strategy goes well beyond the mandate of the next Commission. While political leaders, such as President Macron or German finance minister Scholz, occasionally attempt to intensify reform debates, the stronger impetus is more likely to come from the next crisis, which has already hit the EU in the form of the COVID-19 crisis. In any case, a shift from the gradual to the crisis-driven scenario is inherently risky, as there is no guarantee that member states and EU institutions will be able to orchestrate the turning-point agreement that stops further escalation. Moreover, if the crisis is to enable any reform progress, it needs to change the single-dimensionality of Eurozone politics by rearranging the North–South coalitions along additional dimensions and by opening space for some kind of package deal or grand bargain.

The gradualist reform strategy puts the stability of the EMU at the mercy of the economic cycle. As long as future recessions and financial shocks remain mild and do not escalate to a crisis, testing the new policy mechanisms of the EMU, the EU may have enough time to complete gradual reforms. At the same time, the Eurozone is better prepared for the next crisis than for the last one. The ESM, the Banking Union or the extraordinary intervention tools of the ECB make the EMU more resilient, despite the prevailing incompleteness of its crisis-management framework.

Only the future will tell whether the gradualist approach in the spirit of muddling through (Schlosser 2019) and ‘governing the commons’ without a clear hierarchy of responsibilities (Schelkle 2017) are conducive to the preservation of the euro, which is and remains an extraordinary experiment of regional integration. While the question of democratic legitimacy is here to stay, the current large support from EU citizens for a common currency should bode well.

NOTE

1. German chancellor Angela Merkel’s speech in Bundestag on 19 May 2010 on the approval of the 123 billion share in the rescue package of (at the time) €750 billion.

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