

# **A Theoretical Approach of Economic and Monetary Union: Does Practice Vindicate Liberal Intergovernmentalism?**

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## **Abstract**

The literature strongly suggests that the creation of Economic and Monetary Union (EMU) was largely influenced by the “power of ideas”, an accommodation to international markets challenges. The outcome was EMU’s political-economy inspired by the monetarist school, a considerable disempowerment of national governments. Put in the perspective of European integration theories, EMU seemed to reject liberal intergovernmentalism claims that member states’ interests are the major input to European integration developments. However, since the monetary union was launched several events showed that national governments re-captured the influence they theoretically lost with EMU. Notably the persistent breach of the Stability and Growth Pact might be the evidence that EU institutions (especially the Commission) and other societal actors lost ground to national governments. The paper asks whether the operation of EMU reflects a paradigm change in terms of European integration theories: how liberal intergovernmentalism emerged as the theory with greater explanatory potential of EMU in motion.

## **INTRODUCTION**

When Economic and Monetary Union (EMU) was designed and subsequently launched, a deep impact on member states’ economic policy autonomy became noticeable. Section 1 presents the theoretical framework for understanding whether EMU evolution is instructive of a paradigm shift. For that purpose a brief review of the main theories of European integration is undertaken. This exercise provides the foundations for the following sections, notably how the influences of EMU and following events that changed European monetary integration adhere to one or more theories of European integration.

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Section 2 reviews the literature on the symbolism attached to EMU, notably how ideational change was a powerful driving force behind the wheel of European monetary integration. EMU was a break on long-established patterns of autonomous national economic policy, since its core (monetary policy) was transferred to the hands of a supranational institution (the European Central Bank) that is constitutionally independent from national governments and other European Union (EU) institutions. To a certain extent, monetary integration brought the de-politicisation of economic policy. This section discusses the theoretical implications of EMU's political-economic orthodoxy. Monetary Union is thus examined through the lens of European integration theories. The goal is to present a theoretical understanding of monetary integration.

To that purpose, section 3 isolates a crucial ingredient of EMU: the Stability and Growth Pact (SGP). On the one hand, the original SGP is reviewed in order to place it within the spectrum of European integration theories, to realise whether the pact confirms the theoretical standards of EMU laid down in section 1. On the other hand, the awareness that the SGP was under severe tension and later reformed (2005) adds important questions. I am not going to address whether the pact was killed (Buiter, 2005) or just underwent pragmatic reform that makes it more flexible and feasible. I am particularly interested in an interpretation of the events that triggered reform: the forces that drove change in terms of fiscal discipline; the actors behind the SGP reform; the outcome (the analysis of the new version of the SGP brings new insights); and, finally, whether change goes against the theoretical tide of EMU or is just a confirmation of its new theoretical paradigm.

## **1. A BRIEF SURVEY ON THEORIES OF EUROPEAN INTEGRATION**

Theoretical discussions on European integration lead to the contrasting perceptions of mainstream theories (the only accepted theories *per se*) – liberal intergovernmentalism and neo-functionalism (Rosamond, 2000: 50-4 and 130-41). In addition, the emphasis on these theories arises from their strong explanatory potential for European monetary integration. Two middle-range approaches will also be tested, again for the valuable inputs they might offer to the theoretical background of EMU.

According to neo-functionalism European integration was built upon successive steps that opened new windows for increased integration (Stone Sweet and Sandholtz, 1998: 5-6). The process was continuous and causal, obeying a cumulative rationale. The outcome was an irreversible process: once a certain function was added to the

supranational entity's catalogue of competencies that was the window of opportunity to add other powers in the future to facilitate the operation of the previous one(s). The scholarly example to back up the spillover rationale is the connection between the Single European Market (SEM) and the project of monetary integration.

According to the theorists of neo-functionalism European integration has its own rationale, which is autonomous from member states' willingness. The spillover effect provides the explanation: once one step is taken to deepen European integration, future steps that support the process will be independent from member states (Pollack, 1998). In addition, the process of European integration is captured by the interests of certain societal groups. These elites influence supranational institutions and both (institutions and elites) act as the driving forces of European integration (Jensen, 2003).

Supranational governance emerged as a sophistication of neo-functionalism. The difference between supranational governance and neo-functionalism is the recognition that some moments of European integration are shaped by intergovernmental interests, although they do not work alone in that direction (Dinan, 1999). European integration is a continuum between supranationalism and intergovernmentalism. In every moment the EU stands alongside this continuum, and European integration developments reflect a pendulum shifting from the supranational to the intergovernmental poles, and vice versa (Cram, Dinan and Nugent, 1997).

Supporters of liberal intergovernmentalism take an opposite approach to European integration (Moravcsik, 1993). The key aspect that explains European integration is member states' preferences and powers. Accordingly, only member states shape the European integration process. If member states consent deeper European integration that is a signal of how powerful economic interdependence is and how they are unable to control it (Cini, 2003). Instead of letting sovereignty be diluted in the vortex of globalisation, member states accept a dynamic supranational polity. Nevertheless, they are the owners of European integration developments. The EU was created by member states' impetus as a necessary tool to preserve sovereignty inside a protective shell against the destructive forces of international economic interdependence (Milward, 1992). Supranational institutions are not endowed with the autonomy suggested by neo-functionalism and supranational governance theory, because they are directly or indirectly commanded by the juxtaposition of member states' political willingness, and they exist only to serve their masters' (member states) interests (Moravcsik, 1993).

Liberal intergovernmentalism limits the analysis of European integration to the interpretation of the main negotiation moments that contributed to the development of the European Union. Thus the emphasis is on intergovernmental conferences. These constitutional moments shape the future of European integration and provide the context to supranational institutions' action between constitutional moments. Member states are, by implication, the inspiring forces of European integration (Magnette, 2005).

In contrast the theory of supranational governance does not neglect member states' role or the relevance of intergovernmental conferences as moments of constitutional re-foundation of European integration. The emphasis is, however, on what happens in between two intergovernmental conferences. All the work done by supranational institutions after an intergovernmental conference has an influence on national representatives' behaviour when they meet again on the following intergovernmental conference (Shaw, 2000).

In the spectrum between two 'grand theories' of European integration lie several other partial approaches. From an extensive range of approaches<sup>1</sup> I selected only two to widen the analysis on how EMU fits European integration theorisation: *new institutionalism*, and *the fusion thesis*.

According to new institutionalism, governance deploys the context of European integration developments. Here governance is understood as a plural concept, that is, there are different patterns of governance depending on the policy arena under analysis (Bulmer, 1998). The core argument laid down by new institutionalism is that EU institutions are the main actor shaping European integration (Kohler-Koch, 1996). EU institutions perform functions and achieve goals that were not in national authorities' minds (Koslowski, 1999). Supranational institutions have their own preferences and are powerful enough to shape expectations, influence outcomes and constrain member states' activity.

The reasoning of new institutionalism depends on the logic of path-dependence (Caporaso and Stone Sweet, 2001). Structures, institutions and actors working within these institutions all give the input that feeds change in the EU. Path-dependence reinforces supranational institutions' autonomy and power. The reasoning is twofold: i) the more agents interact within the organisation the lower the costs of cooperation and

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<sup>1</sup> See Wiener and Diez (2004).

the higher the benefits; and ii) the more successful cooperation is, positive effects for outsiders become more visible, which is similar to a ‘push-in effect’ propelled by supranational institutions’ activism.

The ‘fusion thesis’ is another attempt to theorise European integration (Wessels, 1997). This approach merges elements of divergent theories of European integration – neo-functionalism, the pendulum thesis and the realist approach – into a coherent framework. Another element of fusion emerges from member states’ public instruments blended with the Europeanisation of several actors and institutions.

As both levels increasingly interact the more self-reinforcing are the influences observed. On the one hand, member states show their own interests and play an influential role in shaping the outcomes of European integration – either its constitutional momentums or the ordinary decision-making process. On the other hand, the development of European integration provides important inputs for the re-definition of statehood. A supranational decision that emulates a certain member state’s best practice is at the end generalised to other member states. These member states also implement that supranational decision. Maybe they have to accommodate domestic institutions and political and administrative practices to the supranational setting (Wessels, 1997).

For the fusion thesis supranational institutions are autonomous from member states. Firstly, they have their own will, show their own ambition and resist to member states’ influences whenever appropriate. Secondly, they act as important agenda-setters and have a say on the decision-making process (Wessels, 1997).

Table 1 summarises the main features of each of the theories and approaches examined. Each theory and approach’s order is intentional. Neo-functionalism contrasts with liberal intergovernmentalism. Supranational governance, as a sophistication of neo-functionalism, is closer to this theory. New institutionalism and the fusion thesis are middle-range approaches. The former has some connotation with neo-functionalism, while the latter accepts some ingredients of liberal intergovernmentalism. For these reasons, they are organised as the table shows. The purpose of this summary is to provide a theoretical grid against which EMU (section 2) and the SGP (section 3) will be assessed.

Table 1 – Theories and approaches of European integration: basic features

	<b>Neo-functionalism (NF)</b>	<b>Supranational governance (SG)</b>	<b>New institutionalism (INS)</b>	<b>Fusion thesis (FUS)</b>	<b>Liberal intergovernm. (LIG)</b>
<b>Actors' prominence</b>	EU institutions' autonomy (NF1)	EU institutions' autonomy (SG1)	EU institutions' autonomy (INS1)	EU institutions' autonomy + member states' influence (FUS1)	Member states capture European integration (LIG1)
<b>European integration ontology</b>	Spillover (NF2)	-----	Path-dependence (INS2)	EU decisions impact on member states (FUS2)	EU instrumental to member states (LIG2)
<b>Engines of European integration</b>	Societal interests (elite driven) (NF3)	Pendulum (between NF and LIG) (SG2)	EU institutions' prominence (INS3)	EU institutions + national governments (FUS3)	National preferences and power (LIG3)
<b>Time dimension</b>	Between IGCs (NF4)	Between IGCs (SG3)	-----	-----	IGCs (LIG4)

## 2. ECONOMIC AND MONETARY UNION THROUGH THE LENS OF EUROPEAN INTEGRATION THEORIES

### 2.1. The rationale of Economic and Monetary Union

The main ideational force behind EMU was monetarism. It is therefore important to acknowledge the reasons that lead the architects of monetary integration to choose a monetarist-led model. To that purpose four aspects are analysed throughout this section: the fear of inflation and a culture of stability; intense economic interdependence worldwide that diminished national governments' ability to run Keynesian-led economic policy; the way member states encouraged monetary union to launch painful domestic reforms; and the way EMU impacted in terms of decentralisation.

EMU was not an ideological orphan. The ideational underpinnings of EMU ran together with member states' shift to a different economic policy-making paradigm. Before EMU European integration already accommodated to neo-liberalism, going alongside a major structural tendency among industrialised countries (Gillingham, 2003: 99). The implication was the death of Keynesianism as the template for government's active intervention in economic policy (McNamara, 1999: 457)<sup>2</sup>.

<sup>2</sup> The landmark was Mitterrand's change on French economic policy in the early 80s: the French president accepted monetarist-led ideas. This is reported as the momentum for ideational change in Western Europe (McNamara, 2001). Subsequently all centre-left parties charged of national governments accommodated to neo-liberal ideals (Verdun, 2000). In fact, '(...) the Maastricht provisions on EMU represent the culmination of an 'historic economic policy convergence' in the Western Europe of the 1980s, as governments of the left as well the right sought to emulate the economic success of the

Aside the failure of Keynesianism, other aspects explain the neo-liberal agenda that inspired recent developments of European integration and EMU in particular. The climate of market liberalisation in Europe was particularly important, notably after the Single European Market (SEM) planned for January 1<sup>st</sup>, 1993. The SEM project created a new impetus for monetary integration, supporting the reasoning of the spillover effect that is characteristic of neo-functionalism (Sandholtz, 1993; Eichengreen, 1998; Featherstone, 1999; Verdun, 2002)<sup>3</sup>. Moreover, intense economic integration changed the relationship between states and capital, increasing markets' power and decreasing member states' ability to run economic policy (Hooghe, 1998). These events show that the neo-liberal agenda was already in motion when EMU started to be discussed. The outcome was a monetarist influenced EMU, the extension of the neo-liberal agenda already established in European integration. Nonetheless, since EMU was launched macroeconomic orthodoxy stimulated by monetarism was strengthened.

In Europe a wide community of professional economists, among whom central bankers were the visible face, was the biggest supporter of sound money (McNamara, 2001). Hence price stability emerged as the sacred goal of EMU, since '*(...) it was the first and (...) perhaps the second and the third commandments as well*' (Sandholtz, 1993: 5). The implication of this 'culture of stability' is that whenever any other goal established in article 2 of the Treaty on the European Union conflicts with price stability, the former must be sacrificed (Amttenbrink, 2002).

EMU also signalled member states' awareness of intense economic interdependence worldwide. National authorities realised that their ability to provide efficient economic policy solutions was damaged (Collignon, 2003a). This in turn fed their willingness to transfer certain powers to the supranational level as they recognised this strategy was suited to accommodate globalisation's intense effects (McKay, 1999; Dyson, 2002a). The independent variable was increasing capital mobility at the international level. This variable significantly empowered financial markets. National governments were eager to attract floating capitals. Therefore, they became prisoners of financial markets' will. Capital mobility undermined national politicians' control of some of the most important macroeconomic variables (Underhill, 2002).

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*Bundesbank, embracing the monetarist project as the most promising answer to the economic policy failures of the late 1970s*' (Pollack, 2000: 276). Therefore, macroeconomic ideological convergence predates EMU.

<sup>3</sup> For an opposing approach, see McNamara (2001).

This helps to understand how (and why) member states accommodated to the monetarist school. Convincing accounts specify that member states were not spontaneous in their adherence to monetarism. Instead they were influenced by the strong pressures exerted by globalisation, operating through the effects of international capital mobility (Padoa-Schioppa, 1997; Rhodes, 2002). Hence, ‘(...) *the governments of Europe followed a pragmatic, not ideologically purist, type of monetarism*’ (McNamara, 1999: 466). Maybe for this reason certain sectors reject that globalisation hampered member states’ autonomy (McNamara, 2002). EMU rationale is captured as an intentional attempt to control international financial markets’ activity (Moran, 2002). The conversion from Keynesianism to monetarism was planned to tackle distributive conflicts at home. EMU simply attenuated the intense pressures from globalisation and portrays member states’ strategy designed to keep their power unchanged.

The fact that change took place is nevertheless more important than finding out whether the drive towards monetarism was ideologically committed or only an opportunistic tactic. The contention that EMU closely matches the adjustment to globalisation re-emerges (Underhill, 2002: 37). This rationale paves the way for the relationship between EMU, neo-liberalism, and member states: *EMU adjusted to a neo-liberal model* (disseminating even further this model). EMU was not the scapegoat for member state policies’ neo-liberal shift (Crouch, 2002).

The aforementioned rationale unveils how member states were pushed towards monetary integration by an external constraint. It seems indisputable that

(...) *European governments favoured EMU because it would provide the highest possible level of credibility; monetary union would once and for all ‘tie their hands’.*  
 (...) *In fact, monetary union would provide price stability for governments that would be unable, for domestic political reasons, to achieve it on their own* (Sandholtz, 1993: 35).

According to Jones (2002: 163), member states sought to tie their hands in order to enforce painful reforms at home. Three reasons validate the idea: i) before EMU national politicians were free to manipulate macroeconomic data to meet the pressures exerted by powerful lobbies. This is no longer possible with EMU; ii) EMU’s political-economy is anchored on price stability, thus granting strong independence to the ECB and forcing national governments to sound fiscal policy. The consequence is that income redistribution can only be accomplished through (national) fiscal policy (not anymore through exchange-rate and monetary policies). Fiscal policy must be intrinsically efficient and transparent. Otherwise the purposes of income redistribution



are unclear and troublesome; iii) in the pre-EMU scenario national governments easily resorted to inflation because it was unproblematic to hide the costs to voters. With EMU this behaviour is no longer an option.

These arguments provide evidence of a shift in economic policy legitimacy after EMU. EMU is not a threat to democracy; on the contrary, the aforementioned arguments show how EMU reinforced the democratic legitimacy of economic policy (Jones, 2002: 163). Supranational action is legitimate whenever it provides an efficient outcome on certain goals that member states alone could hardly deliver (Dunn, 2000; Menon and Weatherill, 2002). This is in line with the 'result-dominated theory': '*(...) once EMU provides successful economic effects, the institutions will gain credibility and legitimacy*' (Verdun and Christiansen, 2000: 169). Considering that the move towards supranational monetary policy is closer to citizens' concerns (it is *policy, not politics*) and aims a culture of stability, it feeds a *result* that is easily explainable in terms of democratic legitimacy. Nonetheless, this democratic imprint stands outside the conventional state-centric approach of democratic legitimacy.

Crucial for this analysis is the identification of net winners. Assuming that national governments' ability to run economic policy was severely constrained, and that supranational institutions were not the winners, the only possibility left over is to acknowledge that markets and the society as a whole are the champions in this process. National governments' constraints bear a specific meaning: they involve a decentralisation feature, simultaneously economic and civic. Since national governments lost power to markets they are at the mercy of painstaking actors who are eager to assess the quality of policies. As such, national governments are forced to show their policies meet increased quality patterns.

As far as civic decentralisation is concerned, Jones's arguments are instructive. National governments can no longer turn their back on citizens as they did before EMU. Increased accountability that member states' governments face is an additional guarantee of citizens' power. By implication, not only national governments' democratic legitimacy is reinforced through the operation of EMU, but this also entails a decentralisation imprint.

Because intense globalisation was undermining national governments' capacity to run autonomous economic policies, and since the fear of inflation was evenly spread across industrialised countries, monetary union was the answer to the challenge of economic

interdependence at the world level. The result was the awareness that EMU constrained member states without involving a corresponding strengthening of the supranational level. On the contrary, EMU was geared towards lower levels, running away from politics and approaching effective policies.

## 2.2. The combination between Economic and Monetary Union rationale and theories of European integration

Table 2 maps EMU features within the characteristics of European integration theories and approaches surveyed. For that purpose, table 1 is used as the template for positioning EMU basic elements.

*Table 2 – Theoretical cartography of EMU*

	<b>Neo-functionalism (NF)</b>	<b>Supranational governance (SG)</b>	<b>New institutionalism (INS)</b>	<b>Fusion thesis (FUS)</b>	<b>Liberal intergovernm. (LIG)</b>
<b>Actors' prominence</b>	(NF1)	(SG1) ECB powers (monetary policy)	(INS1)	(FUS1)	(LIG1)
<b>European integration ontology</b>	(NF2) <i>Single market-monetary union</i>	-----	(INS2) EMU: neo-liberal economic policy strengthened	(FUS2) Scope for domestic reform	(LIG2) Adjustment to international economic interdependence
<b>Engines of European integration</b>	(NF3) <i>Price stability + monetary policy</i> ; Design: Delors Committee	(SG2)	(INS3) ECB exclusive powers (monetary policy)	(FUS3)	(LIG3)
<b>Time dimension</b>	(NF4) <i>Design: Delors Committee</i>	(SG3)	-----	-----	(LIG4) Creation: IGC

In some cases, juxtaposition emerges between different theories and/or approaches for the same level. Whenever this happens, the reason is the somewhat ambiguous assessment for a certain characteristic of monetary integration, or the fact that EMU captures the influence of more than a single theory or approach of European integration. Nevertheless, I try to put emphasis on the theory or approach with more explanatory power. In that case, an emphasis is made on table 2.

Some remarks about this cartographic exercise. In the first place, doubts might arise for the theoretical qualification of EMU when one acknowledges that member states' drive towards a neo-liberal EMU was not spontaneous, rather it was a strategically pragmatic choice based on the need to accommodate to increasingly uncontrollable international economic interdependence. At the first glance, this might be a powerful evidence of

how EMU was instrumental to member states' interests (thus, LIG2). Nonetheless, member states were forced to accommodate to a new political-economic context. This is instructive of how national governments followed something they were unable to domesticate on a unilateral basis. Since they could not swim against the tide, they were forced to embark it. Even though EMU reflects national preferences, it is wrong to assume that it also mirrors member states' power (if that was the case, then LIG3 should be mapped).

At the same level, other theoretical influences emerge. The connection between SEM and EMU seems indisputable (NF2). In addition, since EMU's inception neo-liberal orthodoxy was strengthened as far as economic policy-making is concerned, which is consistent with new institutionalism path-dependence rationale (INS2). An additional piece should be added to the jigsaw: the recognition that member states used EMU to enforce painful domestic reforms. This aspect could be included on LIG1, meaning that national governments captured EMU for their own domestic agendas, thereby strengthening their power vis-à-vis citizens. I find FUS2 more appropriate. On the one hand, it is wrong to conclude that national governments embraced EMU because their calculations were consistent with a priori awareness that monetary integration would speed up domestic reform (Dyson and Featherstone, 1999). On the other hand, EMU implications for national governments' autonomy are clear in terms of economic policy: they lost monetary policy to the ECB (SG1, ruling out liberal intergovernmentalism as an explanation for this specific aspect); and, following Jones' analysis (Jones, 2002), more responsible standards of fiscal policy empower citizens vis-à-vis national authorities, denying liberal intergovernmentalism (rejection of LIG3).

The second remark looks at the juxtaposition between NF3 and INS3. This is only apparent, because central bank's exclusive powers in terms of monetary policy (INS3, a connection with new institutionalism) is only an implication of the model chosen by the Delors Committee. The studies carried over by this committee were very influential for the final outcome. Central bankers were key actors within the Delors Committee (Verdun, 1999), which reflects how elite-driven the transition towards monetary integration was (NF3). Price stability is the sacred macroeconomic goal to be achieved. Monetary policy is the appropriate instrument to achieve price stability (for both, NF3 again). The result was putting monetary policy in the hands of a constitutionally independent supranational central bank (INS3).

Finally, a short note on why neo-functionalism and liberal intergovernmentalism share explanatory potential at the bottom level (respectively NF4 and LIG4). Notwithstanding EMU was born after the intergovernmental conference that gave rise to the Maastricht Treaty (LIG4), the outcome was predetermined by the contribution of the Delors Committee (NF4).

All in all, table 2 suggests that EMU was by far outside liberal intergovernmentalist explanations<sup>4</sup>. Most of EMU features fall within neo-functionalism and new institutionalism. To this extent, monetary union in Europe was not, as it was designed and henceforth implemented, an outcome largely influenced by member states. Neither did EMU reinforce national governments' power. The relationship between governments and citizens, with the latter empowered by comparison with the pre-EMU setting, is evident. Moreover, national power was not strengthened vis-à-vis supranational institutions, as it stands clear that monetary policy (crucial for overall economic policy) was transferred to a politically independent ECB. Possibly another straightjacket to member states' power emerges when fiscal policy is addressed. That is the scope for section 3.

### **3. THE STABILITY AND GROWTH PACT: WITH OR AGAINST THE THEORETICAL STANDARD?**

There are three different reasons lying behind the Stability and Growth Pact (SGP): the first is a consequence of EMU macroeconomic orthodoxy; the second accommodates member states' interests in a supranational setting with deep fiscal externalities; the third addresses normative judgements supporting the existence of the SGP.

Germany prompted the discussion of fiscal rules at the supranational level. The result was the proposal laid down by the then German Minister of Finance, Theo Waigel, to extend sound fiscal policy beyond the inception of stage three of EMU<sup>5</sup>. The SGP is a case of strict *negative integration* because the underlying purpose was to establish the conditions under which unsound fiscal policies are not accepted. There is no additional effort to define what is the 'appropriate substance' required for member states' public finances (Dyson, 2000: 45).

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<sup>4</sup> See Moravcsik for an opposite perception (Moravcsik, 1998: 379-430).

<sup>5</sup> Good historical records of the negotiations leading to the SGP are, among others, in Buti, Franco and Onghena (1998), and Stark (2001).

The most striking reason supporting fiscal discipline relied on the need to avoid fiscal profligacy after the beginning of stage three of EMU. Cutting national fiscal authorities' obedience to fiscal rules could bring a dangerous outcome, since

*(c)ountries going through the convergence game may act opportunistically, i.e., they may do this today so as to gain access later. Once they are in the Union, they will reveal their true preferences* (de Grauwe, 1997: 146),

i.e., to loosen fiscal discipline. The first motivation of the SGP was backed on positive externalities that fiscal policy soundness conveys both to EMU's operation and for member states (as fiscal authorities).

Focusing first on the extent to which the SGP helps EMU's coherent operation, the belief is that rules mitigate the imbalance between supranational monetary policy and national fiscal policies (if they have different directions). It was feared that the ECB could be severely affected by national governments' irresponsible fiscal policy. Constitutional political independence granted to the ECB and its embryonic credibility could be threatened (Artis and Winkler, 1998).

Credibility risks were real, particularly if the ECB was to be driven by political pressures to bailout profligate member states or to loosen monetary policy when such decision runs against its own preferences. The SGP insulates the ECB from political pressures, helping the central bank to build its credibility and to anchor itself to independence (Wyplosz, 1999). These fiscal rules reinforce the role played by the ECB and emphasise the dominance of monetary policy (Fitoussi and Creel, 2002). The central bank is able to deliver monetary policy offsetting whenever the SGP is threatened by member states' fiscal indiscipline (Brunila, Buti and Franco, 2001).

The second implication from the SGP is on member states as fiscal authorities. Standing on the assumption that intense economic interdependence undermines national fiscal authorities' autonomy, the SGP is a helpful device for improving their performance. With EMU member states lost monetary and exchange rate policies as instruments for macroeconomic adjustment. They only keep fiscal policy. This means that national governments face increasing obstacles to neutralise country-specific shocks. As a result, they are forced to improve fiscal policy efficiency. The rationale behind the SGP is that *'(...) strong fiscal discipline in good times goes hand-in-hand with fiscal stabilization in bad times'* (Artis and Buti, 2000: 568).

Recent experience might reflect the need for enhanced fiscal discipline at the national level. National governments must be aware that fiscal laxity during a boom is not a reasonable option (Collignon, 2003b). Unwillingness to avoid expansionary fiscal policies during booms might explain fiscal profligacy that some key member states faced (Galí and Perotti, 2003). Absent fiscal prudence during upswing exacerbates trouble once recession hits the ground. Then it becomes troublesome to respect the SGP.

The final justification comes from normative judgments that strengthened the faith in fiscal soundness. Borrowing from public choice analysis, some scholars claim that the pact was necessary to avoid the detrimental effects following national governments' irresponsible fiscal behaviour. The SGP is normatively interpreted as a necessary external constraint to curb national governments' deficient performance in the fiscal arena (Buti, Franco and Onghena, 1998). Furthermore the SGP was designed to protect taxpayers' interests against the misbehaviour of national fiscal authorities (Dyson, 2002b).

Keeping the public choice reasoning in mind, it is instructive to assess member states' past experience. Politicians face a strong incentive to prioritise short-term solutions to solve long-term problems; and even to pay attention to short-term targets since they produce a huge impact on how the public judges them (Loedl, 2002). By implication, politicians face the temptation of excessive deficits as a strategy to extend their staying in office, because the public's perception is directed towards short-term effects of policy-making (Beetsma and Uhlig, 1997). This policy option is rejected by the SGP. As a result, the quality of national fiscal policies is likely to increase, as there is diminished room for mistakes. The pact also stops national governments from imposing serious constraints on their successors by relaxing fiscal policy that henceforth creates difficulties to those who come into office after them (Virén, 2001).

### **3.1. The original Stability and Growth Pact: with the tide**

When it comes to understanding why the SGP was created and how it was designed, some fresh insights come to the surface in terms of theories or approaches of European integration. Table 3 summarises the location of SGP features within the theories and approaches of European integration.

Table 3 – Theoretical cartography of the (original) Stability and Growth Pact

	<b>Neo-functionalism (NF)</b>	<b>Supranational governance (SG)</b>	<b>New institutionalism (INS)</b>	<b>Fusion thesis (FUS)</b>	<b>Liberal intergovernm. (LIG)</b>
<b>Actors' prominence</b>	<b>(NF1)</b>	<b>(SG1)</b>	<b>(INS1)</b> Goal (1): preserve ECB independence and credibility	<b>(FUS1)</b>	<b>(LIG1)</b>
<b>European integration ontology</b>	<b>(NF2)</b> Rationale(1): EMU orthodoxy; Goal (2): fiscal discipline for member states	-----	<b>(INS2)</b> Goal (3): improve the performance of national fiscal policy	<b>(FUS2)</b> Rationale (2): Germany extends fiscal discipline to EMU	<b>(LIG2)</b>
<b>Engines of European integration</b>	<b>(NF3)</b> Rationale (3): faith in fiscal discipline; Rationale (4): protect taxpayers	<b>(SG2)</b>	<b>(INS3)</b> Outcome (1): ECB role strengthened Outcome (2): (re)emphasise monetary policy	<b>(FUS3)</b> Operation: monitoring (Commission) + judgement (Council)	<b>(LIG3)</b>
<b>Time dimension</b>	<b>(NF4)</b> EU regulation (after Maastricht)	<b>(SG3)</b>	-----	-----	<b>(LIG4)</b>

The map reveals how neo-functionalism and new institutionalism are the dominant theoretical matrixes of the original SGP. Considering that new institutionalism is closer to neo-functionalism than liberal intergovernmentalism, further evidence emerges of how EMU fiscal rules were designed to constrain member states' power. This assessment deserves two qualifications, though. Firstly, the pact was negotiated following the pressures exerted by the German government. Nevertheless it is wrong to take for granted that the pact's rationale was an outcome of member states' preferences. It is reported that Germany had in mind the extension of fiscal rules for the final stage of EMU as a necessary device to secure EMU's successful operation, especially to prevent damages on ECB's independence and credibility. More than just understanding the creation of the SGP as an emulation of German interests, it was on the monetary union's own benefit that fiscal rules were approved. Instead of placing this within the realm of liberal intergovernmentalism it should be credited to the fusion thesis (FUS2), especially for the interlocking effects between domestic best practice (Germany) and the other member states that accepted it through an EU decision.

Secondly, the operation of the pact brings an important nuance to its mixed nature of neo-functionalism and new institutionalism. Procedural rules assigned different roles to different EU institutions. While the Commission monitors member states' fiscal policy

and delivers recommendations to member states who did not respect fiscal deficits limits, the decision on whether member states that violated the pact should be fined belongs to the Council of Ministers. Despite the fact that the Commission performs an important role on the preventive dimension of the pact (avoid fiscal leniency), the dissuasive dimension is reserved to the Council of Ministers (implementation of pecuniary sanctions). Qualitatively speaking, the role assigned to the Council of Ministers is more important than the one given to the Commission. Considering that the Council of Ministers represents national interests (although the Council is formally an EU institution), a degree of national interests is at stake in this model. It was feared that the pact's enforceability was at risk due to the strong likelihood of partisan implementation, a kind of mutual solidarity between national governments (Buti, Eijffinger and Franco, 2003). Subsequent events (see section 3.2) showed how the risks of non-enforceability were underestimated by EU institutions and national governments. Accordingly, operational details of the SGP give expression to the way EU institutions and national governments cooperate in supranational governance, which is consistent with the fusion thesis (FUS3).

Other than these exceptions, the prevailing features of the SGP are placed within neo-functionalism and new institutionalism. The awareness that national governments should respect fiscal discipline emerged as tensions between supranational monetary policy and decentralised fiscal policies were troublesome. The pact again pegged to EMU's political-economic orthodoxy (NF3), namely price stability, the relevance afforded to monetary policy (INS3), and the crucial role assigned to the ECB (INS3). Thus, the autonomy of the ECB was at stake (INS1 and INS3), preventing harmful pressures exerted by a coalition of national governments that encouraged fiscal profligacy if fiscal rules were absent. Importantly, the SGP was the logical step after the creation of monetary union. It was the coronation of EMU's orthodoxy, suggesting the spillover rationale (NF2). The other important evidence of neo-functionalism is the temporal dimension: an EU regulation gave birth to the pact (NF4), meaning that a crucial step forward was taken outside intergovernmental conferences.

The cartography of the SGP provides an illustration of how its theoretical influence is very much consistent with prevailing theoretical forces of EMU. Therefore, the original SGP worked alongside monetary union. Both reveal the predominance of neo-



functionalism, with some inputs given by new institutionalism and, to a lesser extent, the fusion thesis. Thus, the pact was running with the (theoretical) tide of EMU.

### **3.2. The reformed Stability and Growth Pact: against the tide, or just a new paradigm?**

Scholars did not agree on the future prospects of the SGP. At the outset, disagreement on the pact's enforceability was the keyword. Amidst criticism about the rationale of the SGP, scepticism on the feasibility of pecuniary sanctions implemented to member states that breached the public deficit ceiling, and the defence of the pact, some turmoil affected the credibility of fiscal rules within the Euro-zone. Several events raised doubts about member states' commitment to the rules. By the time that critics declared the death of the SGP for the multiple violations of the pact's core – not respecting quantitative rules for public deficits did not trigger pecuniary sanctions – the pact underwent reform. What matters is whether the chain of events that culminated in SGP reform left a footprint of change on the theoretical paradigm of EMU and the SGP. For that purpose, it is crucial to capture the symbolism of events that paved the way to reform, and to pay attention to what changed in the pact after it was reformed.

Some of the aforementioned events took place on a single week (14-18 July, 2003). On 14 July, 2003 the French president, Jacques Chirac, called for a flexible SGP. Flexibility was needed to avoid the pact's harmful effect, because it was believed that it prevented economic growth. One must be aware of the specific context of Chirac's plea. France was facing huge difficulties to avoid an excessive deficit. Recent official data announced this member state would go into fiscal profligacy for the third consecutive year, thus putting France on the road for pecuniary sanctions. Bearing in mind that the other locomotive of European integration (Germany) was also facing fiscal indiscipline, Chirac's statement was the first serious call for a flexible SGP.

Surprisingly, the European Commission threw more fuel into the fire at the end of the week. On 17 July the Sapir Report (Sapir *et al.*, 2003) was released. Notwithstanding members of the Commission reacted differently (from severe opposition, to muddled reactions made of partial refutation and partial acknowledgment, to Romano Prodi's silence), the Commission was committed to the report. The Sapir Report concluded that the SGP should be more flexible, notably by loosening the exceptionality clause that enables a profligate member state to avoid pecuniary sanctions, and through a different understanding of public expenditures that fall under the deficit calculation. In the

meantime, Romano Prodi gave an interview in which he recognised that the pact was “stupid”.

On the same day Prodi’s interview was published he went to Berlin and met with the German chancellor, Gerhard Schröder. The agenda was how to make the SGP operational in the face of severe economic downturn. The president of the Commission was among those who wanted to make the SGP more flexible. All in all, the two largest national economies of the Euro-zone were unable to stick by the rules of the pact. This is somehow consistent with the claim that a *syndrome of asymmetry* affects the operation of the SGP: *the pact works well for small member states and not that well for the largest member states* (von Hagen 2003: 22-3).

On mid-October 2003 the French government announced another year of excessive deficit. Furthermore the French finance minister, François Mer, said France was not willing to pay SGP fines because they were detrimental to economic growth. Commission’s first reaction was prudence, despite threats that it would trigger the procedure that might lead to pecuniary sanctions. This institution was aware that political turmoil should be avoided. Otherwise Euro-zone credibility might be in danger. Nevertheless the Commission was caught on a trap: between issuing a recommendation suggesting pecuniary sanctions, and thus enforcing the pact’s rules; and the tactical prudence of not enforcing sanctions.

At the end the Commission recommended the implementation of sanctions if France was unable to curb excessive deficit by 2005. The Ecofin meeting on 24 November 2003 should discuss the implementation of pecuniary sanctions to France and Germany, because these countries presented an excessive deficit for the third consecutive year. Following a first meeting on the 4<sup>th</sup> November, the Council postponed the final decision because there was no consensus among national ministries. The Netherlands, Austria and Finland rejected granting France an extra year for bringing the deficit down.

After a lengthy discussion, Ecofin decided not to submit to vote the Commission’s proposal that called for sanctions on Germany and France. Instead national ministers discussed an alternative proposal that allowed France and Germany to remain in excessive deficit for 2004 without triggering SGP fines. This proposal was approved, but the Netherlands, Austria, Finland and Spain voted against.

In practice, two profligate member states escaped SGP pecuniary sanctions. The dissuasion dimension of the pact was not working at all, as it was already happening with the preventive dimension (due to reiterated excessive deficits in those member states). The 24<sup>th</sup> November Ecofin meeting brought to the surface axiomatic characteristics of European integration: a bargaining process made of national governments' strategic actions, searching side payments that reward their vote alongside the interests of larger and powerful member states; and an asymmetric EU, where larger member states' preferences are given priority and influence the outcome of Council meetings.

Ambiguity was still the dominant aspect when discussions about the SGP sat on the table. A vast majority of influential actors (national finance ministers, even prime-ministers that became involved in the meantime, the Commission and, to a lesser extent, the ECB and the European Parliament) recognised that the original pact had to be changed. The challenge was to reform the pact without changing its nature. Fiscal rules were still a building block of EMU. The scenario called for changing the content of fiscal rules. They should be more flexible, ruling out original tightness. Two goals were sought: i) a cosmetic surgery designed to make fiscal rules more flexible, thus easier to respect by member states; ii) a realistic approach, according to which the pact's credibility would be restored as long as severe rules were diluted.

At the end, consensus emerged between the Commission and national governments. The pact was reformed in 2005. According to the reformed version, lenient member states are given an extra year for accommodating an excessive deficit (Buti, Eijffinger, and Franco, 2005). Hence, the likelihood of pecuniary sanctions is lower for the additional adjustment time granted to member states facing excessive deficits. This raises important questions about how effective renewed fiscal rules are. It seems that the dissuasion dimension is only a question of rhetoric, a bundle of rules that is very unlikely to become implemented as they exist but it is doubtful that they will ever be tested (Feldstein, 2005). Furthermore, the exceptionality clause (allowing excessive deficits in years of economic downturn) was relaxed. This comes in line with the flexibility rationale that spreads all over the SGP. Excessive deficits are not monitored whenever countries face negative GDP growth. In the original version, automaticity only worked when negative GDP growth was higher than 2 per cent points. The reform of the SGP encompassed a flexible solution for public expenditures that account for

deficit calculation. Certain items might be excluded (expenditures related with structural reforms, roughly speaking), which can be viewed either as a strategy that promotes relaxed fiscal policy or a manoeuvre of statistical illusion that artificially ensures SGP enforceability. Finally, more attention is paid on the public debt, especially on debt sustainability as a criterion that excludes penalties to member states that present an excessive deficit (Annett, 2006).

Considering that EMU political-economy took away monetary policy from national politicians' competences and that national fiscal policy autonomy was curtailed by the original SGP, the question is whether the reform of the pact signals member states' willingness to recapture power they would have lost if (and only if) the original SGP was fully respected. The chain of events that fuelled reform, and the outcome of reform itself, seems to match member states' interests. It makes sense to review the cartography of the SGP, adjusting table 3 to the framework that influenced the reform of the pact and to the new pact itself.

*Table 4 – Theoretical cartography of the reformed Stability and Growth Pact*

	<b>Neo-functionalism (NF)</b>	<b>Supranational governance (SG)</b>	<b>New institutionalism (INS)</b>	<b>Fusion thesis (FUS)</b>	<b>Liberal intergovernm. (LIG)</b>
<b>Actors' prominence</b>	(NF1)	(SG1)	(INS1)	(FUS1)	(LIG1) Background(3): member states won the Commission
<b>European integration ontology</b>	(NF2) Rationale (1): EMU orthodoxy (relaxed)	-----	(INS2)	(FUS2)	(LIG2) Rationale (2): SGP flexibility Goal: member states' room of manoeuvre Outcome (1): more fiscal policy activism
<b>Engines of European integration</b>	(NF3)	(SG2)	(INS3)	(FUS3) Operation: monitoring (Commission) + judgement (Council)	(LIG3) Background(1): member states' collusion = no sanctions (2): asymmetric EU (power of big countries) Outcome (2): member states recapture power
<b>Time dimension</b>	(NF4) EU regulation (after Nice IGC)	(SG3)	-----	-----	(LIG4)

## CONCLUDING REMARKS

The comparison between tables 3 and 4 shows how the reform of the SGP fed a theoretical shift in EMU. Since the SGP is a crucial ingredient of European monetary union, the reform produced a substantial impact when the theorisation of EMU is at stake. Events and changes propelled by the pact's reform shifted the cartography towards the right. Significantly, the comparison of pre and post-SGP reform shows a desertification of neo-functionalism and new institutionalism boxes. Conversely, boxes lying within liberal intergovernmentalism grew in importance. This reflects how member states' interests were the key aspect not only in the political turmoil that showed a non-enforceable SGP, but also on the way reform was negotiated.

Therefore, the SGP faced theoretical transhumance from a mix of new institutionalism and neo-functionalism towards liberal intergovernmentalism. To this extent, maybe the theory of supranational governance is the best mirror of an inter-temporal examination of the SGP. Despite static analyses provide different theoretical paradigms (tables 3 and 4), a long-term, dynamical assessment brings the SGP close to the theory of supranational governance for the shift from the neo-functionalist extreme towards current liberal intergovernmentalist dominance. Somewhat similarly, Heiphetz and Verdun (2005) suggest an eclectic approach that combines several theories applied to several aspects of the "SGP affair". The difference between Heiphetz and Verdun's approach and my own is that while I resume to the theory of supranational governance, and especially to the explanatory power provided by the pendulum theorisation, the eclectic view broadens the scope to encompass more theories and partial approaches of European integration: intergovernmentalism, domestic politics, neo-functionalism, and an "expertocratic" approach.

As it was stated at the outset, this paper is part of an ongoing research about European integration theories applied to two different case studies – Economic and Monetary Union and the analysis of political legitimization discourse. The research is still in its introductory stage. Therefore, much of what has been put forward in this paper is provisional, open to improvements coming both from comments and from researchers' following steps. Other theories and approaches must be tested, in order to know whether they fit with particular aspects of European monetary integration.

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