Explaining governmental preferences on Economic and Monetary Union Reform

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Abstract

This article examines the extent to which economic or political factors shaped government preferences in the reform of the Economic Monetary Union. A multilevel analysis of EU member governments' preferences on 40 EMU reform issues negotiated between 2010 and 2015 suggests that countries' financial sector exposure has significant explanatory power. Seeking to minimize the risk of costly bailouts, countries with highly exposed financial sectors were more likely to support solutions involving high degrees of European integration. In contrast, political factors had no systematic impact. These findings help to enhance our understanding of preference formation in the EU and the viability of future EMU reform.

Keywords

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Introduction

Since the outbreak of the Eurozone crisis in late 2009, European policy-makers have agreed to a string of reforms that together amount to a profound deepening of fiscal and monetary cooperation in the Eurozone. Fighting a rearguard battle against the crisis, European Union (EU) governments have created joint resources for Eurozone states in crisis (European Financial Stability Facility and European Stability Mechanism), strengthened the Stability and Growth Pact through multiple sets of reforms (Six-Pack and Two-Pack), agreed on a new treaty to force a balancing of government budgets (Fiscal Compact), and adopted measures to establish a banking union (Single Supervisory Mechanism and Single Resolution Mechanism). These reforms have not come lightly. On the contrary, they have typically resulted from an intense battle against the raging crisis and arduous negotiations among the governments. It is also far from clear that they will be sufficient to deal with fundamental tensions in the construction of the European Monetary Union (EMU). Still, these reforms illustrate how European integration often feeds on crises to take significant new strides.

This article examines national preference formation concerning these reforms. What were the factors that shaped governments' preferences about EMU reforms? Did concerns about countries' structural economic vulnerability matter, or rather fluctuations in public support for the Eurozone? The appreciation of how economic and political factors combine in explaining the Eurozone crisis and ensuing reforms is still limited in existing scholarship (Copelovitch et al., 2016: 812-13). A more solid comprehension of preference formation on Eurozone reform, however, is central to deepening our understanding of the logics and mechanisms of European economic governance. Moreover, unveiling the factors that led governments to adopt certain positions on Eurozone reform informs us about the limits and possibilities for establishing a viable supranational monetary union in the EU and beyond.

Existing research debates whether government preferences on EMU reform are primarily determined by structural economic factors or by political considerations (Armingeon and Skyler, 2017, Schlipphak and Treib, 2017, Tarlea 2018, 2019). We take our starting point in the economic perspective and develop an argument emphasizing financial sector exposure as a determinant of government preferences. Countries' financial sectors are varyingly vulnerable because of their cross-sectoral and cross-national interconnectedness. The more exposed a financial sector, the greater the expected vulnerabilities of a country to external shocks. As a result, governments with highly exposed financial sectors should be more likely to prefer European rather than national solutions to the crisis. This is in line with expectations formulated by integrationists for whom interdependence is generally a driving force of regional integration (cf. Leuffen et al., 2012).

We contrast our argument with an alternative explanation of governmental preference formation on EMU reform focusing more strongly on the impact of political factors such as public opinion, institutions and the surge of Eurosceptic parties. These factors tie in with the domestic politics literature on international relations, which highlights the importance of vote maximization for explaining preference formation more generally (Bernhard and Leblang, 2016; Kim, 2016; Walter, 2016).

We rely on the EMU Positions dataset (Wasserfallen et al., 2018) in order to empirically analyze the economic and political factors that informed national preference formation during the Eurozone crisis. The dataset contains information about the preferences of the 28 member states on a broad range of policies, including issues on financial transfers, fiscal discipline, financial regulation and institutional reform under discussion between 2010 and 2015. The issues are scaled in a way that ranges from 0 (representing the least ambitious reform proposals) to 100 (representing the most ambitious reform propositions). When conceiving of 100 as the more 'European' solution (be that with respect to redistributive measures or supranational

restrictions on national economic and fiscal policies), the scale captures what integrationists would call more 'European integration'.

A series of multilevel regression models of government preferences on 40 selected reform issues suggest that preferences for more European economic integration are largely a function of a country's financial vulnerability, controlling for a number of economic and public opinion indicators. We account for the clustered structure of the data of government preferences into policy packages. More specifically, the evidence suggests that countries' financial sector exposure is the strongest predictor for national preferences on EMU reform; in contrast, measures relating to domestic politics have no systematic impact. These findings are robust across a range of alternative model specifications, including one that tests for the potential influence of ideas.

The article shows that reaching preference compatibility necessary for enacting political change is far from trivial given that member state preferences for EMU reforms are primarily driven by financial vulnerabilities that differ for each member state. At the same time, our analysis highlights that more economic interdependence in the Eurozone contributes to a stronger alignment of preferences and that party politics play a smaller role than expected. Finally, we demonstrate that predicting preferences for EMU reform is quite straightforward, which may facilitate elaborating realistic scenarios and solutions in future crisis situations.

Theory

Our theoretical argument is centered on member state preference formation concerning policy change and integration in the area of EMU. The existing literature offers contrasting economic and political accounts of EMU reform during and in the aftermath of the global financial crisis. We side with the economic perspective and develop a hypothesis focused on how financial market exposure shapes governmental preferences. We expect a higher market exposure to be correlated with a higher degree of support for European integration. We then provide an overview of several alternative explanations that place political factors center-stage.

Economic determinants of governmental preferences

Our argument rests on the assumption that governments act as risk minimizers, particularly during a crisis, and that they were mainly driven by national economic considerations when deciding on EMU reforms. As the political economy literature extensively documents, during the Eurozone crisis different countries witnessed different degrees of economic vulnerability due to an uneven exposure of their banks to debtor countries (e.g. Frieden and Walter, 2017; Hall, 2012). In contrast to economic theories of the optimum currency area that emphasize systemic challenges in the EMU (Mundell, 1961; Obstfeld, 1997), political economists stress the importance of political decisions about capital flows. Before the crisis erupted, banks in trade surplus countries had excessively lent money to the private and public sectors in less competitive countries (Blinder, 2013).

Indeed, moving capital from surplus countries is in the short term attractive for most involved actors as banks of surplus countries search (and find) financing options with higher yields in the fast-growing economies of deficit countries, while trade deficit countries can expand their economy through consumption and credit (Hall, 2012). If policy-makers do not enact counter-measures against this dynamic, the imbalances among deficit and surplus

countries accumulate up to a point where housing or asset markets of borrowing countries grow into a boom and then a bubble (Blinder, 2013). In fact, a number of authors even consider the Eurozone crisis primarily a problem of accumulating balance-of-payments imbalances, where large sums of financial capital flow from banks of current account surplus countries to borrowing countries (Copelovitch et al., 2016; Scharpf, 2011). Frieden and Walter (2017: 373) summarize what happened when this dynamic found its detrimental end: "When the bubble burst, lending dried up, and the heavily indebted countries found themselves unable to service their debts, unable to make up for the collapse of domestic demand by exporting, and unable to borrow additional funds[.]"

As one consequence, when the bubble burst, both debtor and creditor countries ended up with a related problem: debtors had to pay back their debts, while creditors were concerned about the ability to reclaim their assets. For the creditor countries, this entailed the risk of needing to bail out their heavily exposed banks and thereby significantly threatening their own budgets, possibly with major systemic impacts. In order to avoid such scenarios, *both* creditors and debtors had an interest in finding solutions at the European level.

In particular, we expect the exposure of a country's financial sector – irrespective of its status as creditor or debtor – to have influenced its government's preferences on EMU reform. The more exposed a country's financial sector, the greater the vulnerabilities to external shocks, including a worsening of the Eurozone crisis. Governments with more highly exposed financial sectors should therefore be more interested in joint European solutions to the crisis than countries with lower financial exposure. In other words, it should not be whether a country was a creditor or debtor that mattered most for its preferences, as is often assumed, but the degree to which it was financially exposed towards other EU countries by registering high claims or liabilities.[i]

This logic ties in with existing political economy theories of governments' preferences (Frieden, 1991; Rodrik, 1998; Hall and Soskice, 2001) and the roles of leading economic sectors and macroeconomic conditions in shaping EMU reforms (Copelovitch et al. 2016; Frieden, 1991; Moravcsik, 1997, 1998; Wasserfallen, 2014). In the words of Copelovitch et al. (2016: 825), 'policy-makers in the Eurozone confront a number of [economic] trade-offs, which strongly affect the incentives they face as they weigh their options'.

This also corresponds to theories of European integration. Both liberal intergovernmentalists as well as supranationalists have stressed the importance of interdependence or transnational exchanges in order to explain integration preferences (cf. Leuffen et al. 2013: 251). In particular, more interdependence should lead to rising support for European integration. In the field of EMU, more European solutions either as more redistribution or a stricter regulation of national budgetary and fiscal policies can be considered a form of European integration.

H1: The greater a country's financial sector exposure, the more likely this country's government will be to prefer more power delegation to the EU.

Alternative explanations: Public opinion, institutions, and Eurosceptic parties

An alternative approach to explaining preference formation privileges domestic politics variables. From this vantage point, it is not economic conditions that shape government preferences but rather domestic political actors and institutions. This explanation emphasizes three main mechanisms focusing on public opinion, domestic parliaments, and partisan ideology, respectively.

The first mechanism refers to public opinion. While the majority of citizens have long been supportive of the European integration project, the opt-outs of the Maastricht Treaty and

several failed referendums on further integration steps indicated that ordinary citizens were less Europhile than elites (Aspinwall, 2002). The Eurozone crisis led to an intense politicization of EU politics (cf. de Wilde and Zürn, 2012; Hooghe and Marks, 2009 ;), illustrated by numerous demonstrations against or in favor of European integration in different member states. Public opinion may shape government preferences, as governments may consider that if they do not accommodate citizens' concerns, they may be punished by voters at the ballot box. As citizens care about and have structured opinions about economic policy related to the Euro and the EMU (e.g. Chalmers and Dellmuth, 2015; Hobolt and Wratil, 2015; see Hobolt and de Vries 2016 for an overview), public opinion may indeed shape domestic governments' preferences about European integration.

The second mechanism works through parliaments and governments. While citizens' opinions may directly translate into governmental preferences, domestic parliaments may play a crucial role as a 'transmission belt' between citizens and the international arena. Several studies suggest that the parliamentary arena played a prominent role particularly during the Eurocrisis (e.g. Degner and Leuffen, 2016; Puntscher Riekmann and Wydra, 2013; Wonka, 2016), suggesting that there may be an impact of these parliamentary actors on a governments' negotiation position as well. In this line Auel and Höing (2015) illustrated that national parliaments became particularly active when they have institutional power and economic urgency in their nation. A large literature on parliamentary oversight in the EU has shown that the power of national parliaments has increased in the last decades and varies between countries (Winzen, 2012). National parliaments can in some instances even give binding advice to governments as to which position to take (as in the case of the Danish EU affairs committee), leading to the expectation that governments react to parliaments the more institutional power they have.

This second mechanism also captures considerations related to the ideological orientation of political parties. Although political parties represent citizens to some extent, parties may have a distinct influence on governmental preferences given an increasing gap between citizen and party opinions on the issue of European integration (Steenbergen et al., 2007). To begin with, the left-right orientation of political parties in government may play a role in shaping governmental preferences. Using voting in the EU Council of Ministers as a proxy for government preferences, there is tentative evidence that governments' ideological orientation affects voting in the Council (Hagemann and Hoyland, 2008; Mattila, 2004). However, other studies cannot confirm this finding (Bailer et al., 2015; Wasserfallen, 2014; Zimmer et al., 2005). This controversy suggests that the left-right attitude of governments may matter for explaining governmental preferences under specific conditions.

With regard to the third mechanism, also the Eurosceptic orientation of parties in and outside government may matter for government preference formation. In this respect, extreme parties from the left and the right use quite different arguments – either economic insecurity or national sovereignty related arguments – to influence their voters (De Vries and Edwards, 2009). Domestic oppositional parties have adopted a populist rhetoric, blaming the EU and the International Monetary Fund (IMF) for domestic economic difficulties resulting from the global financial crisis, suggesting that international organizations constrain domestic sovereignty (Lubbers and Coenders, 2017; Vasilopolou et al., 2014; Schlipphak and Treib, 2017; Tarlea 2018). In an effort to win back voter support for parties adopting a Eurosceptic rhetoric, governments may be influenced by this type of rhetoric in forming preferences on EMU reform.

Taken together, this literature yields three expectations about how domestic political factors should matter for governments' preferences on supranational fiscal policy formation:

H2: The more a country's citizens support further supranational integration through EMU reforms, the more likely this country's government will be to prefer more power delegation to the EU.

H3: The more a country's citizens support the Euro, the more likely this country's government will be to prefer more power delegation to the EU.

H4: The stronger Eurosceptic parties in a country, the less likely this country's government will be to prefer more power delegation to the EU.

Research design

Next, we detail how we empirically evaluate our argument and the alternative explanations for governmental preferences about EMU reforms. We begin by discussing the operationalization of the dependent variable and the independent variables, and then move on to present the statistical model (see Online appendix for a detailed overview of the measures).

Measuring governmental preferences on EMU reforms

The dependent variable taps a country's observed preferences on a given issue.[ii] We use original data on 47 issues of each of the 28 EU members from the 'EMU Positions' dataset (for a discussion of the data, see Wasserfallen et al., 2018). To construct our dependent variable – and assure comparability – we select 40 of the 47 issues in the data set that share an underlying integration dimension; seven issues do not conform to this unified scale, hence they were deleted from our analysis (see the Online appendix).[iii] Following the spatial model of politics, issues are scaled from 0 to 100, substantively capturing the least and most integrationist positions, respectively, taken by the political actors. There is no natural or objective ending or starting point to this scale, and in the coding process we depended on expert judgements for relatively positioning the different actors in the political space. Different measures such as a preference regarding a certain size or scope of a redistributive measure, or the degree to which supranational EU institutions should gain control over national economic and fiscal policies, can be linked to degrees of support for integrative measures in the EU or Eurozone polity. A position of 0, in practice, only partially corresponds to the status quo; most policy proposals were responding to an acute crisis. 'Doing nothing', or preserving the status quo was not a viable policy option. Therefore, although our scale builds on the relative positioning of actors and their positions, the scale can still be substantively interpreted and allows comparison across the different issues covered in our empirical analysis (see Wasserfallen et al., 2018).

For example, when in 2012 the European Council agreed to set up a permanent crisis mechanism (ESM), some member state governments, such as Germany, insisted on it being financed only through paid-in capital and guarantees from Eurozone members (0 on the scale). Other countries, such as France, suggested incorporating additional sources, potentially expanding its size (100). The final compromise based the ESM financing on paid-in capital and state guarantees (0).

Our dataset contains a number of 792 observations at country-issue level (resulting from 40 issues times 28 member states minus missing values, see the Online appendix for a list of missing values). In the analyses, we account for the clustered structure of the data, allowing for standard errors to be correlated at the level of six groups of issues. Figure 1 provides a more fine-grained indication of average governmental preferences within the individual groups of issues. The underlying data are the 792 values of our dependent variables, assigned to six groups. Figure 1 shows, for instance, that in the banking union group, France was supportive of more power delegation to the EU, while Germany was less supportive. Similarly, the second group shows Greece being a full supporter of increased fiscal transfers, while Germany opposed more power delegation to the EU regarding all issues included in the fiscal transfers group. In the last group on future policies, including the Five Presidents Reports and the Eurobonds, Luxemburg was supportive of the policies put forward by its former prime-minister Juncker.
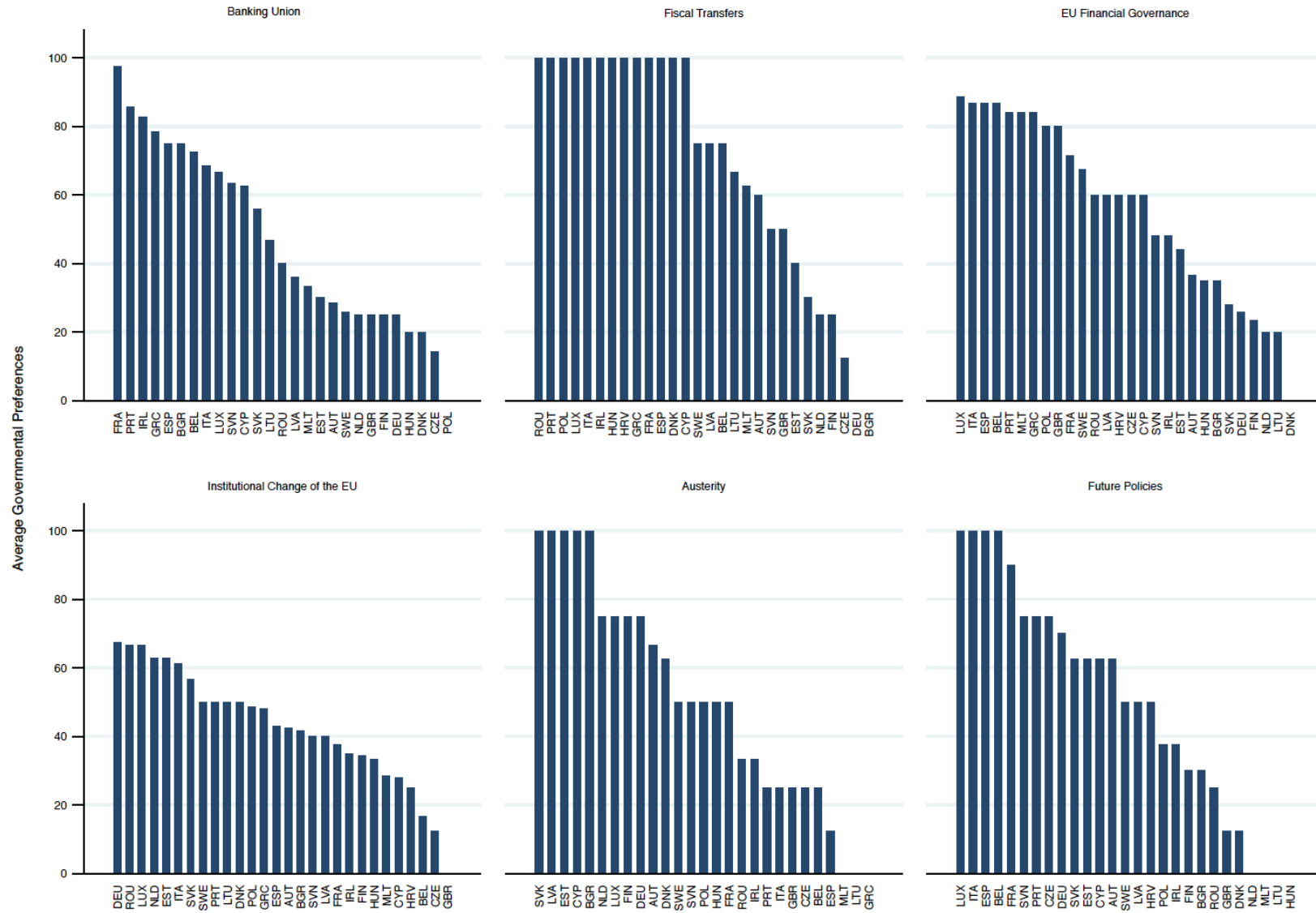
Figure 1: Governmental preferences across groups of issues

Independent economic and political variables

We expect the financial vulnerability profile of a country to be correlated with its willingness to delegate more powers to Brussels, or with its willingness to support policies implemented in all European countries. Empirically, a country's vulnerability to the crisis can be meaningfully captured by (a) the financial liabilities of its private sector, and (b) the exposure of its financial sector to the Eurozone.

We use a measure of the total non-consolidated financial sector liabilities as share of gross domestic product (GDP) in percent (Eurostat 2017, See the Online appendix) to measure the liabilities incurred by private financial institutions in every member country of the European Union. This indicator shows that the European sovereign debt crisis was first and foremost a private sector crisis (except for Greece). This eventually transformed into a sovereign debt crisis once governments had to bail out their private banks (Hall, 2012). This speaks to the complex spillover effects between banking sector risks and sovereign risks.

Financial sector liabilities are a general measure regarding the level of indebtedness of the private financial sector in a country. They are registered vis-à-vis other domestic or international institutions and are not defined in relation to other European countries. One peculiarity of this variable is that it includes data on financial institutions that have attracted large deposits, Luxemburg being one prime example in this respect. Banks that have attracted large deposits are vulnerable during a crisis, being also exposed to the risk of a bank run. A more direct measure of our main hypothesis would include only cross-border claims within the EU. The Bank of International Settlement (BIS) reports such banking statistics, but only for 11 EU member states (vis-à-vis all other 27 EU member states, whereas Croatia is missing, and we had to impute data for several dyads).[iv] Overall, the data coverage of this nuanced measure is too low for our analysis. However, this variable on the cross-border claims of private sector

banks within the EU is useful to evaluate the reliability of our main independent variable on total financial sector liabilities introduced above. The more fine-grained, but highly incomplete, variable of financial interconnectedness within the EU correlates highly with the measure of total financial sector liabilities (0.76). This provides further support to the interpretation of the findings on our main independent variable.

To further address the potential bias of the main indicator, financial sector exposure, we also rely on Trans-European Automated Real-time Gross Settlement Express Transfer System (TARGET) balances that are recorded on the balance sheet of the European Central Bank (ECB) as either 'Intra-Eurosystem Claims' or 'Intra-Eurosystem Liabilities' in the form of bilateral positions vis-à-vis the ECB (Whelan, 2017). Positive TARGET balances reflect countries that have lent money to countries *in the Eurosystem* that register TARGET liabilities. Therefore, a positive TARGET balance captures the vulnerability to risks of bond market depositors and large corporate depositors in lending countries in the Eurosystem. We use the yearly average of average monthly TARGET balances in each country of the Eurozone. Given the nature of the indicator as a balance, we divide it into positive TARGET balance (if balance higher than 0) and negative TARGET balance (if balance lower than 0). The Online appendix provides a descriptive graph regarding governmental preferences in TARGET surplus countries compared to deficit countries.

In order to be able to isolate the relationship of the financial sector to governmental preferences, we control for other potentially intervening macroeconomic variables. Following standard practice in the social sciences, we log the GDP variable to treat effects of deviations above and below the mean GDP in the same way. Trade balance is considered as a measure for competitiveness (the more competitive an economy, the higher its trade balance) allowing us to operationalize the theoretical expectations that governmental preferences during the Eurocrisis have been shaped by its level of competitiveness within the global economy.

According to the findings of Armingeon and Cranmer (2017), the level of competitiveness should be a strong predictor of a country's position during the crisis.

Scholars use the interest rates for long-term government bonds as a market measure of how the crisis varied across EMU countries. The empirics clearly show that there is a correlation between trade deficits and the depth of the economic crisis: the worse the current account balance of a country, the more the long-term interest rates increased in the crisis years. We include long-term interest rates for Germany (percentages per annum; period averages; secondary market yields of government bonds with maturities of close to ten years) that we refer to as spread on the German bonds. The levels of public debts are also expected to explain variation in our dependent variable. Countries with higher debts should be more likely to favor power delegation to the EU. Relatedly, we also control for the size of the public sector, which is as an approximation for the role of the state in the economy and the associated ideas about its function in society. The variable used is total general government expenditure as a percentage of GDP (See the Online appendix).

Similarly, higher unemployment levels are expected to be associated with a government's preferences for more European integration. Lastly, being a member of the Eurozone could also influence governments' preferences for more European integration, as Eurozone countries are more directly influenced by the EMU reform negotiations.

To test the alternative explanation, we introduce several measures tapping the three identified mechanisms through which domestic politics may influence government preferences (i.e. citizens, parliaments, and parties), respectively.

We capture citizens' potential influence through three public opinion measures based on Eurobarometer data. The first two measures, *EU trust* and *euro support,* capture the percentage of those citizens that tend to trust the EU and the percentage of those citizens who support the euro. They are coded yearly. The third measure, *EMU reform support,* captures public support

for more integration through EMU reforms at the level of policy groups. To code this measure, we use the responses to different Eurobarometer questions for the different policy groups. For example, for the issues categorized in the group of issues related to the 'Banking Union' that were decided in 2013 and 2014, we use a measure from 2010 capturing the percentage of citizens who think that the EU should prioritize strengthening the regulation of financial markets (Eurobarometer 84.3, 2015). For all issues, we used Eurobarometer data measured in the year preceding the adoption of the respective fiscal policy reform proposal at the EU level. Where this was not possible, we used the temporally closest Eurobarometer (see the Online appendix). All public opinion measures were aggregated at the country level using post-stratification weights.

With regard to the institutional channel, we include two yearly measures. First, the *Parliamentary Power Index* introduced by Winzen (2012) that seeks to capture the control of national parliaments over EU affairs. Second, we calculated the *left-right government ideology* using time-invariant unweighted mean values of information from party expert surveys on a 0 to 10 scale (cf. Döring et al., 2016).

To capture the influence of political parties, we use three main measures. First, we include the left-right orientation of parties in national government in terms of time-invariant unweighted mean values of information from party expert surveys on a 0 to 10 scale. If there are multiple cabinets in one year, we code the cabinet with most days in office (Döring and Manow, 2016). Second, the attitudes of parties in and outside government toward European integration may matter. We capture this using two measures. First, we use the percentage of the vote share of Eurosceptic parties more generally by using data from the European Parliamentary Elections.[v] We code a measure of the 2009 vote share of Eurosceptic parties, and another capturing the percentage change in vote share of Eurosceptic parties from 2004 to 2009. For some Eastern European countries, there were no elections in 2004 but in 2007, so that we

calculated the percentage change from 2007 to 2009. This latter measure allows us to check if the growth or decline of Eurosceptic parties may have mattered. We coded the vote share for 'hard' Eurosceptic parties only. Such parties are in principled opposition to European integration (cf. Szczerbiak and Taggart, 2008) and are listed in De Vries (2018: 134-136).

Model specification

To explore our argument and the alternative explanations empirically, we specify a series of multi-level models which take into account that government preferences for more European integration may vary across different groups of issues. For example, we would expect financial sector liabilities to have a larger impact on governmental preferences when issues deal with the banking union than with EU financial governance more broadly. To create groups of issues, we categorized the 40 issues in six groups: EU financial integration, fiscal transfer, banking union, treaty or secondary legislation change, austerity, and future policies. Individual issues pertaining to each group are listed in the Online appendix. Governmental preferences show interesting variation across groups of issues (see Figure 1). On average, preferences to shift more power to the European level in respect to fiscal transfer and to the Banking Union, have been higher than for the other policy groups. For example, the banking union group included issues measuring governmental preferences about an EU cap on bank bonuses. The disagreement was whether this should be legally approved, or whether shareholders' approval would suffice. Issues pertaining to the austerity group and to future policies have registered average support reflected in governmental preferences. The austerity group includes, among others, the debate regarding the first Greek bailout. Governmental preferences have been not to delegate more power to the EU for issues in the group on the institutional change of the EU.

We add a variable denoting the six groups in order to use random-intercept models including covariates at level 1 for the 28 countries and a random intercept at the level of groups.

The intercept is allowed to vary across groups to accommodate cross-group differences in government preferences (cf. Gelman and Hill, 2007). While country preferences change over time and the issue-groups are clustered in years, we do not have theoretical expectations about time-varying preferences. We therefore do not account for time in the main regression tables and instead provide robustness checks including fixed-effects for years. These robustness checks show that our main results are robust (reported in the Online appendix). Based on these considerations, the general model is written as follows:[vi]

$$y_{ij} = \zeta_j + \beta X_i + \beta V_{ij} + \varepsilon_{ij},$$

where ζ_j is the intercept that varies over policy group j, x are vectors for country-level controls, v are vectors for controls varying across countries and policy groups, and εij is the error term that is separate for group-level j.

Results

The key result from the multi-level regression analysis is that economic factors have explanatory power, while political factors have little (Table 1). The first two models include the economic variables of our argument, Model 3 operationalizes the political factors, while Models 4 and 5 are concomitant models including all variables.[vii]

Four robust results stand out. First, the coefficient of financial sector liabilities is statistically significant and positive throughout, indicating that a government is more willing to increase the prerogatives of European institutions if its economy has an oversized financial sector that would be difficult to control (or bail out) domestically. This suggests that if a financial sector is a few times higher than the entire GDP of the country, this is perceived to be as a too great risk to be only dealt with at domestic level, implying that governments prefer greater supranational integration in reforming the EMU.[viii] Countries registering very high

financial sector liabilities have been Cyprus, Ireland, Luxemburg, Malta, Spain, and the United Kingdom (UK). Romania and Slovakia had the lowest scores on the financial sector liabilities variable. Given that the financial sector liabilities metric captures currency and deposits, debt securities, loans, equity and investment fund shares/units, insurance, pensions and standardized guarantee schemes, financial derivatives, and employee stock options (Eurostat, 2017), this result indicates that a larger financial sector in relation to a country's GDP may indeed increase perceived vulnerability and thus government preferences for deeper EMU integration. This finding indicates that high exposure of the financial sector – in debtor and creditor countries alike – is associated with particular preferences on EMU reform.

Second, the significant interaction term between a target surplus dummy and target balance suggests that a more positive TARGET balance strengthens pro-integration preferences in TARGET surplus countries, but does not do so in TARGET deficit countries (Model 2), controlling for GDP/capita and financial sector liabilities. This suggests that countries whose central banks register higher claims towards other central banks in the Eurosystem are more likely to be supportive of European integration than those that register higher liabilities. We depict the marginal effect of target balance on governmental preferences in Figure 3.

Third, with regard to the remaining structural factors that we test, results suggest that governments prefer more ambitious solutions to the EMU reforms if unemployment rates are relatively high. A 1 percentage point increase of unemployment rates moves government two units up on the anti- vs. pro-integration scale (e.g. Model 4). Fourth, governments appear to prefer EMU reform solutions that lead to relatively more integration the larger the public sector of their country is. Indeed, moving public expenditure per GDP up by 1 percentage point leads to an expected 1-2 unit increase on the anti- vs. pro-integration scale (e.g. Model 4).With respect to the political explanations, we did not find a correlation between public opinion and governments' positions, even for the quite nuanced measurements of public opinion on the

policy group level. This finding does not corroborate the account that governments are responsive to public opinion in EMU negotiations. That national domestic politics (in the form of the partisan left-right orientation of the governemnts) appears not to have mattered could be due to the variation in how far EMU reform was politically contested in member states. For example, in Finland, partisan political conflict on the issue of EMU reform was absent and reforms entered the political debate rather late after they were decided on. In Germany where there was more partisan political conflict (Degner and Leuffen, 2018; Wimmel, 2012), the two largest parties, the Christian Democrats and the Social Democrats, from 2013 onwards were in a governing coalition and therefore had strong incentives to find consensus on reforms rather than publicly debating the issue (e.g. Koalitionsvertrag, 2013). However, we also see comparatively strong intra-party dissent, highlighting that external pressures might have silenced ideological differences.

On the institutional side, the parliamentary power index is negatively significant in Models 3 and 4, which led us to further explore its effects. To do so, we replicated Table 1 by excluding the unemployment measure which is moderately correlated with some of the structural economic factors (see the Online appendix). Finally, the results on the parliamentary power index suggest that powerful parliaments may tend to favor less integration and influence government preferences accordingly, probably in order to keep their control over EU affairs. However, the finding is not robust across models. We also replicate the results in Table 1 by coding the dependent variable as a binary variable. All issue positions below 50 are coded 0 and 1 otherwise. Zero captures the least ambitious reform proposals, while 1 the most ambitious reform proposals on this binary scale. Results are robust to this specification (see the Online appendix).

Table 1. Multi-level models of governmental preferences

	1.	2.	3.	4	5
Budget Deficit	-1.10	-0.88		-1.21	-1.52*
	(0.56)	(0.45)		(0.74)	(0.51)
Financial Sector Liabilities/100	0.28***	0.23**		0.21***	0.26*
	(0.08)	(0.08)		(0.06)	(0.11)
Eurozone Member				-12.98	0.00
				(11.64)	(0.00)
Trade Balance	-0.00	-0.01		0.00	-0.00
	(0.01)	(0.01)		(0.01)	(0.01)
Spread over German bonds	-1.05	-0.56		-2.06*	-1.47
	(1.01)	(1.22)		(0.86)	(0.65)
Unemployment	1.62*	0.65		1.97***	1.35
	(0.77)	(1.08)		(0.56)	(0.90)
Public Sector Size	1.71	0.85		1.93***	1.89
	(0.88)	(0.96)		(0.48)	(0.98)
Log GDP/capita	-6.33	-2.29		-8.15*	-11.61
	(5.32)	(5.71)		(3.52)	(10.67)
TARGET Balance/100	0.00	-0.01			-0.00
	(0.00)	(0.00)			0.00
TARGET Surplus		-12.31			-7.67
		(8.23)			(9.15)
TARGET balance*TARGET surplus		0.01*			0.00
		(0.00)			.
Public Trust in the EU			-0.07	-0.25	-0.07
			(0.31)	(0.42)	0.46
Public Support for the Euro			21.57	39.68	
			(14.41)	(23.52)	
Public Support for EMU Reform			-6.66	-8.67	-8.41
			(4.64)	(6.46)	(10.80)
Parliamentary Power Index			-17.18*	-10.40**	10.53
			(7.63)	(3.92)	(5.54)
Left/Right Govt Ideology			-0.97	-2.37	-1.01
			(1.42)	(1.64)	(2.02)
Eurosceptic Party			-0.49	-0.78	-0.36
			(0.33)	(0.58)	(0.99)
Constant	23.20	29.27	83.79**	65.51	104.60
	(42.57)	(44.80)	(29.78)	(46.26)	(84.84)
Constant Level 1	4.53**	6.29***	0.00	1.83	
	(2.41)	(2.83)	(0.00)	(5.12)	
Constant Level 2	45.73***	45.18***	45.19***	43.93**	43.40***
	(1.58)	(1.83)	(1.82)	(2.35)	(2.46)
N	499	499	565	542	381
N (group-level)	6	6	6	6	6
BIC	5265.90	5255.87	5947.73	5677.24	3990

Notes: Unstandardized coefficients with robust Huber-White standard errors in parentheses. Linear random-intercept models using maximum likelihood estimation. Significance levels: $^* p < 0.05$, $^{**} p < 0.01$, $^{***} p < 0.001$.
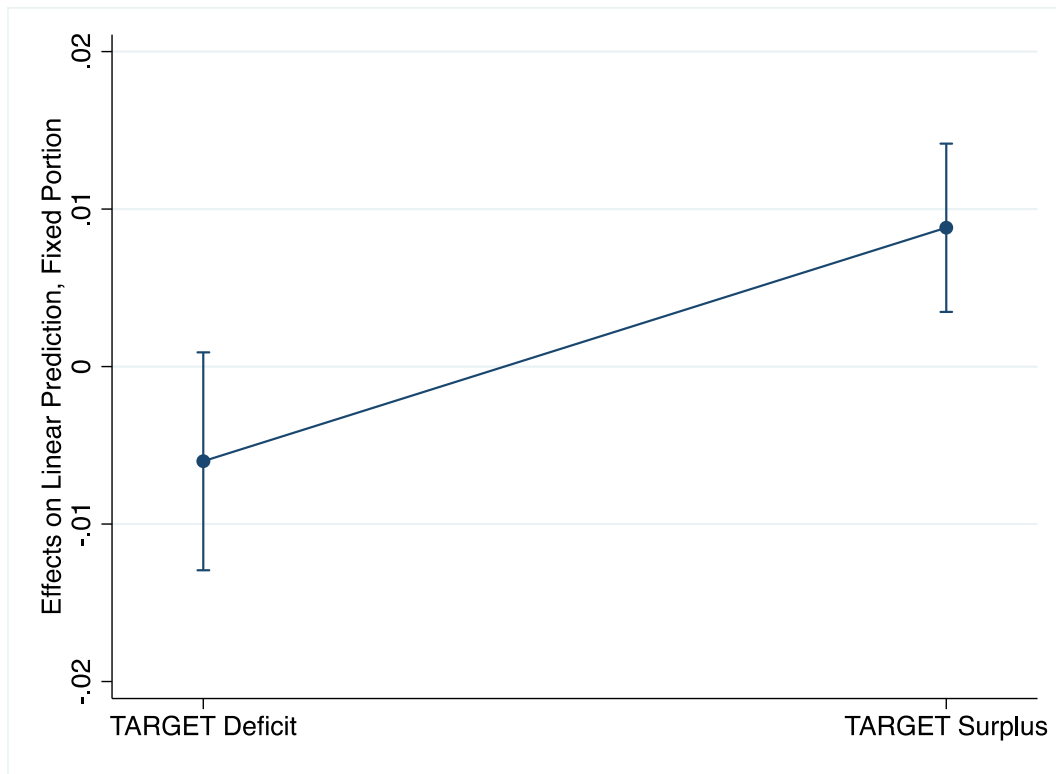
Figure 2: Average marginal effects of target balance surplus versus target balance deficit with 95% confidence intervals (Model 5)

Conclusion

In this article, we have systematically examined the factors shaping the formation of governmental preferences on EMU reform in response to the Eurozone crisis. Our analysis shows that governmental preferences were mainly informed by the conditions of the domestic financial sector. As such, large financial sectors captured by financial sector liabilities and TARGET balances have been systematically associated with governments' preferences regarding European integration. According to our analysis, financial sector vulnerability has shaped preferences in debtor and creditor countries alike, challenging the common understanding that proposals for EMU reform pitted these countries against each other. By contrast, political explanations capturing the responsiveness of governments to public opinion on the common currency and fiscal policy reform options, and the strength of Eurosceptic parties, do not seem to have mattered for governmental preferences.

Our findings have three broader implications. First, we conclude about the relative importance of domestic *economic* conditions in contrast to domestic *political* conditions. We show how much even highly politicized decisions have been shaped by economic fundamentals. In the realm of our analysis, voters seem to have mattered less, whereas the financial sector has taken center stage. While this might be sobering for close observers of the democratic process within the European Union, the context of the EMU reform negotiations was extraordinary. In this crisis setting, member states' governments were constrained by economic necessity. Hence, political accountability was deemed to rank lower.

Second, the article further underlines the importance of studying the complete process leading to the adoption of European Union policies. This process spans from preference formation, analyzed here, to conflict dimensions (Wasserfallen and Lehner, 2018), to interstate bargaining (Lundgren et al. 2018), and bargaining outcomes. This article complements the contribution of Wasserfallen and Lehner (2018), in which governments' underlying preferences

are found to be reflective of a fiscal transfer – fiscal discipline dimension. Governmental preferences explained in this article also form the basis for the analysis testing various bargaining models in the Eurozone crisis (Finke and Bailer, 2018).

Third, our results highlight how agreement among governments on supranational monetary union reforms may be difficult given that domestic preferences are anchored in different economic conditions (Jones et al., 2016; Wasserfallen, 2014). These structural economic conditions are likely to further constrain future Eurozone reform given their embeddedness in different political economic models (Iversen et al., 2016; Noelke, 2016). Structural economic conditions are more stable and stickier than political factors. This is not only relevant for monetary integration in the EU, but also in other supranational monetary unions in different world regions, where political integration institutions are weaker, such as the Central African Economic and Monetary Community, Eastern Caribbean Currency Union, and West African Economic and Monetary Union. Better understanding the conditions for successful financial market regulations and other crisis resolution mechanisms in such monetary unions is important given that financial crises strongly affect citizens' lives.

Notes

[i] [i] Note that our explanation of the influence of banks in the creditor states builds on the systemic or macroeconomic consequences rather than on a special interest logic as promoted by Grossman and Helpman (2001).

[ii] for the Online appendix contains a description of the operationalization of this and all other variables introduced in this section, a list of the issues covered as part of the dependent variable as well as descriptive statistics and bivariate correlations

[iii] In order for the scale to be consistent, we recode two issues, IMF involvement in the European Financial and Stability Facility (EFSF2) and IMF involvement in the First Greek Problem (G2). More IMF involvement is coded as less support for European integration. Also, we exclude five issues of the 'EMU Positions' dataset from the analysis because they cannot be reasonably put on a scale between more or less European integration. We drop *Institutional responsibility for SSM at ECB (BU5), private sector involvement (ESM4) and conditionality (ESM3) in the ESM, the legal form of the debt brake (FC3) in the Fiscal Compact, Debt relief in the second Greek package (G4)* and *the six-pack rules on good and bad debts (SPA4) and the asymmetry of macroeconomic imbalances (SPA5).* For example, in the case of the debate on the appropriate form of the legal commitment to the stability and fiscal discipline (debt break and balanced-budget 'golden rule'), some member governments argued for constitutional-type of commitment, whereas others were reluctant to accept constitutional change due to misfit with their legal traditions and/or need to approve the change by the referendum. This issue pertains to domestic legal traditions and cannot be categorized as delegating more or less power to Brussels.

[iv] This data can be found at the BIS banking statistics homepage for Austria, Belgium, France, Germany, Greece, Ireland, Italy, Netherlands, Spain, Sweden, and the United Kingdom https://www.bis.org/statistics/consstats.htm?m=6%7C31%7C70, last accessed June 5, 2018.
The BIS plans to collect data on bank claims for other EU countries as well, but this information was not available when this article was completed.

[v] See http://www.nsd.uib.no/european_election_database/election_types/ep_elections/

[vi] There is evidence of variation in the intercepts, supporting the specification of a random intercept model. Predicting random intercepts from this general model using *preferences* as a dependent variable indicates a 15% difference in *preferences* on a scale from 0 to 100 between groups of issues. Moreover, the level-2 error term ε_{ij} shows how mean preferences in a particular group of issues deviate from the grand mean preferences, with the variance of ε_{ij} being about 35 for the models presented in the next section.

[vii] The models are estimated including different sets of economic variables due to correlations between GDP, financial sector liabilities, unemployment rates, and TARGET balances (as reported in the Online appendix).

[viii] To further examine if the effect of the financial sector is more pronounced on some issues than on others, we allow the slope of financial sector share of the economy to vary across issues. However, differences in random slopes are very close to zero, so that we opt for a 'conservative' interpretation and choose not to interpret this result.

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