THE MARK OF THE BUNDESBANK

GERMANY'S ROLE IN EUROPEAN MONETARY COOPERATION

DOROTHEE HEISENBERG

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Germany's Role in European Monetary Cooperation

Dorothee Heisenberg

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To my parents,
Jochen and Irene Heisenberg, with love

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Dorothee Heisenberg

CONTENTS

TABLES AND FIGURES

TABLES

FIGURE

1

Introduction

Imagine Europe in late 2002: a Europe where one travels across borders without exchanging money; a Europe where French wine, Italian shoes, and German cars are bought in euros and cents;[1] and, more globally, a Europe whose currency rivals the dollar in international trade. This brave new world is the realization of European federalists' dreams and the culmination of thirty years of monetary integration in Europe. Arguably, it is the most significant element of European integration since the signing of the Treaty of Rome. How did this monumental achievement of cooperation occur? How could twelve European Union (EU) member states with disparate economies and differing European visions agree to make this enormous leap toward a single currency?[2]

To understand the December 1991 decision at Maastricht creating the timetable for a single currency in Europe, it is necessary to examine the earlier monetary cooperation among the EU member states. Plans for European Monetary Union (EMU) did not emerge sui generis but evolved from a contentious history of monetary cooperation in Europe following the breakdown of the Bretton Woods regime. Understanding EMU therefore requires knowledge of why the member states cooperated in earlier exchange-rate agreements like the "Snake" and the European Monetary System (EMS) and what the perceived flaws of those arrangements were. By noting the historical continuities, the 1991 EMU plan seems somewhat less radical in its thinking than the first EMU plan in the early 1970s (since it had been proposed in substantially the same form) but more adroit in its execution. The member states had experienced different arrangements of monetary cooperation, and those lessons shaped their preferences for the type of arrangement they wanted and helped them to avoid problems that had previously derailed their plans.

If one follows the chronology of European monetary cooperation closely, however, there is a puzzle that is not immediately apparent to casual observers of the European Union: why would Germany agree to EMU at all? To understand why this is a puzzle requires a background on the status quo before EMU negotiations began, a topic described in considerable detail in Chapters 4 and 5. For this introduction, however, it suffices to say that the then-existing currency regime, the EMS, was structured to give Germany the best of all economic worlds. Germany had stable exchange rates with its primary trading partners (thus not disrupting Germany's ability to export into those markets), and at the same time it had monetary policy autonomy so that it could tailor monetary policy to the demands of its domestic economy. Germany's partners, of course, were not equally advantaged since they had to forsake monetary policy autonomy in order to remain in the EMS.

For Germany's partners, therefore, the agreement to forge a single European currency was a step toward having some small measure of control over their monetary policy. With respect to these countries, it is perhaps more fruitful to ask why they would agree to the EMS, which was so favorable to Germany. This question is also explored in this book. For Germany, however, EMU was a retreat from the optimal currency regime, and herein lies the puzzle of German cooperation.

Why did Germany decide to cooperate in EMU? Why did it give up its monetary policy autonomy and its primacy in European monetary matters in order to enter into a currency union with historically inflation-prone, fiscally irresponsible states like Italy, Spain, and Portugal? Moreover, why were Germany's responses to monetary union proposals so schizophrenic? In any given week during the negotiations, a newspaper reader could find one government representative championing the necessity of EMU and another decrying the risk to Germany and Europe. Did Germany have stable, ordered, and coherent preferences for monetary union? Was the government incapable of representing a German position to its European partners? In addition, why did the German political elite ignore the preferences of the German public and conclude a treaty that would relinquish the deutsche mark (DM)? Finally, if Germany genuinely desired EMU and was negotiating in good faith, why did it present its EU partners with, essentially, take-it-or-leave-it proposals?

These are some of the questions about German cooperation that I seek to answer in this book. Explaining German participation in EMU in light of the success of the EMS is a difficult task. By delving into the empirical details, this book shows which actors and institutions had an impact on the European decision. In so doing, it explains the politics behind the member states' decision to move from a stable, functioning currency regime to an untested and tendentious supranational institution.

One of the problems, as noted above, in understanding Germany's willingness to give up the EMS in favor of monetary union is that German preferences for international monetary cooperation seem incoherent. On the one hand, the chancellor was always interested in exchange-rate cooperation, but on the other, finance ministers and central bankers generally expressed significant reservations about cooperation. Fundamentally, this apparent lack of an ordinal preference structure in Germany can be traced to an institutional conflict between the federal government and the independent central bank—the Bundesbank. Thus, in order to understand the origins of Germany's international preferences and negotiation strategies, it is essential to understand the institutional relationship between the Bundesbank and the federal government.

This book traces the manner in which the relationship between the Bundesbank and the federal government shaped Germany's negotiating preferences at the international level. Over time, as the policy successes of the Bundesbank became admired abroad, the bank became more influential domestically. More important, the bank's modified stature domestically impacted the negotiating dynamics at the international level as well. I examine these changes in Bundesbank policy and document the "coming of age" of the Bundesbank as a major actor in determining international monetary cooperation in Europe. As a consequence of earlier lessons in monetary negotiations, Germany's partners eventually learned to consider the Bundesbank's preferences seriously, rather than relying on the federal government to appease the bank. Describing and explaining the changing role of the Bundesbank is the other goal of this book.

Dividing the analysis of the development of European monetary cooperation into Bundesbank and federal government positions makes it possible to trace the institutional changes in the Bundesbank from 1968 to 1998. It also highlights changes in the federal government's positions toward European monetary cooperation. Although all three of the chancellors (Willy Brandt, Helmut Schmidt, and Helmut Kohl) desired currency coordination in the post–Bretton Woods era, they did so to varying degrees and for different reasons. Examining the circumstances surrounding the chancellors' initiatives in these cases makes it possible to scrutinize the underlying motives for cooperation.

To generate some potential answers for the conundrum of German cooperation, insights from different theoretical literatures in international relations, comparative politics, and European integration are used below. As will become quickly obvious, however, this work primarily uses an inductive framework rather than hypothesis testing. The attention here is to empirical detail rather than theory building. Thus, although there is one approach—historical institutionalism—that features the variables that turn out to be significant in this issue area, this book is not a procrustean attempt to form a theory.

I must also acknowledge explicitly what this book does not do. Because I consider Germany's attitudes toward cooperation to have analytic primacy over other factors in explaining international agreement, I do not attempt to explain many other facets of international monetary cooperation. There are elegant insights from diverse literatures that help to explain, for example, why the other countries largely capitulated to Germany's preferences or how the international system constrained the policy choices of the member states. To analyze these questions thoroughly, however, would require focusing as intensively on the preferences of other member states as on Germany, a task beyond the scope of this study. Nevertheless, on occasion the responses of other member states during negotiations are relevant to the emergence of German preferences, and have therefore been included here. For example, the question of why the other member states agreed to the EMS, a system that worked almost entirely in Germany's favor, is examined in detail in Chapter 3.

Why Is Monetary Cooperation Difficult?

Historically, there have been many attempts to stabilize international monetary relations. When successful, these coordination strategies generally contributed to economic expansion and prosperity for all participating states. However, often sovereign states had difficulty accepting the loss of policy autonomy that was the inevitable result of exchange-rate coordination.[3] Because membership in an exchange-rate regime forces a choice between stable exchange rates and complete monetary policy autonomy, there are incentives and disincentives to cooperate. The choice and rules of exchange-rate regimes are therefore consequential because they determine how the costs of adjustments will be borne and what economic constraints a state faces.[4] Thus disagreements about monetary regimes are fundamentally about the character of the member states' economies, an area in which sovereignty is jealously guarded.

Although central bankers and economists have shared a consensus since the 1970s that Keynesian demand-management policies and the Phillips curve[5] are discredited,[6] that consensus seems to collapse when policymakers decide how much growth they are willing to sacrifice for a small risk of inflation. In other words, the degree to which other EU member states are willing to subjugate all other policy objectives to maintain the German standard of acceptable inflation (2 percent or less) is smaller than the oft-repeated consensus would lead one to believe. In fact, the lack of a fundamental consensus about inflation risks remains one of the primary concerns of Bundesbank officials and German economists in the construction of the European Central Bank (ECB).[7]

The question of monetary coordination is therefore not trivial. The costs and benefits of cooperation are unevenly distributed among participants, and they change, depending on the rules of the regime.[8] Moreover, the choice of rules generally advantages one economic philosophy over others.[9] For these reasons, the process of negotiating the rules of a new monetary system is critical and usually extremely controversial. Because essential elements of a sovereign state's economic policymaking toolkit are at stake, cooperation in this issue area is the exception rather than the rule.

Why, then, would Germany agree to cooperate in EMU when the existing regime, the EMS, was so favorable to Germany? Below, five explanations are sketched, and these explanations are then explored in greater detail with their theoretical underpinnings in the following section.

The first explanation is that German policymakers knew that Germany would dominate EMU, and thus the single currency was the means by which Germany would more effectively exploit the other participants' economies. As a large export economy, Germany depends on stable exchange rates at reasonable, not overvalued, rates. These conditions can only be guaranteed by a single currency in the long run. Germans knew that the way to lock in their comparative advantage was to have a single currency.

A second possibility is that Germans supported EMU because their perceptions of "German interests" had been reconfigured by participation in the EU for many years. Germans immediately preferred a multilateral European solution[10] to the problem of exchange-rate instability because they had socially constructed new interests that do not focus narrowly on material or short-term interests. EMU, by this reasoning, was the natural remedy to the existing EMS, which the Germans reluctantly dominated.

Third, even if a Germany-wide interest reconfiguration was not apparent, perhaps the decision can be traced back to Helmut Kohl or Hans-Dietrich Genscher. As German policymakers who came of political age in the early postwar era, they put a great deal of emphasis on Germany's historical legacy and the necessity of continuing to integrate Germany into Europe as much as possible. Perhaps the binding of Germany to Europe was due primarily to the political preferences of a generation of Germans (and, consequently, may change after they pass).

A fourth explanation follows closely the logic of the third, with Kohl's motivation being not a pro-European vision but rather a political deal that would allow German unification in 1990. This explanation assumes that Kohl was coerced by Germany's partners to accept EMU as the quid pro quo for German unification. Since Kohl did not have control over monetary policy anyway, it was an easy choice for him to make.

The final interpretation of Germany's willingness to cooperate is based on domestic politics. Because the Bundesbank was becoming increasingly influential domestically and internationally, Kohl decided to get rid of the rival institution in the most politically expedient way, by "supranationalizing" its functions. Even though the Bundesbank Law could be changed by a simple majority vote in the parliament, that was too public and too politically dangerous. Kohl's version was far more subtle and effective.

Theoretical Underpinnings of the Explanations

In this section, these five explanations are discussed in greater detail using insights from the theoretical literature. Each explanation is based on assumptions that are highlighted in order to better assess its fit. Thus, the theories have been arranged into five categories of explanation corresponding roughly with the explanations given above: (1) cooperation works in Germany's favor; (2) cooperation is the result of German interest reconfiguration; (3) cooperation furthers EU integration; (4) cooperation is the result of quid pro quo bargaining; and (5) cooperation emanates from domestic structures.

Cooperation Works in Germany's Favor

Perhaps the most common answer to why Germany participated in EMU and monetary cooperation generally is that Germany has benefited disproportionately from that cooperation. The most dramatic statement of this view was British secretary of state for industry Nicholas Ridley's statement that EMU is "a German racket designed to take over the whole of Europe."[11] Most realist conceptions of monetary cooperation essentially embrace Ridley's sentiment, albeit in considerably more diplomatic and scientific language. The most common variant of realist thought in this context is hegemonic stability theory.[12]

Hegemonic stability theory posits that cooperation among sovereign states can only occur if there is a hegemon that has the economic resources and power to organize the system. According to this theory, Germany, as the largest European economy, had the necessary structural power to organize cooperation. Additionally, the export-oriented trade structure of the German economy provided the incentive to stabilize the value of the DM relative to its European trading partners' currencies. Germany organized EMU in order to advantage these sectors, and thus EMU was in Germany's economic self-interest.

Aside from the obvious question of whether Germany is large and dominant enough to be considered even a European hegemon,[13] applying hegemonic stability theory to Germany also depends on which version of hegemony one accepts. Duncan Snidal correctly identified two distinct branches in hegemonic stability theory, corresponding to benign and coercive interpretations of the hegemon's motivation.[14] The benign version assumes that the hegemon organizes cooperation in order to prevent anarchy, even at the expense of its interests. The other participants take advantage of the hegemon by free riding on the system. Thus, in this scenario, Germany cooperated in EMU because it was amenable to accepting a disproportionate share of costs, and the other countries accepted the system proposed by Germany because their costs would be reduced. Germany's willingness to sacrifice its material self-interest in order to organize cooperation must be explained, however. If one accepts the benign version, German cooperation must be explained using additional variables like German identity and Germany's role in the EU.[15] Given that France and other EMS partners were clamoring to have Germany accept EMU, this is the more likely version of the theory. But if one is going to explain Germany's acceptance of EMU with ideational variables, it is unclear what value the hegemonic stability theory adds.

The coercive version of hegemonic stability theory posits that the hegemon organizes cooperation because it can shift the costs of cooperation to the participants, and the hegemon can free ride. With respect to Germany's cooperation in EMU, additional questions arise if one accepts the coercive version. If Germany organized cooperation because it benefited more than the other countries, how can one explain these countries' acceptance of the regimes? How, in short, *could* Germany coerce the other states into joining EMU? As mentioned above, there is little empirical evidence that Germany was coercing the other member states to join EMU. Perhaps it is fair to say that Germany coerced them into accepting Germany's preferences for the rules of EMU, but again, alternative explanations of Germany's ability to coerce, which do not rely on Germany's hegemonic status in Europe, exist.

A second question arising from the coercive explanation is, how and to what extent Germany's willingness to accept a leadership position in Europe changed? Research on postwar German behavior has consistently shown Germany to be unwilling to act unilaterally and to lead.[16] If this consensus about Germany's unwillingness to cooperate is correct, one must ask what has changed about Germany's propensity to lead, and if this is a permanent change or simply an issue-specific anomaly. As will become clear, the German federal government's dominance in this issue area was the result of an institutional configuration that is not replicated in other issue areas.

There are also questions about the economic assumptions underlying Germany's motivation to cooperate. Because the German economy is heavily export-oriented, the "economic self-interest" explanation assumes that the natural outcome of the domestic political process was that Germany would organize exchange-rate stabilization programs among its major trading partners in order to maintain stable exchange rates and to prevent competitive devaluations or extreme currency appreciation.

Using the issue area of European monetary cooperation, some authors explain the EMS decision in terms of conflict and bargaining between sectoral interests favoring either stable exchange rates or price stability.[17] In his examination of the motivations of the weaker-currency countries, Jeffry Frieden analyzes the distributional consequences, showing how the domestic coalitions in France and Italy changed in order to allow linking to the DM.[18] A more recent analysis of Germany's motivation to join the single currency explicitly posits that the export sector's importance to the German economy was a significant factor in Kohl's decision to accept a single currency.[19] In this view, EMU was an economic win for Germany.

There is, however, no explanation of why German business would be largely favorable and supportive, given that the status quo, the EMS, was functioning well and stabilizing exchange rates:

> Anxiety [about currency volatility] is much less [than in Britain] or even non-existent in countries such as France and Germany, which are full members of the European Monetary System. More than 40 per cent of both these countries' trade is with other EMS members. "When French businessmen talk about currency movements these days, they mean the dollar and the yen. They aren't really troubled by fluctuations within Europe," says Mr. Philippe Combin, financial director of the Patronat, the French employers' federation. The BDI, its German equivalent, says *most of its members are happy with the stability provided by the EMS.*[20]

The idea that EMU was in Germany's economic self-interest is usually proposed in conjunction with a situation of no exchange-rate coordination among Germany's export markets at all. If one considers, however, that the EMS was the status quo, it is difficult to make the claim that EMU was an economic benefit to Germany. Moreover, any EMU design would entail political risks against which businesses could not hedge. Thus there were significant costs that would accompany the single currency. Before and during the intergovernmental conference (IGC, the negotiation conferences of the Maastricht Treaty) German businesses were, at best, uncertain and agnostic and, at worst, extremely skeptical. The BDI (Confederation of German industry) and the DIHT (German Chamber of Commerce) did not take public positions to encourage Kohl in his EMU negotiations. At best, they exhorted him to ensure price stability as the primary consideration. Moreover, the banking lobby was openly skeptical of the planned timetable to Maastricht.[21] Thus, to rely on business interests to provide Kohl's motivation is empirically questionable.

Such a sectoral approach explains monetary cooperation in "bottom-up" terms, an unusual element that sets sectoral explanations apart from most of the other theories in this issue area. For the most part, monetary politics were considered "high" politics that were shielded from interest group participation through undemocratic or secretive institutions like the Monetary Committee or the Bundesbank. Moreover, the uncertainty surrounding the potential outcomes, and the fact that the costs of adjustment were diffused among disparate interest groups made the interest calculation among groups difficult. This is the fundamental question: did the sectors and interest groups recognize their interests as clearly as the theory assumes? With respect to the EMS, one can argue, the interests were reasonably clear because it was essentially based on the same dynamics as the "Snake." With EMU, however, the uncertainties surrounding the rules and their effect made clear interest definition much more difficult. Indeed, it is possible that the opacity of interests was a critical element in achieving a deal on EMU at Maastricht.[22] During the IGC, the interests were immobilized because there was no clear-cut cost-benefit analysis to be made. Only after the Treaty had been signed and interests had a basis on which to explore how the single currency might affect them did they begin to take positions on the desirability of EMU.

An additional problem is that, in order to make the link between interest group pressure and negotiating positions at the elite level, it is necessary to show exactly which groups had access to policymakers, through what channels, and with exactly which preferences. Unless we assume that elite policymakers internalized the interests of certain sectors (in precisely the same way),[23] it is imperative to have empirical evidence to demonstrate the access of the interests and the effect of those communications.

Cooperation Is a Result of German Interest Reconfiguration

The literature on this idea encompasses the role of ideas as intervening variables and the role of regimes in reconstructing interests.[24] The main focus of these arguments is that ideas can be causal variables in and of themselves and are not relegated to epiphenomenal status, as the realists assert. As a consequence, ideas can explain at which of several Pareto optimal points cooperation will be established. In the issue area of monetary cooperation, the power of economic ideas has been demonstrated.[25] By focusing on how the consensus among economists and financial journalists changed during the course of the late 1970s and early 1980s, this literature reveals how the ideas of monetarism gained credibility within the economic policymaking elites in Britain.[26] That consensus eventually affected the French policymaking elites and led to the stability of the EMS regime.

Within the ideas literature, there is a divide between those who credit ideas with informing the choice of regimes[27] and those who insist that ideas not only express which point on the Pareto frontier is chosen but also actually *change* the interest calculations and preferences of the states.[28] It is in this context that the Franco-German relationship can be discussed as a causal force. The long-standing personal relationship between the leaders of both countries and the heightened sensitivity to the interests and preferences of France, for example, could explain Germany's willingness to cooperate in EMU. Constructivist theories emphasize the social construction of identity.[29] Not only are Germany's preferences shaping the EU, but EU preferences (as aggregated by the EU institutions) shape the German identity. Thus, it would be difficult to speak of "German" preferences or interests independent of the institutional context of the EU. Certainly, there have been a few aberrations of German preferences being distinct from EU preferences (the most notorious case being the early German recognition of Croatia[30]), but these cases are notable because of their exceptionalism. Overall, say constructivists, German preferences are shaped by Germany's identity as a "European Germany" embedded in the EU's institutional structure. European monetary cooperation, because of this altered interest configuration, is completely explicable.

The hypotheses arising from the reconstructed interests theory are difficult to operationalize and test. What could be considered signs that Kohl's interest calculations reflect the (EU-reconstructed) interests of Germany rather than personal conviction? How can we know that most German policymakers share a similar conception of Germany's interests in order to make the claim that those interests have been reconfigured in the long term by the constraints of EU membership?[31]

Cooperation Furthers EU Integration

There is another explanation for Germany's acceptance of EMU: Kohl's (and Genscher's) personal belief in the importance of EU integration. Both men belong to a generation of policymakers who believed that Germany's past required certain sacrifices of sovereignty in order to be able to act collectively within an integrated Europe. Thus both men were unabashedly federalist in their European visions, and both recognized the potential for EMU to become not only another area that was successfully integrated but also a stepping-stone to further integration in fiscal policy, taxation, and even political integration. To what extent is Germany's cooperation in EMU due to an interest in deepening European integration?

Neofunctionalist, or "spillover" models of integration stand out as the original theories of EU integration.[32] Functional spillover occurs when a previously integrated issue area or policy intersects with an area still controlled by multiple member states. Because it is easier to interact with an integrated entity than with six or fifteen different member states, the second issue area is also integrated. Integration thus follows a functional path.

Political spillover, by contrast, occurs as the administrators and bureaucrats switch loyalty or identity from the national member state level to