Italian Political Science Review/Rivista Italiana di Scienza Politica (2017), 47:2, 205–225 © Societá Italiana di Scienza Politica 2017
doi:10.1017/ipo.2017.7

Italy and the Fiscal Compact: Why does a country commit to permanent austerity?

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The paper investigates the factors that led the Italian government to accede to the Fiscal Compact in spite of its demanding requirements for the country's budgetary policy. Specifically, the paper assesses the extent to which Italian government's support for the Fiscal Compact was driven by the logic of the 'vincolo esterno' in a replication of the pattern that led Italy to sign the Maastricht Treaty. The paper finds only limited support to the 'vincolo esterno' argument. Rather than being motivated by domestic dysfunctions or socialization to the fiscal discipline doctrine, the Italian government acted mainly out of market punishment fears. Interestingly, however, three factors filtered such external pressures and contributed shaping government's support for the new Treaty. First, the Economic and Monetary Union unfinished architecture, and in particular the lack of a European financial firewall, weakened opposition to the new Treaty. That is to say, the institutional context constrained the choices that Italian policymakers could pursue. Second, the pro-European orientations of government members contributed to elevating the new Treaty to a symbol of European integration. Finally, the Italian government confronted a quite large domestic win-set during the negotiations, as the parties supporting the Monti government also supported Italy's participation to the new Treaty.

Keywords: Italy; Fiscal Compact; international economic negotiations; Eurozone crisis

Introduction

Since the start of the sovereign debt crisis in 2010, several measures have been adopted to fix and strengthen the governance of the Eurozone. Among them, the adoption of the Treaty on Stability, Coordination and Governance (TSCG) – also known as the Fiscal Compact – certainly stands out for the scope of intervention on budgetary sovereignty and the speed of its adoption. On the one hand, the Treaty contains provisions that harden member states' commitment to budget discipline and create mechanisms to ensure compliance along the ones that exist under EU legislation. On the other hand, the Treaty was negotiated in just a couple of months[1] – 'an unprecedented achievement' as measured by the usual length of EU negotiations (Tsebelis and Hahm, 2014: 1388).

Given its high level of public debt and stagnating economic growth, Italy's position under the new rules is, at best, problematic. To comply with the new rules,

[1] As will be recounted at greater length below, negotiations took place between December 2011 and February 2012.

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https://doi.org/10.1017/ipo.2017.7 Published online by Cambridge University Press

Italy will be required to knock around 2% of gross domestic product (GDP) (€30 billion) off its public debt every year for decades even after balancing its budget (*Wall Street Journal*, 2012).This means that 'any thought of budget-stimulated growth ideas will have to go away', as the then Italian Prime Minister Mario Monti candidly admitted' (*Wall Street Journal*, 2012). Despite this demanding commitment, which could also turn out to be economically and politically unsustainable (Eichengreen and Panizza, 2014), Italy was one the original signatories of the Treaty and a country that did not question its basic principles (*Financial Times*, 2011).

Why did the Italian government accede to an international agreement whose implementation is so constraining of the country's budgetary sovereignty and potentially damaging for the country's social and political stability?

Previous studies on Italy and EU negotiations – as well as cognate works on international economic negotiations – suggest two potential explanations to the puzzle here analyzed. The first explanation, which can be traced back to the arguments on the 'external constraint' ('vincolo esterno'), emphasizes the combined effect of the normative orientations of Italian policymakers and domestic political dysfunctions. From this perspective, Italian policymakers have traditionally accepted to curtail domestic economic autonomy via signing onto European rules as a way to sidestep a sclerotic political system and modernize the country (Dyson and Featherstone, 1996, 1999; Ferrera and Gualmini, 1999; Radaelli, 2002; Quaglia, 2004).

The second explanation for the Italian support to the Treaty emphasizes the importance of financial constraints. In this reading, which is reminiscent of the debate on policy convergence under conditions of financial globalization, Italy would have been virtually coerced to accept the Treaty because of market pressures and the implicit threat of having to sign to an international financial assistance program. This argument has recently been applied to the Italian case in order to explain the adoption of a demanding structural agenda by the Monti government (Sacchi, 2015).

The article assesses the extent to which the logic of the 'external constraint' and the discipline exerted by financial markets influenced the Italian stance in the negotiations for the Fiscal Compact. In a short anticipation of the findings, available evidence lends only limited support to hypotheses derived from the 'external constraint' argument. In particular, in contrast to what happened in the early 1990s, the technocrats involved in the negotiations in 2011–12 did not actively seek for a European anchor to enact domestic adjustment and did not appear to be persuaded of the benefits of a policy strategy that prioritized fiscal consolidation over other policy objectives. The influence exerted by market pressures was, instead, paramount. Interestingly, however, Italian policymakers did not simply cave in to market pressures in anticipation of potential punishment costs. In other words, the influence of market pressures cannot be considered automatic and its effect predetermined. But three factors filtered the external pressures and contributed shaping government's support for the new Treaty. First, the Economic and Monetary Union (EMU) unfinished architecture, and in particular the lack of a European financial firewall, weakened opposition to

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the new Treaty. That is to say, the institutional context constrained the choices that Italian policymakers could pursue. Second, the pro-European orientations of government members contributed to elevating the new Treaty to a symbol of European integration. Finally, the Italian government confronted a quite large domestic win-set during the negotiations, as the parties supporting the Monti government also supported Italy's participation to the new Treaty. The large room of maneuver granted to the government led to the prevalence of its preferences in the international negotiations as the logic of the two-level game suggests (Putnam, 1988).

In what follows, the article illustrates how different factors combined to shape the Italian negotiating stance for the Fiscal Compact. Given the short timeframe and the opacity of the intergovernmental negotiations, the analysis draws from a limited but important number of documents to provide a systematic analysis of the Italian government's negotiating position. These documents include the official pronouncements of the key executive actors who negotiated for Italy at the EU table, namely the Prime Minister Mario Monti and the Minister for EU Affairs Enzo Moavero Milanesi.[2] In the period under investigation, both Monti and Moavero delivered speeches on EU-related issues to the Parliament and responded to parliamentary questions on the negotiations.[3] Government actors also released interviews to the international financial press and selected audiences to discuss Italy's stance on the Fiscal Compact and the future of the Eurozone economic governance. The public pronouncements of the actors that led the negotiations provide a powerful tool to get a comprehensive view of the motivations that shaped their choices. These pronouncements can thus be likened to what Ross defines as narratives. That is to say, Monti and Moavero's statements provide the 'stories' that policymakers 'recount to make sense of their social and political world' (Ross, 2009: 136). By providing a glimpse into policymakers' justifications for action, these documents thus allow to dig deeper into the sources of preference formation.

In addition to the public pronouncements, the article also draws on interviews with Italian and European officials in Rome and Brussels.[4] Empirical evidence is also extracted from the reports in the international and domestic financial press as well as scholarly works and commentaries.

The article proceeds as follows. Firstly, the article introduces the reforms to EU economic governance adopted since 2010 and discusses the implications of the

[2] The list of documents used in the analysis is provided in the Online Appendix.

[3] In the empirical analysis, I rely mostly on the speeches and interviews delivered between December 2011 and March 2012. However, I also examined the public pronouncements issued till December 2012 with the aim to ascertain whether new information on the negotiations were made available after signature of the Treaty.

[4] I conducted seven interviews with officials involved in the negotiations in the period May - November 2014. In Brussels, I interviewed officials at the General Secretariat of the Council of the EU and at the office for the permanent representation of Italy to the EU. In Rome, I interviewed officials at the Finance Ministry and the Bank of Italy. Interviews were conducted under conditions of anonymity. Their content has been used as background information only.

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enhanced budgetary discipline for Italy. Secondly, I review the arguments on the EU as the 'external constraint' and those on financial markets constraints with the view of extracting the main propositions that will be tested in the ensuing empirical analysis. Thirdly, the article examines the Italian negotiating position between December 2011 and February 2012.

Reforms to Eurozone economic governance

The sovereign debt crisis that started in 2010 has triggered an unprecedented 'existential crisis' to the EU integration process (Jones, 2012: 54). Its origins are compounded with the institutional limits of the political project that revolves around the monetary union (Baldwin and Giavazzi, 2015; Matthijs and Blyth, 2015). As market pressures intensified, some sovereigns were priced out of the market, or lost market access altogether, and private borrowing costs diverged widely within the currency union – despite the common monetary policy (Allard *et al.*, 2013: 6). The crisis and its contagion also revealed that EMU rules were unable to ensure sustainable budgetary positions and prevent national fiscal policies from imparting adverse spillovers to other countries and to the union as a whole.

European policymakers responded to these challenges by reforming the governance of the Eurozone in a number of important respects. As the centerpiece of the EU fiscal governance framework, the Stability and Growth Pact (SGP) became the first target of reform.

Adopted in 1997, the SGP provides the framework through which to coordinate member states' fiscal policies in a way that ensures fiscal sustainability while also encouraging economic growth. The SGP was originally built on three principles: the requirement for member states' budgets to be 'close to balance or in surplus' in the medium term; a ceiling of 3% of GDP for the overall fiscal deficit; and a ceiling of 60% of GDP for public debt. Until 2011, only breaches to the 3% budget deficit target triggered corrective action under the excessive deficit procedure (EDP).

Before the sovereign debt crisis, the SGP had already been revised in 2005 following the political debacle associated with the breach of the deficit ceiling by France and Germany. In particular, the 2005 reform increased the flexibility of the fiscal rules by introducing the notion of country-specific medium-term budgetary objectives (MTO) (on the political factors surrounding the origins and evolution of the SGP see Heipertz and Verdun, 2010). In 2011, the adoption of the 'Six Pack' legislation further revised the working of the SGP.[5] Among the major innovations, the new legislation introduces an expenditure benchmark to help assess progress toward the MTOs. The other major innovation is the operationalization of the debt criterion that had guided the fiscal framework since 1997: if the 60% reference for the debt-to-GDP ratio is not respected, the EDP will now be activated even if the

[5] The 'Six Pack' includes five regulations and one directive proposed by the European Commission and approved by all 27 Member States and the European Parliament in October 2011.

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deficit is below 3% (more on this below). The new legislation also tightens the EDP for Eurozone members by introducing reverse qualified majority for the adoption of financial sanctions.

The commitment to fiscal discipline was further strengthened through the adoption of the Fiscal Compact, which is part of an intergovernmental treaty known as the TSCG. The Treaty incorporates most of the commitments that had already being adopted through EU legislation, namely through the Six Pack. For instance, the Treaty incorporates the debt rule introduced under the Six Pack legislation. Under Article 4, Member States are required to reduce the gap in the level of public debt-to-GDP ratio to 60% by 1/20th annually. As anticipated, if countries fail in bringing down the debt ratios sufficiently quickly they become liable to the EDP.

Although it builds on existing legislation, the Treaty is also innovative in at least two important respects regarding the commitment to balance budgets and the correction mechanisms. First, the Treaty stipulates that a government's annual budgetary position shall be balanced or in surplus, a provision also known as the *golden rule*. Specifically, Member States commit not have a structural deficit greater than 0.5% of GDP.[6] This commitment differs from those under the SGP where the lower limit to the structural deficit is 1%. Second, the Treaty strengthens the correction mechanisms in case of slippages from the structural balance budget rule. In particular, translation of the balance budget rule into national law must be done in a binding and permanent way, preferably at the constitutional level, and be monitored by an independent supervisory institution, such as a fiscal council. Furthermore, the Treaty sets up a mechanism of judicial enforcement centered on the EU Court of Justice (ECJ). Specifically, the ECJ is entrusted with the responsibility to assess members' compliance with the provision of passing the golden rule into national law, if requested by one of the signatories. The ECJ can impose a fine of up to 0.1% of GDP in event of non-compliance with its decisions. Among the mechanism to induce compliance with the Treaty, it is also important to note that adherence to the Fiscal Compact is required for a member to have access to financial assistance from the European Stability Mechanism (ESM).[7]

The Fiscal Compact was signed on 2 March 2012 by all EU member states with the exception of the Czech Republic and the United Kingdom. It entered into force on 1 January 2013 following ratification by the 12th Eurozone member state (Finland). The Czech Republic eventually adopted and ratified the Treaty in 2014.

[6] For countries whose public debt is significantly below 60% of GDP, the structural deficit is allowed up to 1% of GDP.

[7] The final version of the Treaty stipulates that EMU countries will be eligible to receive financial assistance under the new ESM only 'as soon as the transposition period referred to in Article 3(2) of [the Fiscal Compact] has expired, on compliance with the requirements of that Article'. TSCG, Preamble (27th recital).

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While keeping the budget in order is certainly a useful recommendation for any government to follow, the constraints to budgetary autonomy contained in the new Treaty are not without problems. This is particularly the case for a country like Italy with the fourth largest stock of public debt in the world and around two-decades of stagnant economic growth.[8] Given its fundamentals, Italy will have to endure a sustained period of adjustment to comply with the new rules. For instance, the International Monetary Fund (IMF) estimates that fiscal effort for Italy will be five times larger than the consolidation needs that will be required in low-debt countries in the Eurozone (IMF, 2012: 39). As a result, it is not unlikely to conclude that adherence to the Fiscal Compact will 'be the embodiment of permanent austerity' in that it will require Italy to run a primary surplus averaging about 5% of GDP year after year (Münchau, 2014). Even assuming the political sustainability of a such a demanding commitment, which cannot be taken for granted as the historical record indicates (Eichengreen and Panizza, 2014), its impact on growth is also debatable. Indeed, although the effects of fiscal consolidation on output depend on the design of fiscal packages, as well as on the coordination with monetary policy, simulations indicate that even under a 'growth-friendly consolidation' scenario,[9] 'the output effects of required fiscal consolidation are sizable' (IMF, 2012: 42). In particular, the required fiscal adjustment will translate into large output losses for the group of high-debt European countries, including Italy.

In short, economic fundamentals are a poor predictor for Italy's stance in the negotiation for the Fiscal Compact. That is to say, a pure economic analysis is confounding because it sits uncomfortably with the empirical record: the Monti government 'supported the Treaty, with a clear positive approach for stronger economic governance' (Pierdominici, 2014). This puzzling negotiating stance thus needs closer theoretical and empirical scrutiny.

Vincolo esterno or market discipline?

The literature on international economic negotiations as well as scholarly works on the Eurozone crisis suggest two main explanations for explaining the disjuncture between a country's structural position and its expressed preferences at the negotiating tables. The first emphasizes the normative orientations of the chief negotiators,[10] who are the Prime Minister and the Minister of European Affairs in the case under investigation. The second emphasizes the financial market constraints within which the negotiators operate. In what follow, I discuss both explanations with particular attention to the studies that have already examined

[8] Italy also has the second highest debt-to-GDP ratio in the Group of Seven advanced economies and the highest debt service ratio in the G7. See Eichengreen and Panizza (2014).

[9] The 'growth-friendly' scenario entails that a consolidation package with measures focused on consumption and that have little negative impact on factor supply and potential output. The 'unfriendly' scenario entails measures with higher distortionary effects (IMF, 2012: 39–40).

[10] The term 'chief negotiator' borrows from Putnam (1988: 435).

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how Italy behaves in EU-level negotiations. The discussion is meant to extract a set of observable expectations to be tested in the ensuing empirical analysis.

The normative-based explanation draws attention to the beliefs of the political actors in charge of the negotiations and the degree to which those actors are free to pursue their preferences given the relationship with domestic constituencies (for the original formulation of these arguments see Putnam, 1988: 488–450). Applied to our case, this argument would hold that the Italian negotiators, who were largely insulated from political and societal pressures because of the technocratic nature of the government of the time (Culpepper, 2014; McDonnell and Valbruzzi, 2014), supported the Fiscal Compact because they came to be believe in its underlying normative orientations. That is to say, Italian negotiators adhered to the view positing the expansionary effects of fiscal adjustment.[11] Common education backgrounds and long-standing relationship between Italian and European policymakers could have provided the mechanism through which the Italian executive became socialized into this view and thus conceived of strengthened budgetary discipline as the preferred bargaining option (Helgadóttir, 2015).

This line of reasoning has already been successfully applied to explain Italian policymakers' negotiating stance in past EU negotiations. In particular, the socialization argument stands at the core of the 'vincolo esterno' hypothesis, which has famously been applied to explain the Italian negotiating position in the negotiations for the Maastricht Treaty in the early 1990s (Dyson and Featherstone, 1996, 1999; Quaglia, 2004). According to Dyson and Featherstone (1999), for instance, Italian support for the Maastricht Treaty can largely be explained in light of a widespread belief among key governmental officials, namely key figures in the Finance Minister and the Bank of Italy. This belief held that Italy needed an external anchor to enforce budgetary discipline through a political system unable to generate necessary reforms internally (see Bull and Rhodes, 1997). This belief was so engrained and widespread among the governing elites to the point that it led to the conclusion that 'there was no acceptable alternative to participation in EMU' (Dyson and Featherstone, 1999: 465).

This belief became the building bloc of the Italian stance in the negotiations for Maastricht Treaty largely because the technocrats, who were the key supporter of the 'external constraint' thesis, were in charge of the negotiations and presented a cohesive front on the desirability of strengthening budgetary discipline (Quaglia, 2004). The cognitive convergence among Italian elites as well as their influence in the 1990s negotiations (and afterwards till the embrace of the common currency) needs to be read in light of long-term processes of institutional change in the country (Radaelli, 2002). At the time the Maastricht Treaty was negotiated, the Italian political system was in the thrones of a full crisis of authority and legitimacy, which involved the political parties but also the domestic institutions (Bull and Rhodes, 1997).

[11] On the tenets of the policy idea of 'expansionary fiscal contractions' and its historical evolution see Dellepiane-Avellaneda (2015).

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The policy leadership of the technocrats was also helped by the fact that the Finance Minister of the time came from a technocratic background (Dyson and Featherstone, 1996: 274).

The parallels with the recent negotiations are easy to spot. The replacement of the Berlusconi government by the technocratic government led by Mario Monti 'replays the pattern of the mid-1990s', as Schmidt and Gualmini (2013: 380) have already noted. Political disarray and the appointment of cabinet members detached form political parties heightened the technocratic leadership during the negotiations (McDonnell and Valbruzzi, 2014). Furthermore, like the 1990s, the technocrats who led the negotiations in 2011–12 came to power with solid credentials for fiscal discipline. As will be illustrated at greater length below, Monti had been an outspoken supporter of Italy's participation to EMU in the 1990s and had repeatedly emphasized the importance of keeping public finances in order in the domestic policy debate.

Extending the logic of the 'external constraint' explanation, the observable implications for the 2011–12 negotiations are as following:

PROPOSITION 1: The technocratic government endorsed the Treaty as the means through which to make fiscal efforts that would be otherwise impossible to be adopted because of domestic political dysfunctions.

PROPOSITION 2: The technocratic government endorsed the Treaty because of the belief in balanced budget as the first-best strategy to achieve economic growth.

If the 'external constraint' explanation implies deliberate actions to tie the government's hands by domestic actors, the second explanation of governments' preferences emphasizes the influence exerted by outside factors. Among them, the influence exerted by financial markets is the one that has probably received the most attentive scrutiny, as attested by the literature on policy convergence under conditions of financial globalization. This literature has showed that international capital mobility is the primary force that limits governments' economic policy autonomy (Goodman and Pauly, 1993; Cohen, 1996) leading to a convergence of policies of the like of smaller governments, social spending cuts, low levels of taxation, and low levels of regulation among others.[12] The underlying assumption of this literature is that, under conditions of capital mobility, markets are reluctant to extend credit to countries that run persistent budget deficits or that impose high level of taxation for mobile factors of production. Hence, capital mobility induces a sort of 'race to the bottom': since investors are responsive to domestic policies in deciding how to allocate their portfolio, countries will be forced to compete on these policies in order to continue attracting capital (Simmons *et al.*, 2006: 792–793). The expected

[12] For a review of the relationship between globalization and governments' policies see Evans (1997) and Garrett (1998) among others.

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outcome of this competition for capital is likely to be convergence as countries choose policies that do not alienate market actors (for a critical review of this argument see, for instance, Drezner, 2001). Competition, however, is not the only channel through financial markets impact on domestic economic choices. Capital mobility constraints domestic policy also through a 'disciplinary' mechanism, that is to say, through the rewarding of some actions and the punishing of others (Andrews, 1994). The punishment channel works primarily through the mechanism of market discipline or, more specifically, through the interest rate charged on government bonds (more below). A similar 'disciplinary' logic underpins the studies that attempt explaining why countries comply with the conditionality imposed by international institutions such as the IMF or the World Bank. In this reading, what leads domestic policymakers to agree on a curtailment of economic sovereignty often lies in the fear of exit by international investors and the credibility signal that an international financial assistance programs provide for those investors (Marchesi and Thomas, 1999; Edwards, 2006; Gray, 2009).

Sacchi (2015) has recently extended the insights of the literature on financial globalization to the Italian case. In explaining why Italy adopted demanding labor and pension reforms in 2012, Sacchi draws attention to the external pressures exerted on the Italian government by both market forces and European institutions and countries. Specifically, structural reforms became the Monti government's roadmap through the 'operating mechanism' of market discipline (Sacchi, 2015: 78). Italian policymakers were thus somehow coerced into structural adjustment because market forces lent support to the reformist measures voiced by the ECB and heighted the credibility of the threat that creditor states might not be willing to provide financial assistance if needed.

Extending Sacchi's argument to the case under investigation, it is plausible to hypothesize that, as market conditions deteriorated in the second part of 2011, Italian policymakers came to realize that they had no alternative but to signal the government's commitment to fiscal discipline in order to calm the turmoil in Italian sovereign debt market and thus avoiding an escalation in the interest rates charged for selling government bonds. This leads to the following observable implications:

PROPOSITION 3: The technocratic government endorsed the Fiscal Compact as the means through which to avoid the punishment of capital markets.

The road to the Fiscal Compact

From the adoption of the common currency, the Eurozone had achieved a very high degree of financial integration. The clearest evidence is the strong reduction in the dispersion of sovereign bond yields. Since 1999, the 10-year government bond spreads across Eurozone countries had become largely negligible (De Grauwe and Ji, 2012). At the same time, current account deficits in peripheral countries were safely financed by private capital flows originating from within the Eurozone.

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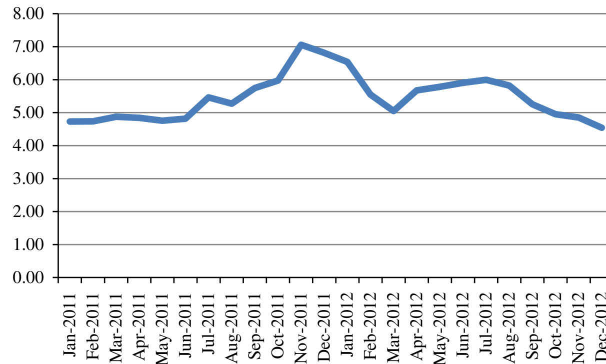

Figure 1 Interest rate, 10-year Italian government bonds (January 2011 to December 2012).

The crisis dramatically reversed these trends. Again, the clearest evidence lies in the pattern of the spreads of 10-year government bonds. Between 2009 and 2015, spreads widened significantly with peaks of around 350 bp at the height of the crisis in 2011–12 (Fondazione, 2016: 2). Intra-euro area capital flows also came to a halt contributing to the economic contraction in deficit countries and to the dispersion of lending rates. That is to say, firms and households started facing different credit conditions according to the country of residence and not to their profitability.

Italy was drawn at the epicenter of the crisis in the summer of 2011 when the borrowing costs on its government debt reached all time highs. In particular, in late 2011, market pressures drove 10-year Italian government bond yields above 7%, a level that is generally associated with high default probability (Figure 1).

Intense market pressures interacted with domestic political stalemate, leading Silvio Berlusconi to give his resignation as Prime Minister (Bosco and McDonnell, 2012). Berlusconi's step back opened the way to the creation of an emergency government led by the economist Mario Monti. The new government sworn into office on 16 November 2011 with a mandate to implement major reforms to rescue the country from its crisis (Di Virgilio and Radaelli, 2013). Monti was thus the PM that led Italy into the negotiations for the Fiscal Compact following the agreement reached at European Council on 9 December 2011. In addition to Monti, who took on himself the responsibility as Finance Minister, the other key government officials in the negotiations were the Minister of European Affairs Enzo Moavero and the vice minister of finance Vittorio Grilli.[13]

Technocrats were thus in the driving seat of European negotiations, similarly to what happened in the early 1990s with the Maastricht Treaty. In 2011–12, the technocratic leadership was accentuated by the features of the Monti's government. As Valbruzzi and McDonnell write, the 'Monti's government stands out … because

[13] The identification of the main policy actors is based on both interviews and parliamentary documents.

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it was an extreme case of a technocrat-led government' in terms of party composition and remit (McDonnell and Valbruzzi, 2014: 668). In addition to the insulation from the party system, the start of Monti government coincided with the breakdown and reconstitution of previous alliances among Italian parties (Ceccarini *et al*., 2012: 57). Partito Democratico (PD) joined the Popolo della Libertà (PdL) in supporting the government, whereas the Northern League moved to the opposition. Political disarray thus combined with market pressures to heighten the leadership of the technocrats.

The Monti government was also a government that started the negotiations with strong pro-Europe, pro-fiscal discipline credentials, again very much in line with the normative orientations of the technocrats in charge of the Maastricht negotiations. Before becoming PM, Monti had served as European commissioner from 1995 to 2004 with responsibility on the Internal Market and Competition. Moavero had served as Monti's chief of staff at the European Commission between 1995 and 2000. Furthermore, Monti was the Rector of the Bocconi University in Milan, an institution which have significantly contributed to the diffusion of the doctrine of 'expansionary austerity' (Helgadóttir, 2015). Monti himself had been an outspoken supporter of fiscal discipline both in the early 1990s (Quaglia, 2004: 1102) and more recently during the Berlusconi government, as attested by his public pronouncements in support of a policy mix combining fiscal discipline and structural reforms to put the country back onto a sustainable growth trajectory (see for instance, Monti, 2011a, b).

In spite of its pedigree, the government's stance toward the EU fiscal negotiations provide limited support to the view that Italian government members sought a new 'external constraint' in 2011–12, akin to the one that Italian technocracy sought in the early 1990s. Quite to the contrary, there was widespread recognition that tightened, external discipline was not necessary to induce the political system towards fiscal adjustment and it was not the best remedy to address the country's long-term economic problems.

That the government did not conceive of the Fiscal Compact as a new 'external constraint' to push the Italian political system into action can be detected in several public pronouncements in which the country's past efforts in fiscal stabilization are clearly acknowledged and endorsed. Speaking before Parliament on the developments in the intergovernmental negotiations, Moavero (2012: 6) emphasized Italy's 'advanced stage' in the process toward balanced budget and informed Parliament members that government leveraged on Italy's fiscal efforts in its interactions with other European governments.[14] Speaking before the European Parliament, Monti (2012a) endorsed the decision taken by the previous government to balance budget by 2013, well in advance of other EU member states. In other words, the government started from the assumption that Italy had already safely embarked on a

[14] The original quotes by cabinet members are provided in the Online Supplemental Material.

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process of fiscal restraint – implying that there was no pressing need for an external anchor to further push Italy in this direction. In an interview with the *Financial Times*, Monti (2012d) even suggested that 'in my view the political parties will not dare go back to the acrimonious, superficial and tough confrontation that animated parliament. The image and style of the public debate has changed'.

If political dysfunctions were not the key motivation that led the Italian government to support the Fiscal Compact, a question can be raised of whether the signing of the Treaty reflects the normative orientations of the technocratic government. That is, support for the Fiscal Compact could be explained in light of the preferences held by key cabinet members, namely preferences that gave pride of place to fiscal discipline as a way to ensure sustainable growth. Again, the empirical record lends limited support to this view. Monti government never laid claim to the content of the Treaty. As Moavero clearly articulates this point before the Parliamentary committees: 'Let me clarify at the outset that – as I guess you already know – the Italian government did not promote the Treaty under discussion' (2012: 4).

That Italian government officials did not act out of a strong preference toward fiscal discipline is also evident in the emphasis placed on growth as a counterbalance to the fiscal provisions contained in the Treaty. In an interview with the *Financial Times* published on 18 January, Monti (2012d) is reported saying that 'Growth not austerity should be the focus of Eurozone policymaking', hinting at the need to rebalance the policy mix toward measures to stimulate the economy as the first-best solution to attain macroeconomic stabilization. As Monti reiterated this point in several occasions, 'growth is an indispensable condition for the sustainability of fiscal discipline in the medium-term' (2012b).

Rather than prioritizing fiscal consolidation, the public pronouncements of the PM and the Minister of European Affairs are instead much more oriented at mitigating the impact of fiscal consolidation by prioritizing growth measures. In Monti's words, 'it is necessary to balance norms related to the discipline in public finances with norms that aims at promoting growth and competitiveness (2012b). Likewise, Moavero (2012: 45) told Parliament that two of the three key objectives of the government's strategy in the European negotiations (in addition to that of avoiding the fragmentation of EU law) were the objective of avoiding 'enhanced discipline' as compared to what had already been agreed in previous EU legislation and the objective of building up 'a long-term perspective relative to the promotion of growth and competitiveness next to rigor and discipline'.

This is not to say that fiscal discipline was regarded as negative or useless. Rather, fiscal discipline is still regarded as 'indispensable' (Moavero, 2012: 4), 'necessary and reasonable' (Monti, 2012b). At the same time, however, the terminology used by the cabinet members that led the negotiations reveals that there were serious concerns about the implications of enhanced discipline. For instance, in presenting the economic policy choices of the government, Monti (2012a) described the fiscal obligations imposed on Italy as a 'very tough constraint'. The PM even implicitly

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admits his reservations on the principles that underlie the new Treaty. For instance, discussing the path that led Italy to participate to the Fiscal Compact, Monti (2012c) observed that 'whatever the government's thinking', his cabinet nonetheless decided not call into question the new rules that had been formulating at the EU level – a statement that suggests that the government might have had different views on the policy priorities to be followed.

If the logic of the 'external constraint' seems not particularly influential to account for the Italian government's support to the Fiscal Compact, the influence exerted by market pressures is comparatively much stronger. Indeed, concerns about how markets would react (or over react) to a potential disengagement from the Fiscal Compact surface in the public pronouncements of cabinet members and, much more explicitly, in the interviews I conducted with the officials involved in the negotiations. For instance, virtually all interviewees mentioned the severe constraints imposed on Italy by the escalation of the financial turmoil in the government debt market since the summer 2011.

Similar concerns emerge in the public pronouncements here analyzed – albeit in a much more nuanced form than the one articulated in interviews (and comprehensibly so given that Italian policymakers were concerned about not alerting financial markets). For instance, Moavero justifies the government's embrace of the new fiscal rules by appealing to 'the extreme difficulty of the crisis that hinges on the country as a whole' (2012: 5). In other words, government members felt that 'the context is one in which we have to signal our adherence to rigor' (Moavero, 2012: 17). Given this 'vulnerable situation' as Monti characterized it, 'we [the Government] concluded not to call into question this objective [the objective of balanced budget] because doing otherwise would have provided the image of a country that is not committed to fiscal discipline' (Monti, 2012c) – a statement that implies the risks that would have followed if the country would not have complied with the presumed markets' preferences for fiscal consolidation. A similar concern can be detected in the observation that Italy had to sign into the Treaty because 'it is necessary to project the image of a mature country that accepts a necessary and reasonable discipline, in reality and in the appearances' (Monti, 2012b).

In short, the Italian government supported the Fiscal Compact mainly out of punishment fears of adverse market reactions. The widespread perception of the country's vulnerability nurtured a sort of 'there-is-no-alternative' mindset that dominated policymakers' thinking and led them not to even conceive of the possibility of looking for alternative courses of action.

While the importance of financial market pressures cannot be underestimated, a question can still be raised of why policymakers came to perceive those pressures as so constraining. This question is particularly important if we take into consideration the pattern of interest rate premiums on Italian government bonds. After reaching its peak between November and early December 2011, the interest rate charged on the 10-year bond started declining – also because of the ECB refinancing operations (see also Zoli, 2013). The Fiscal Compact was thus negotiated as markets were giving signs of normalization, albeit slowly and temporarily.

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The question of the influence of market pressures on Italian policymakers is also interesting from a theoretical perspective. Several studies on the impact of market pressures on domestic policymakers indicate that these pressures do not act automatically but are often filtered by factors such as partisanship and the type of domestic coordination of economic activity (Garrett and Lange, 1991; Garrett, 1998), national models of financial capitalism (Moschella, 2011), and membership to international organizations (Gray, 2009) among the others. Hence, it is worth exploring whether Italian policymakers ceded to market pressures only because of potential punishment costs (e.g. increased interest rate on government bond yields) or because of the combination of other factors. From this perspective, it is interesting to note that the public pronouncements here analyzed point to three factors that might have acted in conjunction and reinforced the influence of market pressures. In other words, punishment was not the only mechanism that allowed market pressures to influence policymakers' thinking and actions.

Institutional constraints

The first factor that combined with market pressures in shaping support for the Fiscal Compact is the recognition of the institutional constraints in which Italy was operating. The major of these constraints was the lack of a Eurozone crisis management framework at the time the Fiscal Compact was negotiated.[15] The absence of an official and automatic insurance to defend member states from financial instability heightened the influence of market pressures because it amplified the potential negative implications deriving from an adverse market reaction. Given this gap in the institutional architecture of the EMU, Italian policymakers felt that Italy had to accede to the new Treaty if it wanted to extract a European insurance against the crisis. Monti's testimony before the Senate in January provides a glimpse into the government's thinking on this issue. In informing domestic policymakers on the evolution of the EU negotiations, the PM pointed to the co-evolution of 'three fundamental components' of the EU economic governance: namely the new fiscal rules but also the development of a European firewall (e.g. the ESM) as well as the debate on the measures to support economic growth (Monti, 2012e). That adherence to the fiscal rules was the necessary requisite to extract concessions on financial assistance can further be detected by the Italian negotiators' insistence that Treaty negotiations had to proceed in lock steps with the ones on the ESM (Moavero, 2012: 7).

In addition to the gaps in the governance of the Eurozone, the fiscal rules that underpin the functioning of the monetary union provided a further motivation against the articulation of opposition to the Treaty. Indeed, the Fiscal Compact is part and parcel of the broader institutional mosaic centered on the SGP – in spite of

[15] On the political–economic origins and consequences of the European crisis management system see Moschella (2016) and Schwarzer (2015).

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the fact that the Treaty was stipulated in the form of an intergovernmental treaty and thus beyond the EU legal framework. As discussed above, the Fiscal Compact builds on and reproduces some previous legislation on fiscal policy coordination among member states. The existence of fiscal rules beyond the Treaty led Italian policymakers to conclude that opposing the Fiscal Compact would amount to no significant alternative course of action. Moavero (2012: 17) made this point in noting that at the start of the negotiations Italy found itself in the 'classical situation of pacta sunt servanda'. These pacta included the rules that had been formulated since Maastricht and revised with the adoption of the Six Pack in 2011. Given the institutional context, the government supported a negotiating stance that did 'not call into question European fiscal rules'. Indeed, the institutional context simply does not allow EU countries to use budget deficits to finance growth: this decision is no longer within member states' 'national competences' (Monti, 2012b). Hence, 'it would have been completely unrealistic to try to modify this institutional framework, which is the result of long-term European decisions adopted with the full participation of Italy' (Monti, 2012b).

Pro-European orientations

The preceding observation leads to another factor that figures among the motivations for supporting the Fiscal Treaty, namely the government's pro-European orientations. In particular, government members showed strong attachment to the European integration project throughout the negotiations. In the words of the PM, 'the government acknowledges the value of the tradition of the relationship with the EU as well as of the political history of the country towards the European construction. This history belongs neither to any single government nor to any coalitions. But it is an asset of the Parliament, of all Governments that has taken office over time, of all parties and all Italians' (Monti, 2012e). Moavero (2012: 16) even articulated his 'federalist vision' of Europe in a parliamentary hearing on the negotiations noting the limitations of a Treaty with 26 and not 27 members.

This pro-European attitude translated into a negotiating stance aimed not only at defending the national interest[16] but also at safeguarding the EU integration project. A clear indication of this stance is the priority that the Italian government attributed to restoring the integrity of the EU legal framework. As both Monti and Moavero explained to Parliament, the 'first objective' that the government pursued in the intergovernmental negotiations was that 'of ensuring the unitary and integrity of the institutional framework of the EU, its legal framework, its laws, its legislative procedures and institutional characteristics' (Moavero, 2012: 4). Monti (2012e) further stressed the need to keep the UK anchored to the EU integration project in

[16] During the negotiations, the Italian government fought hard to ensure that the Treaty incorporated 'other relevant factors' for assessing country's fiscal performance. The 'other relevant factors' are used within the framework of the SGP when deciding whether a deficit or debt-to-GDP ratio is excessive.

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spite of its decision of not signing to the Treaty. In other words, the government was keen on avoiding the political fragmentation of the EU. Given this strong attachment to the integration project, Italy did not even conceive of opting out the Fiscal Treaty because participation was equated to a symbol of the country's commitment to the process of European integration. As Monti put it, 'By participating to the negotiating table of fiscal discipline, we want, at the same time, to participate to the negotiating table of other aspects of EU integration' (2012b).

Domestic win-set

Finally, support for the Fiscal Compact can be traced back to domestic politics: since the major parties supporting the Monti government were in favor of the Treaty, the government had no incentives to look for an alternative negotiating stance. Using the language of the two-level game, a large domestic win-set allows the preferences of the chief negotiators to prevail – and could translate in diminished international bargaining influence.[17] A closer look at the position taken by the parties that supported the Monti government helps illustrate this point.

At the beginning of its mandate, and for most its office, the Monti government was supported by Berlusconi's PdL (People of Freedom), the PD (Democratic Party), and the Unione di Centro (Union of the Center). Among them, the PD provided explicit and quick support for the adoption of the Fiscal Compact in a reflection of the pro-European orientation that the Italian left had developed over time (Conti and Memoli, 2010; Conti and Verzichelli, 2013). For instance, the PD is the first signatory of the motion that contains the political guidelines for the government to follow in the final stages of the intergovernmental negotiations.[18] The motion acknowledges the imbalance between discipline and growth in the letter of the Treaty. However, it articulates support to Italy's participation to the Treaty with the view of reinvigorating the EU integration process. The PdL joined the PD in the support toward the Treaty articulating a positive view of the EU integration process.[19] In short, the major parties that supported the government also supported the decision to participate to the Fiscal Compact. The same pattern seems to be at play in the parliamentary debates for the ratification of the Treaty: a spatial analysis reveals that the parties supporting Monti's cabinet were close to each other and very close to the government's position (Pedrazzani and Pinto, 2013).

In addition to widespread support to the Fiscal Compact among the major Italian parties, it is also important to note that the parties were largely reactive than proactive during the negotiations. The clearest indication is that the first

[17] It is important to note that the relationship between the size of the domestic win-set and the extent of influence in international negotiations is a controversial issue in the literature. See for instance, Rickard and Caraway (2014: 702).

[18] Mozione Franceschini e altri n. 1-00800.

[19] Mozione onorevole Cicchitto e altri n. 1-00802.

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parliamentary motion to influence the government's negotiating stance was produced only at the end of January, when the negotiations were already in a well-advanced stage. And even if Monti (2012e) noted that the government's negotiating stance had been largely aligned with the Parliament's orientations in spite of the absence of explicit political guidelines, it is plausible to think that the large room of maneuver enjoyed by the government did not provide any incentive for cabinet members to reassess the opportunity cost of not signing the Treaty.

Conclusions

> It is hard to find a better definition of 'wrong' than the fiscal pact of 2012, which mandates a universally tight fiscal stance in the eurozone, regardless of whether a country has an affordable level of public debt, regardless of the cost of borrowing and regardless of the state of aggregate demand (Emmott, 2015).

It is not necessary to agree with such a negative depiction of the Fiscal Compact to conclude that compliance will be demanding. And it will be particularly demanding for a country like Italy because of its Eurozone membership and its macroeconomic fundamentals, characterized by high level of public debt and anemic economic growth. This anomaly invites a thorough investigation of the sources of Italian policymakers' preferences during the negotiations.

The article started off this investigation by testing the propositions that can be extracted from past studies on the Italian stance in EU negotiations as well as from the scholarship on international economic negotiations. Specifically, the article assessed the extent to which Italian government's support for the Fiscal Compact was driven by the dysfunctions in the Italian political system, the socialization of government members to the principles of fiscal discipline, and the pressures that operated through financial market instability. Based on a systematic examination of the public pronouncements of the key government officials that led the Italian negotiating team, the article found only limited support for the propositions according to which the government used the Fiscal Compact to led a dysfunctional political system to adopt sound macroeconomic policies. Likewise, the analysis does not support the conclusion that the Italian government supported the Compact out of a profound belief about the benefits of the enhanced fiscal discipline that the Treaty stipulates. Government members did not reject the principle of fiscal discipline as a good practice to be followed. However, they were not significantly persuaded that this was the best strategy to follow in the period under investigation. In short, the analysis thus not lend support to the basic propositions that underpin the logic of the 'external constraint' as articulated in most of the scholarship that examined the Italian stance in the negotiations for the Maastricht Treaty.

If the logic of the 'external constraint' is not substantially supported by the documentary evidence, the logic of punishment was key in inducing the government to support the Treaty. In particular, Italian government officials were deeply

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convinced that the country was in no position to articulate a serious criticism to the edifice of the Treaty because doing otherwise would have led to adverse market reaction. Interestingly, this conclusion was reinforced by the fact that, at the time the Fiscal Compact was negotiated, the Eurozone had still not developed its crisis management framework. Such an institutional gap in the EMU governance exposed Italy to the risk of entering into a financial crisis without a serious insurance from other Eurozone members. Furthermore, the fact that the Fiscal Compact was embedded in a larger set of fiscal rules that would remain in place, even if the Treaty were to be rejected, contributed weakening opposition to the new provisions.

In addition to the institutional set up, the documentary evidence reveals that the weight attributed to market instability was amplified by the pro-European attitude of key government officials. Specifically, the strong pro-European orientations of Monti and Moavero contributed to the conclusion that Italy had to remain at the negotiating table – its costs notwithstanding. As the logic of the two-level game suggests, the preferences of the chief negotiators ultimately prevailed in the EU intergovernmental negotiations also because the domestic ratification constraints were quite permissive: the major parties clearly lent their support to the country's participation to the Treaty.

Although the article gathers substantial empirical evidence to support the arguments just summarized, some limitations need to be acknowledged. To start with, the analysis sheds light on the sources of only one set of preferences: those of the cabinet members that led the negotiations. Future research is needed to provide a systematic examination of the preferences of other domestic actors whose positioning might have influenced the government's stance, including the preferences of economic and societal actors. The analysis is also limited to the domestic level only. However, the interactions at the EU level, coalition patterns and the negotiating strategies used by other member states and EU institutions are all factors that might have influenced the Italian negotiating stance.

Without dismissing the importance of these limitations, the study nonetheless provides a systematic examination of Italy's attitude towards the European integration process and its evolution over time. The comparison with the Maastricht negotiations is particularly important. Whereas in Maastricht, the Italian negotiators purposefully used the EU to extract reforms from a dysfunctional political system, this important motivation is far more nuanced in the negotiations that took place in 2011–12. As already been noted, 'Europe was part of the Monti government's strategy vis-à-vis domestic actors (voters, societal interests, parties), but not as a constraint' (Stolfi, 2013: 183). In short, this study suggests that the relationship between Italy and the European Union has changed significantly as the EU does no longer provide Italian policymakers with the cover to take unpopular decisions and insulation from the pressures of domestic politics (see also Jones, 2017).

The case study also speaks to the broad literature in international economic negotiations. In particular, it offers the opportunity to assess the relative influence of competing factors that help explain countries' bargaining preferences, such as the

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influence of socialization and the one exerted by financial market pressures. The study also allows digging deeper in the mechanisms through which market forces exert influence on domestic policymakers, thus contributing to the debate on how globalization affects domestic politics and policymaking. In particular, rather than solely through punishment fears, the case study showed that market pressures acted through the institutional and political system and was filtered by the preexisting pro-European attitudes of the actors involved in the negotiations. In other words, the influence of market forces cannot be considered automatic but may well be endogenous.

Acknowledgments

The author wishes to acknowledge financial support from the Italian Ministry of Education (PRIN 2010-11 on Italian foreign policy).

Funding Note

This research received financial support from the project 'The Italian Foreign Policy in front of the new challenges of the international system: actors, institutions and policies' (PRIN 2010-2011, grant n. 201032T8ZE) funded by the Italian Ministry of Education, University and Research (MIUR).

Data

The replication dataset is available at http://thedata.harvard.edu/dvn/dv/ipsr-risp.

Supplementary material

To view supplementary material for this article, please visit https://doi.org/10.1017/ipo.2017.7

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