UNIVERSITY OF TWENTE
WESTFÄLISCHE WILHELMS UNIVERSITÄT MÜNSTER

Negotiating the Banking Union
- A trade - off between Germany and France? -

Policy Choice Patterns between two Integration Projects

MA Thesis

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3/23/2014

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In the area of economic and fiscal governance the surrender of national sovereignty has been greater than ever before and mostly dominated by the growing trend of cross-border tasks. Up until 2008, member states were responsible for the policy making and the European Union had few legally binding tools. The previously established SGP and later on, its complementary, the Macroeconomic Imbalances Procedure, weren´t enough to discipline the financial systems. When the financial crisis of 2008/2009 and afterwards the recession hit the European markets, both banks and governments felt a heavy financial pressure. The persistent economic divergences and weak supervisory mechanisms deepened the financial fragmentation left behind by an incomplete EMU. Therefore, the discourse rapidly revolved around the inability of the existing framework to assure fiscal, economic and monetary stability. In the hope of achieving economic and budgetary correction, the Fiscal Compact and the “Two-Pack” legislation were put in place. Furthermore, an institution - based prudential supervision was established, which consists of the three European Supervisory Authorities (Banking, Securities and Markets, Insurance and Pensions). Following the Larosiére Report, the European Systemic Risk Board (ESRB) came into existence, eventually leading to extensive reflections on the future of European banking. Few could have known that this would represent the starting point of the Banking Union. From what we could see during the adoption of the common currency the Member States are rather sceptical when faced with the decision of giving up their sovereignty to a supranational body in a core area. We can therefore suppose the same reluctance with the project of the Banking Union, as states would have to give supervisory authority and crisis management powers to an EU level institution. According to the theories of European integration, there are certain indicators which have to be taken into consideration in the assessment of what or who are the promoters or opponents of integration processes in order to be able to provide an accurate explanation for the decision making process. On the one side neo-functionalism, the functional pressures coming from the EMU and single market for financial services is believed to have a great influence over the member states´ decisions. Liberal intergovernmentalists, on the other side focus on the aggregation of interests of domestic actors on the national level by looking at the issues governmental leaders address in their official statements and policy documents as well as the position they take towards them. Moreover, the bargaining power of important member states is considered to be responsible for the institutional change policy options.

Acknowledgments

I would like to start by expressing my gratitude to both of my supervisors for assisting and supporting me during this process. It has been a rocky road with ups and downs but I could always rely on them and ask for help. My first supervisor Dr. Shawn Donnelly has given me a great deal of practical information and valuable insight in the topic I have chosen. The thing I am most grateful for is that he pushed me beyond my limits and taught me how important it is to express your own opinion. On his recommendation I went to Prof. Dr. Karsten and asked him to be my second supervisor. Even though we did not know each other before that, he showed me a lot of patience and interest in the issues I was writing about.

My appreciation also goes to a dear friend of mine, Svenja Goliasch, who took the time during her internship to review my thesis. I am extremely thankful for her thoroughness and constructive comments. Furthermore, I would like to thank my partner, Alejandro Prialé, for always being there for me and supporting me unconditionally.

Last, but certainly not least, I would like to thank my parents, who, despite the distance and time apart have showed me a lot of understanding and encouragement. I could not have managed without them and will be forever deeply grateful.

April 7th, 2014

Andrada Ioana Vant

Abbreviations

BU	Banking Union
CDU	Christian Democratic Union
COM	European Commission
CSU	Christian Social Union
DGS	Deposit Guarantee Scheme
DSGV	German Savings Banks Association
EBA	European Banking Authority
ECB	European Central Bank
ECJ	European Court of Justice
ECOFIN	Economic and Financial Affairs Council
ECSC	European Coal and Steel Community
EDP	Excessive Deficit Procedure
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilisation Mechanism
EIOPA	European Insurance and Occupational Pensions Authority
EMS	European Monetary System
EMU	Economic and Monetary Union
EP	European Parliament
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
GDP	Gross Domestic Product
IMF	International Monetary Fund
IMP	Macroeconomic Imbalance Procedure
LI	Liberal Intergovernmentalism
MTO	Medium-Term Objective
RRD	Resolution and Recovery Directive
SGP	Stability and Growth Pact
SRA	Single Resolution Authority
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism

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1. Introduction & Research Question

Lately, the only thing we hear on the news is how bad the economy is and of the extensive disputes it creates between powerful countries and officials in Brussels. Experts and the political elites comment on the possibility of a `Euro currency crash`[1] whereas the EU Institutions talk about major structural revisions. No wonder, the European public doesn´t know what or who to believe anymore. But for the sake of being able to see the bigger picture it is highly important to know and understand all the details. In doing so, we should never lose sight of what brought us together, the belief in a `United Europe´[2], the rationale that is the cornerstone of every single European policy.

Looking at the European integration from its beginning in the 1950s one can easily establish a clearly market-oriented trend that unfolded through the years in various institutional frameworks. The European Coal and Steel Community and later on, the European Community were established to foster free trade and make sure that powerful countries would never again engage in hostile activities. "*After months of lengthy discussion, what became known as the Spaak Report, after its principal author, generated the idea of an entirely new kind of inter-state economic relationship.*"[3] The European project unfolded in one of the most disputed harmonization policies that were put forward by the European Commission. A subject for hard criticism within member states evolved around the issue of tackling domestic regulation in the area of the common and single market[4]. Apart from the removal of trading barriers, the aspect of financial integration was highly sensitive for the majority of the member states[5].

When the financial crisis of 2008/2009 and afterwards the recession hit the European markets, both banks and governments felt a heavy financial pressure. The discourse rapidly revolved around the inability of the existing framework to assure fiscal, economic and monetary stability. "*The combination of public and/or private indebtedness was strengthened during the crisis, leading to ever greater interdependence of banks and public finances and eventually a so-called bank-sovereign nexus*"[6].

[1] Spiegel 06.2012
[2] The Telegraph 12.2012
[3] Egan, M. (2007), in Cini, M. (2007) p. 254
[4] Archick, K. (2014)
[5] Mongelli, F.P. (2008)
[6] Niemann, A. et al (2013), p. 2

In the area of economic and fiscal governance the surrender of national sovereignty has been greater than ever before and mostly dominated by the growing trend of cross-border tasks. Up until 2008, member states were responsible for the policy making and the European Union had few legally binding tools. The previously established SGP and later on, its complementary, the Macroeconomic Imbalances Procedure, weren´t enough to discipline the financial systems[7]. Furthermore, the persistent economic divergences and weak supervisory mechanisms deepened the financial fragmentation left behind by an incomplete EMU.

Despite long debates among national and European leaders, the situation didn´t improve as expected. In the hope of achieving economic and budgetary correction, the Fiscal Compact and the "Two-Pack" legislation were put in place, however, "*the decision have fallen short of inspiring the confidence necessary to prevent financial collapse*"[8]. There is no certainty in telling how much more countries can endure for the sake of maintaining the currency at a flow. Judging by the severity of this situation and following the shock financial systems suffered, the European Commission sought the possibility of shared willingness among member states and thus pushed for compromise. Politically and financially powerful member states play a vital role in pushing and fostering heightened cooperation and the institutional choice.

In the first instance, an institution - based prudential supervision was established the European System of Financial Supervision, which consists of the three European Supervisory Authorities (Banking, Securities and Markets, Insurance and Pensions). Following the Larosiére Report, the European Systemic Risk Board (ESRB) came into existence, eventually leading to extensive reflections on the future of European banking. Few could have known that this would represent the starting point of the Banking Union[9].

Several aspects surrounding the emergence of this bold project are still uncertain. Of the four elements defined in the European Commission´s proposal – the resolution and recovery directive (RRD), the single supervisory mechanism (SSM), the single resolution agency (SRA), and the deposit guarantee scheme (DGS) – only on the first two, member states reached a final decision. In both cases, legal questions and aspects regarding the loss of national power were especially disputed.

[7] ECB (05.2012)
[8] Cohen, et al. (2012)
[9] COM (09.2012)

Research Question and Goal of the Thesis

It has come to my attention that the developments of the two integration projects (EMU and BU) seem to unfold following a resembling pattern. Thus I will argue in my thesis that the process of agreement was made possible by a combination of similar structural factors and under the political leadership of powerful countries like France and Germany. Under these circumstances I will further highlight the features that I consider to have created the dynamics in shaping the context of integration.

Firstly, right from the beginning of their conceptualization both negotiations were dominated by powerful countries followed their domestic interests and took control of the bargaining process, managing to eventually implement their requirements. The states´ behaviour appears to correspond with the liberal intergovernmentalist assumption which perceives integration as the result of the power play between relevant states embracing the preferences of their domestic actors.

In the **case of the EMU** the circumstances before the launching of the project were rather difficult due to the collapse of the Bretton Woods System and the critical situation created by the Great Inflation in the 1970s. On the basis of the suspended gold convertibility and lacking economic stability, member states started to show signs of great macro – economic uncertainties and provided divergent national responses[10]. Thus, powerful countries seized the opportunity and became the driving forces of the integration process. As previously mentioned in the last chapter, the circumstance in which *the BU project* was released evolved around congruent factors. The sovereign debt crisis exposed structural weaknesses in the governance of the EU financial sector and of public finances. Member States, especially in the southern part were faced with extremely high external debts and some were in danger of defaulting. Temporary arrangements for the crisis management were insufficient, therefore leading states like France and Germany started to push for tightened policy coordination.

Secondly, the main topic being dealt with in both cases is revolving around the central issue of stepping towards deeper integration within the most disputable area for all member countries. In the **case of the EMU,** the main argument to extend supranational authority in the domain of monetary and exchange – rate policy had both political and economical reasons that

[10] Eichengree, B. (2008)

touched upon the attempt of creating an integrated European Financial System[11]. The **Banking Union** is also striving for converging financial markets and the banking systems on EU level, attempting at changing the domestic distribution of powers and aiming to reach the same goal as 21 years ago, an integrated European Financial System[12]. Judging by the way in which the events evolved in both cases we can depict clear elements of supranationalism in the form of neo-functionalism that predict inter-state cooperation over matters beyond their direct control (economic security), where states see themselves obliged to pursue a certain degree of European economic integration, leading to some loss of national sovereignty to a supranational level[13].

Thirdly, the main argument of putting these projects on the table is to achieve national coordination for a better functioning of the states and eventually stabilizing the position of the European Union in the international arena. The member state´s financial and banking systems have been developing following different paths for a while now, due to the diverse national economic conditions and ideologies. This gave rise to serious harmonization problems and made it clear that there is the need for more efficient mechanisms on EU level to further foster the cooperation and well functioning of EU countries. It is nevertheless a matter of further discussion to establish what stimulated the creation of the institutional design and identify the source of the member states´ orientation towards the BU project.

Drawing from the assumption of the strong similarities between the EMU and BU and based on the explanatory power of the grand theories of European Integration in providing an answer to the question of integration, the aim of this thesis is to investigate the circumstances of the negotiations on the Banking Union and try to predict the course of the project on the basis of the grand theories of European Integration, which have already explained a similar integration process, the EMU. The main research question that will be elaborated in the thesis is the following:

Are Germany and France the "motor" in the Banking Unions implementation? What does the policy choice pattern with the EMU tell us about integration processes?

[11] Cameron, D. (1998), p. 214 from Sanholtz & Stone Sweet (1998)
[12] Buch, C.M. et al (2013), p. 15 - 16
[13] Moravcsik, A. (2005), p. 350

From what we could see during the adoption of the common currency the Member States are rather sceptical when faced with the decision of giving up their sovereignty to a supranational body in a core area. We can therefore suppose the same reluctance with the project of the Banking Union, as states would have to give supervisory authority and crisis management powers to an EU level institution.

According to the theories of European integration, there are certain indicators which have to be taken into consideration in the assessment of what or who are the promoters or opponents of integration processes in order to be able to provide an accurate explanation for the decision making process. For this purpose the preferences of policy choice of the main actors as well as the different levels of governance should be thoroughly analyzed and significant data ought to be collected with regard to the circumstances under which previous integration negotiations have been conducted.

The complex phenomenon of integration has revealed different layers when faced with answering the research question. Therefore I find it central for the thesis to seek the potential of the multiple responses grand integration theories induce and decided to formulate the following sub – questions in and structure my thesis accordingly:

SQ1: What triggered the proposition of the BU framework? What role does an incomplete EMU play?

SQ2: What do the grand theories tell us? What can we learn from previous negotiation outcomes?

SQ2: Who are the main actors? What role do they play in the negotiation process?

SQ3: How can we explain the actors´ behaviour? What is their motivation?

The thesis will show the different focal points of the integration process and hence will be able to answer the question whether the current steps within the negotiations on the banking union are potentially moving towards the completion of a common currency and internal market.

2. Research Design and Operationalization

In this thesis I focus on investigating the correlation between the various hypotheses the grand theories of European integration provide and the actual outcome of the process of decision making. For this purpose the method I will be using is process tracing, which attempts "*to identify the intervening causal process between an independent variable and the outcome of the dependent variable*".[14] Herewith I will be able to uncover the settings under which key actors cooperate in the single case of the EMU and reconstruct potential mechanisms that would have a similar outcome for the case of the Banking Union. The work of Johnson & Reynolds (2008), Checkel (2005) and Babbie (2007) provide profound insight into the theoretical foundations and implications of the method.

As the concept I will be analysing is relatively complex and involves an extensive understanding of different negotiation models and inter – state relationships, I have decided to conduct a literature study and carry out a *qualitative content analysis* of policy documents, official releases of national and international institutions, newspaper articles and statements of relevant actors. This will provide the research with a more objective view of the problematic and pin point at external factors, which may be missed in an individual paper. Furthermore, as supporting data for my thesis I will consult peer reviews of researchers in order to better explain the creation of the institutional setting and the behaviour of the relevant actors.

The study of European Integration has been an ever growing field of empirical research since the foundation of the European Union. Especially the institutional developments in the economic area have been a highly disputed topic. There is a substantial amount of political economic literature on the origins of the EMU reaching from journals and books to edited volumes. However one of the most well-known publications belongs to Dyson and Featherstone (1999), who says that "*the EMU process was part of the `sound money paradigm` and that it was dominated by experts and political leadership, in particular the French – German relationship*"[15]. Due to the novelty of the Banking Union, research on this issue is relatively scarce. Mostly, the literature focuses on the analysis of the financial and banking system from different angles. The most important publications on this matter have been made by specialists in the area of financial crises like Vivian Schmitt, Andreas Busch, Goddard & Molyneux, Emiliano

[14] Checkel, J. T. (2005), p.5
[15] Verdun, A. (2000) p. 826

Grosmann and Thorsten Beck. Especially the study from Goddard & Molyneux (2007) offers an overview of the banking system at the European level, the centre piece of both Monetary and Banking Union. According to them the banking sector of the EU member states has been the subject of far – reaching structural changes enabling further integration for European banking markets while having to deal with severe consequences due to the gaps in the full integration process. The main criticism put forward by scholars like the integration theorist Moravcsik is that the "*20 years after adopting a common currency, Europe is still not an optimal currency area; it makes the difference between good and bad performing countries even bigger*"[16]. There is a clear call for completing the single market in financial services and providing a more centralized mechanism. In a report of the Centre for European Policy Studies, Ayadi & Pujals (2004) delivered a scenario for a more effective European Banking. By asking the question of what would be more desirable for the current national and European structure they concluded in favour of moving to a European structure where further financial integration is required.

Important contributions in clarifying the future of the Banking Union have been made by the Lannoo (2012), Pisani – Ferry et al (2012) and Véron (2012) which tackle the issue of financial stability and architecture as well as the supervision responsibilities of a newly established European conglomerate. Another significant perspective on the institutional development in financial regulation and supervision before and after the crisis hit the European markets is provided by Quaglia (2007, 2008), which gives valuable insights in better understanding what kind of changes the Banking Union will entail.

The literature search will focus on the following time frame: first I will look at the development the Maastricht Treaty and the institutional framework that resulted from the agreements, after which I will analyze the EMU as a reality and draw important conclusions for future integration processes. I will continue with the post-crisis period and structural crisis management framework in order to be able to follow the countries´ behaviour during the whole process of integration and be able to review the policy outcomes properly.

In the previous chapter I addressed the theoretical framework of my thesis while pin pointing at practical examples from the EMU integration process. The analytical chapter will mainly focus on acknowledging the different perspectives grand theories offered in the case of the EMU and apply them to the negotiation process and outcomes of the Banking Union so far.

[16] Ibid, p 58

Thus, I will first look at the preference formation of relevant national, supranational and international actors, which according to the neo-functionalism and liberal intergovernmentalism are responsible for the Banking Union´s developments. These include member states, the ECB, the European Parliament, the European Commission and the IMF, as the leading actor in external structural adjustments. Worth mentioning is also the fact that I decided to focus primarily on the larger member states, which from former experiences with the EMU negotiations, have together pushed the majority of decisions and will most probably continue to do so also in the case of the Banking Union.

Secondly I will test the hypotheses formulated in the grand theories chapter. In **the case of neo-functionalism** I will primarily look at the functional pressures coming from the EMU and single market for financial services and investigate the influence of supranational and international institutions over the member states´ decisions. For this purpose I will focus on the statements of EP officials and their resolutions, the `agenda – setting` power of the European Commission in successfully steering the negotiation process and the orientation of different member states.

Furthermore, in the interpretation of the **liberal intergovernmentalist** elements I will first focus on the aggregation of interests of domestic actors on the national level by looking at the issues governmental leaders address in their official statements and policy documents as well as the position they take towards them. Another an important aspect is the measurement of the bargaining power of the member states by considering their benefits from the institutional change, economic strength and policy options. Hereby I will be able to establish if they find themselves in a threatening or advantageous situation.

By applying these techniques I can conceptualize the different negotiation outcomes which the grand theories predicts, the effects they could have on the Banking Union and compare them with recent events which will eventually support or dismiss my hypothesis.

3. An EMU without a Fiscal Union

The road towards the Maastricht Treaty was hard and long, but finally government leaders, lead by Helmut Kohl (Germany) and Francois Mitterrand (France) managed to reach an agreement. At that time, they believed that a centralized monetary policy didn´t need further centralizations to be fully functional. Member States happily embraced this assumption, believing they could institute the one without risking the establishment of the other[17]. Yet, experts and researchers didn´t supported this outcome and made several speculations about the political interests behind this decision. Was it absolutely necessary to opt for a common currency unaccompanied by unified fiscal tools? What was at stake for France and Germany? What consequences did this decision have for the fiscal fiasco the European Union is currently facing?

In the upcoming section I will present a brief historical overview of the fiscal integration, focusing mostly on the legally binding mechanisms put in place to monitor the member states´ fiscal, economic and monetary stability. Continuing chronologically, I will look into what triggered the excessive deficits in the member countries and analyse the consequences it created. Furthermore, the regulatory tools that lead to the Commission´s Banking Union proposal will be outlined.

3.1. A brief history of regulatory and supervisory integration

"*A major characteristic of European economies has been their historical and national variation in areas such as industrial relations, social welfare and financial systems*."[18] Significant differences in the way member states manage their markets and divide the regulatory competencies have given rise to a clash of ideologies, stressing the need of a unified model which would put aside any tensions from increased competition and promote a liberalized trade and market access. The European Union has been engaged in a challenging journey of creating a market that functions at its full potential and provides a harmonized platform for all national administrations. One of the most important policy choices was the European Economic and Monetary Union. Heads of governments desired to retain control over state finances in order to institute a policy that would promote a better employment rate, sustain peace and social welfare. This would assure national governments a decreased vulnerability in front of their electorate and

[17] Gustavsson, S. (1999), p.2
[18] Zysman (1994), Berger & Dore (1996), Rhodes & van Apeldoon (1998) from Egan, M. (2010), p. 256

level Europe´s position on the geo-political arena vis-á-vis other powerful Nation States. The negotiations were mainly influenced by the dispute between France and Germany over the exchange policy that in large part provoked the European Committee to bring the idea forward. It appears that Member States assumed their national interests would be served by "*extending the authority of existing and new supranational institutions in this policy domain*"[19] and opted for a more institutionalized structure.

In the period after introducing the currency, the EMU unleashed its own dynamics transforming the conditions under which it was initially developed. Due to the fact that national governments were responsible for the fiscal policy, the European Union decided to put in place monitoring tools to peer pressure states into complying with the rules established by the EMU. The first step was taken by implementing the **Stability Pact** (SGP), limiting government deficit and tracking fiscal developments with a `preventing arm`[20]. The mechanism started showing warring flaws and did not fulfil its initial role of sanctioning countries which did not comply with the necessary requirements. Throughout the year the most powerful countries, which a couple of years back were the ´motor´ of integration, exceeded the 3% fiscal deficit without receiving any warnings from the European Council. The relatively loose oversight left France and Germany with enough manoeuvre to interpret the fiscal rules according to their own interests. After repeatedly being accused of circumventing the SGP but without any repercussions the Finance Ministers decided to push forward a **reform in 2005**. The compliance report was supplemented by MTO´s reports (Medium-Term budgetary Objectives), which aimed at calculating an average limit for the countries´ structural deficits and outlining the necessary measures each member state will be implementing to achieve it[21]. Furthermore, under the new `Excessive Deficit Procedure` (EDP), the Council would act as a `corrective arm`, being able to issue sanctions, if necessary[22]. Apart from these, other changes followed: the lowering of deficits and debts during economic growth as well as the opportunity to explain small breaches and the permission to claim ´negative growth rate´. It doesn´t need a specialist´s eye to notice that the strengthening of some rules brought with them multiple cases of exceptions, actually allowing member states a longer period to level their excessive deficit.

[19] Sanholtz & Stone Sweet (1998), p. 191
[20] COM (2014)
[21] Birascho, P. et al (2010), p. 5 - 9
[22] EU (02.2011)

At this stage it became clear that the mechanisms put into place to control the public sector indebtedness failed and resulted being incompatible with the objective of monetary stability. The claim that a currency union and deeper economic integration would work out with loose fiscal disciple, turned out to be wrong. What powerful states back then saw as "*the line of defence against further political integration*"[23] failed to safeguard the welfare state. The EMU had no union wide - fiscal policy which might have been able to intervene in the case of excessive national spending that would threaten the stability of the entire community.

3.2. The trigger: sovereign crisis and its consequences

The financial crisis that started in 2007 and developed into a sovereign debt crisis in early 2010 exposed the flaws of the global financial system and the Economic and Monetary Union in particular. Especially structural weaknesses in the governance of the EU financial sector and of public finances[24] came to light, creating severe consequences for the EU markets.

During the first years of single currency the European Union lacked fiscal discipline. The Stability and Growth Pact (SGP) is a very poor predictor of the difficulties later experienced by Euro zone countries.[25] The most stunning discovery was that between 2001 and 2006, after the euro was introduced but before the global financial crisis erupted in 2007, approximately one third of Euro area member states violated the SGP.[26] This might suggest that a tighter enforcement of the rules-based surveillance would have prevented the crisis. Furthermore, it has become apparent that especially euro area states appear to be more fragile to fiscal crises than non–euro countries. Here the work of Pisani – Ferry (2012) has elaborated on this matter and came up with the following finding: the absence of co – responsibility for public debt, the strict no–monetary financing ruling and bank – sovereign interdependence is the **impossible trinity** that render the euro area fragile.

The main trigger of the crisis was the unsustainable credit and housing boom and with it the **structural imbalances in the current – accounts**. Due to the variations in the economies of the member states, a sovereign crisis of this size was more likely to spread in a faster way than in another case. Weaker countries like Greece, Portugal and Spain were more affected by the

[23] Gustavsson, S. (1999), p. 8
[24] Niemann, A. et al (2013), p. 2
[25] Pisani – Ferry, J.(2012), p. 10
[26] Darvas, Z. (2012), p. 3

domestic bubbles, causing a great degree of financial fragmentation among the EU market. The EU found itself in the impossible situation of not knowing how to proceed in the case that one of these countries lost access to the market. The institutional deficiency posed a major difficulty for the European Union in properly handling the crisis, as the constant obstacle of this institutional misalignment prevented them from making any progress[27]. According to a treaty provision, it is prohibited for the EU or any of the national governments to assume responsibility for the debt borrowed by another member country.[28] With the threat of Greece defaulting on its debt, European officials began to perceive the sovereign risk from a totally different angle. Apart from that, there was a clear mismanagement in the way national authorities dealt with the severe market fragmentation. Instead of merely controlling capital flows, the restrictive regulations imposed had a negative effect on the operations of foreign banks. Also, the rating agencies´ negative evaluation of the financial institutions in the peripheral countries, amplified the situation. These led to a great distrust among member states and their banks, causing bigger financial market turbulence. "*Clearly, market discipline did not function as an incentive for adjustment in the boom years in many European countries that accumulated bubbles, confirming the opinions of those who thought that such discipline only kicks in at times of crisis."*[29]

Among the most pernicious consequences that can be seen in the European markets, are the **cross-border interbank lending** and the **issue of liquidity provision**. Countries which had maintained a high current-account deficit had to face serious declines in flows and bigger liquidity costs. As an immediate countermeasure, the ECB started providing liquidity and powerful economies, like Germany, became important `creditors`. Not long after, the ECB´s monetary policy transmission mechanism collapsed and countries could no longer benefit from low interest rates.

The highly complex flaws that surfaced reinforced the doubts about national supervision. However, it was no longer the sole problem of overseeing financial institutions but more about unified regulatory rules and harmonized prevention measures. To overcome this crisis, several measures have been put in place. We will next focus on those dealing with financial stability and the surveillance and coordination of economic policies.

[27] Sicilia, J. et al (2013), p. 3
[28] Art. 125 EU Treaty
[29] Sicilia, J. et al (2013), p. 4

3.3. New regulatory tools

The EU responses to the crisis have been diverse, mainly covering the coordination of economic policies and having a short to medium – term effect. The EU´s effort to maintain financial stability has also been great; however, fewer tools were implemented in this area. The period I will refer to is stretching from 2010 until late 2012. On a side note, it is important to mention that since the outbreak of the crisis there have been mainly two countries coordinating the main policy decisions for the reconstruction program: government leaders from France and Germany led the negotiations by primarily creating and adapting institutional structures. Despite having to face opt-outs from some countries, the crisis management measures have continued to be proposed and implemented.

One of the first actions was to address the repercussions of the crisis, especially in the public and financial domain. The area which faced most of the changes was the crisis – resolution field. European policy – makers came up with temporary arrangements like the bilateral lending from Euro area partners and the establishment of two financing mechanisms: a temporary one - **The European Financial Stability Facility (EFSF)** and its replacements from October 2012 - **The European Financial Stabilisation Mechanism (EFSM),** which acts as a permanent rescue mechanism.[30] Their mission is to provide bonds or other debt instruments for national governments, acting on the basis of a precautionary programme and finance recapitalisation of financial institutions[31]. The EFSM, will further act on the behalf of its predecessor, including more effective enforcement measures and focusing on prevention[32].

The strict prohibition of ECB monetary financing means that Euro area governments borrow as if they were borrowing in a foreign currency.[33] This suggests that any agreements between a government and the central bank for purchasing debt instruments are strictly forbidden, thus not allowing any interventions to prevent financial turmoil on the bond market. On the verge of the crisis, the ECB could still find an option to purchase sovereign bonds for the member states and actually did so with the launch of the so called **Security Market Programme in May 2010.**[34] Still, the program didn´t last long as in September 2012 it was replaced by the **Outright Monetary Transactions Programme**, which gave the ECB more space of manoeuvre

[30] Darvas, Z. (2012), p. 5
[31] EFSF (2013)
[32] Com (11.2013)
[33] Darvas, Z. (2012)., p. 6
[34] Pisani – Ferry, J. (2012), p. 16

and helped lower government bonds yields. This may buy some time and prevent the crisis from drastically evolving but it can definitely not eliminate the risk of an eventual Euro area exit, as countries are facing further fundamental difficulties.

Next, the **`Euro plus Pact`** was established. It was a complementary measure to the already established SGP and pursued the fostering of competitiveness among member states. The treaty covered mainly the area of employment, public finance and financial stability[35]. Speculations were made, regarding the fact, that this was only a form of assurance for Germany and France, in order for them to concede to the increase of ESM funds. Nevertheless, it fostered economic integration and tightened compliance, as states had to hand in, together with the Stability and Convergence Report, the National Reform Program, which would serve as a monitoring measure for the European Commission. Through the so called **´European Semester´** the Commission would have the necessary competencies to annually inspect, make recommendations and endorse macro-economic, budgetary and structural policy.[36] There was still an inconvenience, namely the fact that member states retained national control, therefore being able to choose which policies would be appropriate to implement in their respective countries.

Furthermore, the fiscal discipline needed to be improved and hereby completed as soon as possible in accordance with the latest developments. The EU took the initiative and strengthened the provisions for national fiscal institutions by creating the so called **`Six - Pack` legislation** which pushed forward the adoption of a number of strict economic and fiscal policies aiming at tightening the regulatory system. As a direct response the EU introduced the so called **Macroeconomic Imbalance Procedure (IMP)** with the aim of assessing countries and correcting in time any private sector imbalances. However the effectiveness of this procedure is still to be reviewed as up until now there is no conclusive data determining if it has been successful. Immediately after, the **`Two – Pack´** was implemented, however its applicability covered only the Euro zone countries. The legislation consisted of two regulations that followed the coordination and implementation of surveillance mechanisms. One regulation focuses on monitoring and assessing draft budgetary plans while ensuring the correction of excessive

[35] EUCO 10/1/11 REV 1
[36] EUCO 10/1/11 REV 1

deficits, whereas the other one facilitated an enhanced surveillance for countries experiencing financial difficulties. [37]

One of the last measures to be taken was the **´Fiscal Compact´**, also referred to as the Treaty on Stability, Coordination and Governance. The idea was put forward by Germany and suffered drastic changes until reaching an agreement, nevertheless representing one of the biggest achievements up until that point of time. Covering a wide range of provisions, the treaty is mainly aiming at strengthening fiscal discipline through the `balance budget rule` and the ´automatic correction mechanism´[38]. Countries are requested to ensure an annual structural government deficit of maximum 0.5% of their GDP and maintain it in line with the country-specific minimum benchmark figure[39]. The compliance will be verified annually in the context of the European Semester. Apart from that, in the case of deviation the correction mechanism will be automatically activated, forcing countries to adjust the deviation over a predefined period of time. The European Court of Justice (ECJ) will have the right to issue penalties in the case of non-compliance.[40] Based on this framework, member states are bound to implement structural reform, assuring therefore a better coordination of economic policies and hopefully preventing further negative effects of the crisis.

Looking further at the area of banking supervision, this was organized under the Lamfalussy framework, where the decision making process underwent four level of committees with only advisory functions**.** During the years of existence several bottlenecks were identified for which the EU Council proposed a number of improvements. The first and one of the most significant ones, was the establishment of the European System of Financial Supervisors in 2009. Under the framework of the EFSF **three new European Advisory Authorities** took the place of the three committees from the Lamfalussy structure, earning a stronger institutional status and a wider range of competences. Thus a new macro – and micro prudential supervisory was established, tightening rules and introducing new initiatives into the EU decision making bodies.[41] These authorities were completed by a **European Systemic Risk Board (ESRB)**

[37] COM (07.2013)
[38] EU Council (01.2013)
[39] ESM (10.2012)
[40] EU Council (01.2013)
[41] Niemann, A. et al (2013), p.3

under the responsibility of the ECB, which established its own committee infrastructure and was supported by the analytical capacity of the ECB.[42]

Despite short term resolutions and policy coordination efforts the European Union was still lacking banking policy integration which eventually led to a fragmentation of the euro area´s financial space in times of instability.[43] Moreover the limits to a purely national stabilisation policy became very visible as entire economies were priced out of the market and no measures were in place to counteract the damage from this massive deleveraging process.[44] In early 2012 a significant number of banks started requiring guarantees form the states to avoid insolvency. However the high amount of guarantees proved to be far too big for the public finances of the states, resulting in a `bank – sovereign nexus` that could not be appropriately handled with the existing instruments and institutional framework.[45]

Consequently it became obvious that the existing tools for the crisis management were insufficient to address the unsolved issues and restore stability as well as trust in Europe´s banking system. Once again the **disputes between Germany and France** have a great deal of influence on the policy outcomes as they are the ones putting forward the main arguments and most of the Member States look up to them. Now, during the negotiations for the Banking Union, France´s firm position for a co-ordination of EU economy policy[46] and a progress in mutualising risks[47] is facing a heavy opposition from Germany, who is more concerned about protecting their saving banks and reluctant of giving up full financial supervision. These discussions present a major obstacle for the further progress of the Banking Union project.

Despite of the oppositions, the European Commission remains firm in its mission and puts forward the acute need for a long-term system in which liability and control is ensured and supported by all participating actors. It remains to be seen if it is possible to make EU economies converge and achieve a balanced Euro zone[48].

[42] Niemann, A. et al (2013), p. 5
[43] Véron, N. (2013), p. 2
[44] Pisani – Ferry, J. et al (2013), p. 3
[45] Niemann, A. et al (2013), p. 6
[46] Emerging Markets (10.2012)
[47] Independent (12.2012)
[48] Moravcsik, A. (2012) p 40

4. The Grand Theories

The central argument of this chapter is to offer different interpretations regarding the meaning and nature of integration from the perspective of European Integration Theories. Thereby the assessment of the EMU policy projects will be facilitated and essential features regarding the development of the BU negotiations will be made. I will present alternative hypotheses to investigate the position of relevant actors, the formation of their interests as well as the strategic policy choices they incline to make.

4.1. Neo-functionalism

At a first glance both neo-functionalism and liberal intergovernmentalism theories offer explanations for the same policy outcome, however there are significant differences with respect to who they perceive as the key actors in the integration process and what predictions they generate about the actors behaviour and the political negotiations.

Neo-functionalist authors describe the development of arriving at collective decisions at European level as a system where political actors' interests are served and integration is an elite-driven process. Where leaders of relevant political actors do not see a solution for their political and economic problems in the national framework, they turn to supranational agencies and procedures[49]. As rational actors, driven by self-interest, they are striving to maximize the utility of their individual interests. The benefits of integration would become apparent to domestically located interests groups who would lobby their governments accordingly, since integration would be promising to serve their material interests.[50]

The theory´s main presumption is that actors are cable of learning and can form their preferences and interests accordingly. Consequently they appear not to pay much attention to the side effects of their decisions and tend to `stumble` from one decision making process to the next. "*Adjustments and further steps in integration are often driven by unintended consequences of previous decisions*."[51] Interstate cooperation is often characterized as a positive-sum game, where there is a "*cumulative pattern of accommodation in which the participants refrain from unconditionally vetoing proposals and instead seek to attain agreement by means of*

[49] Haas, E.B. (1958), p. 14
[50] Rosamond, B. (2000), p. 58 - 62
[51] Nieman, A. & Schmitter, P. C. (2009) in Wiener & Diez (2009), p. 50

compromises upgrading common interests".[52] According to Haas (1985, p. 16) "*the end result of political integration is a new political community, superimposed over the pre – existing ones*".

Unlike liberal intergovernmentalism, that stresses the role of powerful member states, neo-functionalism emphases the influence of supranational institutions on the integration process. These are potentially the agents of integration that deliver coordinative solutions to the states and open up new political channels to help acquire expertise and information for the integration process[53.] By having their own political agenda, "*supranational institutions are believed to overpass national interests and shift their loyalties and expectations towards a new centre where more integration is needed*". [54] Philippe Schimmter (1969) argued that "*as integration proceeds Member States governments become less and less proactive and more and more reactive to changes in the supranational environment to which they belong".* In the case of the EMU, the Commission was crucial in fostering the idea of a European currency by undertaking several projects which eventually led the ideological struggle to shape the EMU. The committee of governors was established to support the 1974 Barre plan and to launch the 1977 Jenkins initiative. Furthermore, the Commission insisted on the inclusion of the vision of the EMU in the preamble to the Single European Act, mediated between European leaders and was important in overcoming British opposition to the EMU[55].

At the core of neo – functionalism is the spill over concept, which explains "*how the structural context of the EU decision making changes and particularly how it constrains intergovernmental bargains*."[56] "*Spill over refers to the process whereby members of an integration scheme, agreed on some collective goals for a variety of motives but unequally satisfied with their attainment of these goals, attempt to resolve their dissatisfaction by resorting to collaboration in another, related sector (expanding the scope of mutual commitment) or by intensifying their commitment to the original sector (increasing the level of mutual commitment) or both.*"[57]

Often one can distinct between three types of spill over according to the means of driving the integration process forward. Firstly, there is the **`cultivated spill over`** which refers to

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[52] Haas ,E.B. (1964), p. 66
[53] Stone Sweet, A. & Sandholtz, W. (1997), p. 300
[54] Jensen, C. S. (2010) in Cini ,M. et al (2010), p. 75
[55] Sadeh, T. & Verdun, A. (2009), p. 282
[56] Peterson, J. (1998), p. 9
[57] Schmitter, P.C. (1969) in Cini,M. et al(2010) , p. 162

situations where supranational actors, like the European Commission in particular, push the process of political integration forward when they mediate between the member states.[58] Due to its privileged position in the European political arena, the Commission is able to redirect the national interest groups towards further integration by using the dynamics between member states during negotiations and trying to convince them of the advantages of supranational cooperation. In the case of the EMU, the Commission president, Jacques Delors, secured the European Council's support for his proposal to establish a high – level working party to draw up a proposal for achieving the EMU.[59] One year later, the outcome of the proposal was to gradually establish a single currency and eventually implement the EMU, as this "*can be seen as the natural complement of the full realization of the Single European Act and of the realization of the 1992 objective - the internal market without frontiers*"[60]. Not complying with this recommendation would possibly lead to the destabilisation of the current arrangements (EMS) and eventually hinder the creation of capital market liberalization. Undoubtedly the most important decision the member states had to take was whether to accept the removal of all controls in pursuit of enabling a free movement of capital unfettered by national regulatory constraints and achieving a greater variability in the relative value of currencies.

Secondly, **´political spill over´** occurs when pressures from non-governmental and political elites dictate the integration process. They argue that specific problems cannot be resolved at national level anymore and therefore look for other solutions in the European arena. "*A gradual shift in the expectations towards supranational institutions occurs when the elites decide to move their political activities and even their loyalties to a new European centre*".[61] Neo – functionalist theory explains the development of supranational loyalties by the process of "*elite socialization", it states that "over time, people involved on a regular basis in the supranational policy process will tend to develop European loyalties and preferences*."[62] These would eventually put pressure on national government and force them to speed up the integration process. By applying this to the EMU, I came across the research from Jeffry Frieden (1991), who argues that "*social groups within Member Countries have justified their support for the EMU by referring to the economic benefits they will take out of the dissolution of the remaining*

[58] Jensen, C.S. (2007) in C. Mini (2007), p. 76
[59] Richardson, J. (2001), p. 232
[60] COM (1990), p. 5
[61] Niemann, A & Schmitter, P.C. (2009) in Wiener & Diez, p. 50
[62] Jensen, C.S. (2007) in C. Mini (2007), p. 91

barriers. Leading financial and multinational firms would profit tremendously from the lowering of the currency exchange costs and risk premiums if a monetary union was to be established" [63]. Furthermore, it appears that once national leaders decide to pursue monetary integration, their efforts benefit from solid business support.

Thirdly, we have the **`functional spill over´,** where the basic assumption is that "*some sectors are so independent that it is impossible to isolate them from the rest, thus, the integration of one sector at the regional level is only practicable in combination with the integration of other sectors, as problems arising from the functional integration of one task can only be solved by integrating yet more tasks*"[64]. A so called ´technical´ pressure develops, heavily influencing member states incentives and pushing them to opt for further integration. The current institutional setting creates functional spill overs which automatically generate a demand for integration where member states act as suppliers.[65] Therefore, contrary to liberal intergovernmentalists, neo-functionalists believe that the ´demand´ for integration comes first, immediately followed by the ´supply´ of integration. In the study of Sandholtz (1993) and Pado – Shioppa (2000) the creation of the European Monetary Union is explained as the result of a `technical spill over` from previous integration processes in the trade area. They claim that this decision was fostered by domestic economic interests of the member states and it represented the "*natural extension to the internal market project*". After completing the internal market project national currencies were responsible for some of the few remaining trade barriers, such as exchange commissions and exchange rate risk[66]. This represented a burden for nation states' exchange rate stability as the full capital mobility is incompatible with the divergent national monetary policies. Thus, neo-functionalist saw as the next obvious step the establishment of a currency union, as a natural extension for the internal market and the achievement of long-lasting objectives. Haas (1970) believes that "*decisions in this arena are normally taken with very imperfect knowledge of their consequences and frequently under the pressure of deadlines*", therefore raising the assumption of secondary factors, which may intervene in the decision – making process. Arne Niemann and Ioannou Demosthenes (2013) suggest in their paper that "*the strength of functional spill over logics is not only being influenced by the degree of*

[63] Sandholtz ,W (1993), p. 25
[64] Haas, E.B. (1958), p. 297
[65] ibed
[66] Sadeh, T. & Verdun A. (2009), p. 279

interdependence of the policy areas, but that there are two further aspects that have a significant impact on the policy process". He moreover emphasizes that by looking deeper into this matter, we would be able to identify exactly when and to what extent this functional tensions affect the actors´ behaviour. Firstly, he mentions that there is a higher probability of a ´**amplified functional pressure**´ when previous functional discrepancies are not immediately compensated with further integrative steps, causing sever hits that during their management would considerably accentuate the necessity of integration[67]. Secondly, the researcher makes reference to the relevance of functional logics as indicators for the development of the `**political discourse**´. Actors´ behaviour is not automatically determined by functional structures, they first must perceive functional logics as absolutely crucial in order for them to proceed with a political decision.[68] By including these factors in the analysis of functional spill over, especially in the case of supervisory reforms such as the Banking Union, I will be able to provide a founded explanation of the incentives of member states in this policy area.

By analyzing the background of neo-functionalist assumptions we can conclude that the theory is able to predict negotiations of high politics in the context in which it is shaped from below by transnational political actors. Therefore the following hypothesis will be tested:

H1: Integration is an automatic process which occurs under amplified functional pressure.

H2: Supranational and international actors are the main promoters of integration, influencing the orientation of the member states.

H3: The development of the political discourse is being influenced by the relevance of functional logic to the decision-makers.

H4: The member states´ basic motivation for pursuing further integration is to achieve their national material interests.

[67] Niemann, A. et al (2013), p.7

[68] ibed, p. 8

4.2. (Liberal) Intergovernmentalism

If neo-functionalism puts more focus on explaining how the EU context changes over time, liberal intergovernmentalism views integration as a continued bargaining process. The theory looks at isolated events and rejects the assumption that there is an automatic and incremental way towards integration. Moravcsik (1993) believes that "*states reach collective decisions through intergovernmental bargains and that they act as rational actors coordinating the negotiations*". Therefore, contrary to neo-functionalism, functional pressures and EU institutions are perceived as the trigger factor for the member states´ operations; liberal intergovernmentalism assumes that "*states preferences are expressed in intergovernmental bargains and are the products of domestic politics*"[69].

Even though the theory places the influence of supranational institutions as secondary and doesn´t agree with the neo-functionalist assumption that they can partly take a life of their own and escape the control of their creators (states), intergovernmentalists stress the need of acceptance from the member states in order for the institutions to exist and function properly. Moreover, they can benefit from interstate bargaining by reducing transaction costs and giving national political leaders more autonomy vis-á-vis domestic societal groups[70].

During the first phase of European economic and monetary integration, there were clear divergences between the economic models the two countries incorporated. When the European Community came forward with the Werner Action plan of introducing a monetary and economic union, a heavy dispute started between France and Germany. The conflict reflected the different positions regarding the role monetary policy should play in the economic integration[71]. On the one side was the ´monetarist´ France that wanted monetary integration first, followed by an economic and political one, whereas the ´economist´ Germany argued for a economic convergence first, followed by monetary and political integration.[72]

Several attempts like the adjustment of exchange rates and stronger institutional frameworks were put into place by the European Union in the hope of reconciling both sides; however the pressure of obtaining the maximum out of the negotiations left the countries empty handed. Years after the fail of the Werner Plan, it came to the attention of the European

[69] Stone Sweet & Sandholtz (1997), p. 5 - 6
[70] Moravcsik, A. (1994), p. 2-3
[71] Schlesinger,H. (1994), p. 4
[72] ibed

Community that the real issue laid in the fixed exchange rate system. This meant that weaker currencies with a high inflation, in this case the French franc, should be aligned to the stronger ones like the Deutsche Mark.

Liberal Intergovernmentalism, ss the name itself indicates, incorporates both liberal and bargaining elements, providing a unique explanation of the interface between domestic and international policies.[73] To better explain the link between the two elements and understand the outcomes of European integration processes, we will turn our attention to the framework analysis provided by Moravcsik (1998) in his research (Figure 1).

We can see that there is a clear division between the **´demand for cooperation and ´supply´ of integration**. Starting from the assumption that states base their decisions on rational consideration while pursuing relatively stable and deeply founded interests it becomes apparent that major negotiations, like the European Integration process, can be divided into three stages: the formation of national preferences, interstate bargaining and institutional choice. Thus, Moracvsik (1999) describes in his book ´The Choice for Europe´ how domestic pressures deriving from geopolitical or economic interests can create variations in national preferences. These are furthermore exposed to interstate negotiations where dominant groups within society shape policy preferences at a national level with the aim of increasing the credibility of their national commitments. By engaging in interstate bargaining, states are able to solve policy confrontation and finally decide if they are willing to delegate powers to international institutions.

National preference formation

According to Moravcsik (2008), "*states show neither fixed nor uniform preferences*", instead preferences "*vary among states and within the same state across time and issues based on issue – specific societal interdependence and domestic institutions*"[74]. Domestic interests tend to vary according to the economic, ideological or geopolitical framework in which intergovernmental negotiations take place, therefore influencing the foreign policy goals of states. From a geopolitical point of view, there is a strong incentive to preserve national

[73] Cini, M. (2010) in Cini, M. et al (2010), p. 79
[74] Moravcsik, A. (2008) in Werner, A. & Diez, T. (2009), p. 70

sovereignty and the control over their territory[75]. Whereas, from an economic perspective, domestic groups desire to increase profitability within cross-border trade and maintain the interdependence of financial markets players[76].

Societal actors play a significant role in initiating, negotiating and shaping the decisions of heads of governments by delegating powers to the states and seizing the opportunity of pursuing their own policies. This relationship is commonly described by the principal – agent concept, according to which any type of difficulties arising from collective action can be overcome. One of the primary goals of governments is to ensure the full cooperation of voters and interests groups in order to continue staying in office[77]. But we already know that domestic interests usually vary, leaving the governments with two possibilities. If societal groups are split, governments have sufficient room of manoeuvre to take decisions in the international arena; however, if they are strongly united they can put national governments under pressure and constrain their actions. Thus, different from neo-functionalists, we here have independent societal actors who exercise their influence indirectly through the formation of national preferences, determining the strategic operations of the states and defining the institutional choice.

Since 1988 French and German governments have developed shared interests in retaining control of the process and outcomes of the EMU negotiations, their informal operating rule being: "better *a second – best outcome at our level than and ′nth-best′ solution in the hands of heads of state and governments and foreign ministers*" [78]. Germany′s and France main motivation was to strengthen their domestic political position and take the most out of the negotiations on the monetary union.

What fundamentally united French and German negotiators was the common conviction of the unification of Europe and the will to achieve reconciliation. The roots of past misunderstandings were due to the different policies concerning the EMU and the appropriate conditions under which it should be established. "*France saw as a prerequisite for the EMU a strengthened political pole or economic governments to which monetary technocrats in*

[75] Moracvsik, A. (1999), p.20
[76] ibed
[77] Moravcsik, A. (1993), p. 500
[78] Dyson, K. (1999), p. 26

Frankfurt would be made accountable whereas for Germany the EMU was to be the final stage of a process of economic and political union"[79].

Interstate bargaining

Furthermore, we will look at the behaviour of governments and their willingness to pool or delegate control to the supranational level. In intergovernmental bargaining "*political preferences are believed to reflect both absolute and relative gains*"[80] while consistently pursuing the protection of national sovereignty. The decision to delegate power to EU institutions with the strictest oversight is perceived as being the most effective way to ensure the cooperation and commitment of member states to the bargaining conditions and to prevent anxious states to preserve their autonomy. Member States are willing to accept these conditions "*as long as it strengthens rather than weakens their control over domestic affairs*"[81]. Thus, institutions play a significant role as they support the states in achieving gains from the exchange of power and diminish the likelihood of defection.

A very important aspect of intergovernmental bargaining is that it reflects upon the bargaining powers of the states involved and focuses on the character and strength of national preferences. Often we experience, especially in the studies on European integration, that ´powerful´ countries are used to explain the policy outcomes. It is important to look into the relative gain each participant has from reaching an agreement. "*Intergovernmental bargaining theory points out three assumptions under which negotiations take place and makes references to the respective factors that might characterize the negotiation outcomes*"[82]. **Firstly,** based on the rational choice orientation of political actors, governments are likely to reach an agreement if each participant sees cooperation as its best option. In the case that one state opts for non – agreement his bargaining power will increase significantly. Thus, governments who are highly dependent on neighbourhood policies will finally see themselves in the situation of having to make compromises due to the influential position of other states that have the possibility to engage in attractive **unilateral alternatives**. Therefore, bargaining will converge on the minimum common ground of the latter ones. After years of disputes, pursue of national interests

[79] Dyson, K. (1999), p. 33
[80] Moravsik, A & Schimmelfennig, F. (2009), p. 68
[81] Moravcsik, A. (1993), p. 507
[82] Moravsik, A & Schimmelfennig, F. (2009), p. 69

and strategic methods to influence the outcome, the EMU managed to emerge as a project combining economic, financial and monetary functions while taking into consideration the need for democratic political leadership and accountability. However if one looks carefully at the components of the Maastricht Treaty, astonishing aspects come to light: the fact that eventually they decided to establish a ´monetary union´ means that France came out in advantage from the bargaining, as the highest sacrifice was made by Germany, which had to anchor the strongest currency within the member countries. Still, there is one victory for the ´economist´ fraction, as the idea of entry criteria determining which countries could join the EMU was strongly supported by the German government.

Secondly, there is the opportunity to engage in **alternative coalitions** changing here with the strategic calculation of the states involved and threatening other member states with exclusion. Again, the bargaining power is expected to increase and create significant pressures for less powerful states which might accept disadvantaging agreements. The establishment of the only independent supranational institution, which represented the heart of the monetary policy, was by far the hardest decision and had to be dealt with carefully. The institution was supposed to review the economic plans of the countries that wished to join the EMU and was in charge of a common monetary policy for the entire region while member countries' central banks were responsible for implementing the policy in their respective countries according to the European guidelines. However, the supervision and regulation of national banks remains in the function of member states whereas the European Commission oversees the maintenance of an economic and fiscal policy system which assures that countries keep the limits stipulated in the SGP. Even though the "*the German central bank wanted permanent constraints on borrowing due to its belief that irresponsible fiscal behaviour would make it difficult for the European Central Bank (ECB) to control monetary policy*"[83], they had met somewhere in between, complying with the requirements of the other actors. They believed that due to the high degree of national differences the interdependence between fiscal policy and social objectives is too fragile and that it would be counterproductive to give up the control over it as countries would not be able to respond promptly in case of economic shocks.

[83] Quesada, S. (2012), p. 14

Thirdly, there are the **issue linkages**, "*which might occur when the countries present asymmetrical incentives on different issues*"[84]. In this context, several agreements can be considered, all of them reflecting better options than the status-quo. Therefore, marginal gains over the issue-areas become more important and tend to push governments into granting each other special agreements[85]. Several attempts like the adjustment exchange rates and stronger institutional frameworks were put into place by the European Union in the hope of reconciling both sides; however the pressure of obtaining the maximum out of the negotiations left the countries empty handed. National elites played an important role, as both President Francois Mitterrand and Chancellor Helmut Kohl grabbed this unique opportunity to link EMU to an initiative for political unification in Europe and the promotion of cooperation between the two rival states. As liberal intergovernmentalism foresees, member states will weigh the benefits and disadvantages, having the option to step out if the compromises are too high. Neo – functionalism however sees no other possible option in this case, thus being unable to interpret this course of action.

The case of the monetary union underpinned a formidable type of elite consensus which has carved out the strong role Germany and France had in the enabling of the integration process. It also illustrates the conflicts between monetarists and economists, nation state and supranational structures as well as the different theoretical approaches. But most importantly it has given impetus to ideas that transcend the imagination of any academic in political science.

As already seen I could depict both neo – functionalist as well as liberal intergovernmentalist features in the analysis of the integration process, however the empirical findings did not support all the theoretical assumption. The fact that the demand of national interests for achieving economic and monetary cooperation was balanced by the outcome of interstate negotiations, which revolved around satisfying the requirements put forward by the strongest economies, remains striking. Nevertheless, both France and Germany were willing to compromise in order to reinstate economic stability, a goal which eventually reunited them.

Deriving from this, I have formulated the following hypotheses that should be tested against the empirical findings from the BU negotiations so far:

[84] Moravcsik, A. (1999), p. 65
[85] Morabcsik, A. (1999), p. 66

H5: The formation of member states´ preferences is the result of the aggregation of the domestic actors´ interests.

H6: Integration is the result of negotiations between those member states with the highest bargaining power.

H7: Member States will reach an agreement only if this allows them to preserve their domestic powers.

5. European Banking Union

A European Banking Union is a new dimension of European Integration enchaining a much drastic sovereignty shift for nation states and creating diverse reactions among authorities. The concept, introduced by the European Commission, entails a fully integrated banking regulation and a federal supervisory system, hence creating a ´genuine Economic and Monetary Union´, as planned initially.

"*The financial and economic crisis spilled into a debt crisis for some of the euro zone countries and threatened the existence of the euro*".[86]After the exposure of the severe weakness of unsustainable economies and most alarmingly, of the national banking system, European officials tried to find new ways of reversing the risks and avoid bankruptcy. Despite small successes the institutional framework and mechanism put into place didn´t fully comply with their task and a new approach was needed.

In the following sections I will provide a brief outline of the Banking Union concept and analyze the positions of the key actors.

5.1. Why is a BU necessary?

Almost seven years have passed since the financial crisis hit the international market and the European Union is still fighting a hard battle against the financial fragmentation. Despite countless debates and several attempts to rescue what could still be rescued, the European markets are continuing to lack stability. There are three main areas whose weaknesses failed to be properly addressed by the mechanisms put into place up until now. Examples of these phenomena include the **cross – border interbank market**, the **liquidity issue** and the **vicious circle between banking and sovereign risk.** Providing this stability requires collectively managed tools by a central authority. Therefore the question I will be addressing in this section is whether the framework of the Banking Union, can cover these necessities and the solution it proposes.

One of the Banking Union´s main goals is to stop the fragmentation process caused by the asymmetric information between creditors and debtors, the increased risk aversion and the major economic differences among European member countries. Moreover, its framework is addressing the serious problem of the European institutional design: "*the banking union is the*

[86] Leska, D. (2013), p. 429

other side of the coin of the monetary union, particularly in a zone where the financial transmission channel is mainly via banks”[87]. In his recent article, Donnelly (2013) makes reference to the tools needed in achieving a systemic stability, which have to be applied in three stages: “*before a crisis, at the onset of a crisis and at the exit of a crisis*”. He believes these are covered by the Banking Union. **Firstly**, there is the issue of restoring trust between banks and recreating a secure financial market environment[88]. This refers to the component of the Banking Union, which calls for an enhanced cooperation in the form of a **statutory supervision and regulation** (prevention measure – before the crisis)**. Secondly**, the malicious banking activity as well as the absence of funds is a contagious hazard affecting the cross – border bank lending. By providing member states with a supranational fund through the Banking Union´s pillar of **direct recapitalisation** (during the crisis), countries with a weaker financial position would have access to extensive credit sources[89]. **Last** but not least there is the **issue of restructuring** (after the crisis), dealing with the problem of structural imbalance in the current accounts. As member states were entitled with the legal authority to intervene, this is still under tremendous risk due to the great amount of toxic assets being held by banks. Therefore the Banking Union would give regulators the central authority to act on insolvent banks[90].

Supervision

Currently, the banking supervision lies in the jurisdiction of national supervisors. Due to the effects of the crisis, most of the national central banks were given supervisory power in the hope of controlling the spread of the risk. Nevertheless, when the crisis reached its highest point and turned out to be unmanageable at the national level, the ECB received macro-prudential supervision through the creation of the European Systemic Risk Board, without binding powers over the European markets and institutions. Moreover, some mechanisms for cross – border coordination have been put in place (EBA), but supervisory authority still resides within the member states.[91]

[87] Sicilia et al. (2013), p.9
[88] Enria, A.(2013), p. 53
[89] Goyal et al (2013), p. 10
[90] Breuss, F. (2013), p. 8
[91] Verhelst, S. (2012), p. 3

With the Commission´s proposal "*the ECB would have sweeping power and full control over all areas of prudential policies*".[92] This step is necessary in order to effectively supervise excessive risks that banks might be taking and intervene in due time. The ECB would expand its mandate and be able, on the ground of its (micro) – prudential supervisory power to protect the solvency and viability of institutions.[93] From a structural point of view, this means significant changes in the organizational management of the ECB. Hence, it was recommended that a special standing committee should be set up, being responsible only for supervisory issues and reporting directly to the ECB. Furthermore, national central banks should carry on their cooperation with the ECB and conduct prudential supervision.

Financing

A deposit insurance protects its depositors against the failure of a bank. Some European harmonisation in this field has already taken place but "*the schemes are still country specific and therefore vary across the European Union*".[94] In the context of the Banking Union this would mean providing for "*joint liability and risk sharing in case of fiscal situation in crisis countries*"[95]. According to the European Commission, with the European Stability Mechanism, it would be possible to pump cash directly into shaky Euro zone banks.[96]

The deposit insurance system involves complex trade – offs between powerful countries as it presents the potential of creating moral hazards which require a thorough review of government guarantees provided to depositors, a highly criticized issue, especially in the case of Greece and Cyprus. There is no doubt that the realisation of a full Banking Union will be difficult to achieve, taking into account the position of some countries and the critiques around the new institutional framework and establishment of more supranational structures.

Restructuring

As the management of banking crises is still a national responsibility and many banks operate on a cross-border basis, "*crisis management requires coordination between member*

[92] Ackermann, J. (2013), p. 2
[93] Lannoo, K. (2012), p. 3
[94] Verhelst, S. (2012), p. 5
[95] Buch, C.M . et al (2013), p. 27
[96] Financial Times (06.2013)

states".[97] The current crisis has shown that the tools in place are not effective enough to protect large and complex financial institutions. Therefore the Commission has proposed the establishment of a pan – European scheme to provide a safe ground for the future: "*clear criteria and procedures will be developed on how to deal with banks in distress and how to share the costs of future cases of bank distress*".[98]

The European Resolution Authority would be in charge of coordinating and applying the resolution tools, showing impartiality in the decision – making process and ensure that the enforcements run smoothly. This is needed "*to prevent the combination of national crisis management decisions from resulting in excessive and avoidable costs to taxpayers in Europe, including burden – sharing with creditors*".[99] In order to be able to introduce prompt corrective actions, the agency will have the power to intervene at all times and national authorities will have to obey the instructions coming from the central office. Nevertheless, national agencies will continue preserving the competence of conducting their own restructuring procedures under the precondition that they consult the authority beforehand.

"*A European Resolution Authority can only be achieved if it can rely on its ´own´ financial resources*".[100] These funds will be used to facilitate bail – in procedures and restructure banks at any time. The financial resources could be gathered "*ex-ante from all the banks participating or be drawn from a European-level fiscal backstop mechanism*"[101], perceived for non – Euro – Area countries, which would like to be part of the banking union.

Furthermore, the European Commission wants to design a ´**single rule book**´ and the introduction of a European banking charter.[102] This should not be a difficult thing to achieve, as during the last past years the European Union´s main focus was to establish a harmonized framework within the banking regulation area. The central issue here is how much freedom national resolution authorities should have over ´**bailing – in**´ and not fall into the same difficult situation as Cyprus did.

[97] Verhelst, S. (2012), p. 3
[98] Buch, C.M. et al (2013), p. 25
[99] Pisani – Ferry, J. et al (2012), p. 6
[100] Buch, C.M. et al (2013), p. 26
[101] Constancio, V. (2013), p. 3
[102] Pisani – Ferry, J. et al (2012), p. 6

5.2. Negotiation process and the outcomes so far

During further negotiation discussions on how to continue preventing more damages to the financial system, both member states as well as EU officials expressed their concern regarding the **`vicious link between banks and sovereigns`**, which needed to be broken. They reached the conclusion, that what the Euro area actually needed was a "*European responsibility for financial market and banking supervision*"[103]. Soon after, EU officials introduced the possibility of direct recapitalization of banks by the then forthcoming European Stability Mechanism[104]. In the following month the so called ´Liikanen Report´ and the report of the four Presidents (Van Rompy – European Council, Mario Draghi – ECB, Jose Manuel Barroso – EC, Jean – Claude Juncker – Euro group) were published, offering a proposal for a more efficient, integrated and sustainable European supervisory system. At the Euro zone Summit in **June 2012** policy – makers eventually came to the understanding that in order to bring the spiral of crisis to an end a transfer of **control of the banking sector to the European level** is needed.[105] Despite great reluctance on Germany's part, EU leaders finally accepted the new permanent rescue fund, thus reaching a compromise with Germany in exchange for first securing an agreement to a European central supervision for banks by the ECB before the ESM will start its operations[106].

In **September 2012** the biggest step towards a single supervision mechanism was put into place. The European Commission published the timetable for a European Banking Union containing the following three documents: a communication titled `A Roadmap towards a Banking Union`; "*a proposal for a Council regulation based on Art. 127 (6), to create the Single Supervisory Mechanism with a* ***central role conferred to the ECB****; and a proposal for a regulation of the European Parliament and the Council to amend the 2010 regulation establishing the EBA in order to adapt it to the creation of the SSM*".[107] The most difficult challenge is to lie down the short – term steps towards accomplishing the fully fledged. "*Although views differ on the precise contents and timing of a genuine banking union, there is wide political agreement in principle on the need for three basic and vital elements*".[108]

[103] Buch, C. M. et al (2013), p. 4
[104] Bloomber 09.2013
[105] Verhelst, S. (2012), p. 1
[106] Spiegel, 07. 2012
[107] Véron, N. (2012), p. 3
[108] Ruding, H. O. (2012), p. 2

The European Union took the plan a step further and in **December 2012** arrived at a **common position towards a Euro zone banking supervisor** as part of a ´Single Supervisory Mechanism´, to prevent banking risk and cross-border contagion.[109] Four changes were made to the initial proposition in September 2012 concerning: most smaller banks with less than 30 billion Euros in assets were exempted from the direct supervision of the ECB and remain under national sovereignty; non-euro area member states of the EU may join the SSM as participating member states; the European Parliament gained additional powers over appointments of the chair and vice-chair of the newly formed Supervisory Board that will coordinate bank supervision within the ECB; and the planned handover of authority to the ECB was delayed from the initially envisaged date of March 1, 2014 to the summer or fall of 2014.[110]

Regarding the overlapping of competences with the EBA, the EU aims at a maximum harmonization with the full implementation of the Banking Union, whereby the ECB would become the licensing authority over all Euro zone banks and adopt the same approach for all member states. Meanwhile the EBA "*could continue to play a role in technical and regulatory standard – setting for the EU level 2 – rules, but this function is expected to diminish over time"*.[111] Its supervisory functions will, however be limited, as the ECB is expected to fully takeover this responsibility. Against the settlements with Germany, European officials decided that "ailing banks will already be able to receive direct aid from the ESM in the spring of the coming year" [112] Thus Germany´s plans to first have central supervision before getting access to the rescue fund failed.

The New Year brought a slightly different statement from the western European countries, which led by Germany argued "*for rules on forced creditor losses at failing banks to be implemented in 2015, three years earlier than proposed by EU draft law, in technical meetings in Brussels*"[113]. Shortly after that, the ECB announced that they will overtake the direct supervision over the 140 largest systemic banks in Europe. This created further opposition from Germany, demanding European officials once again to revise their plans and take their recommendations into account; otherwise they would block the transition of powers to the ECB. In order to prevent this from happening the European Commission gave in considering the option

[109] Ackermann, J. (2013), p. 1
[110] Véron, N. (2013), p. 3
[111] Lannoo, K. (2012), p. 6
[112] Spiegel, 12.2012
[113] Bloomberg, 09.2013

of a treaty change, thus providing Germany with a compromise and distracting them from their actual claims. In the upcoming period, the European Union would officially **approve the legal basis on which the ECB will turn into the central supervision authority**.

EU institutions, especially the ECB used every opportunity to call for a rapid adoption of the SSM and the SRM to be able to guarantee aligned standards for the national banks. During this period, Germany and France were the main actors leading the negotiations on the highly disputed Single Resolution Mechanism (SRM). The first country to make a proposal was Germany, which presented a "*two – step approach to the BU, saying that the resolution mechanism should remain decentralized*[114]". Soon after, France stepped in and both countries agreed to offer their support for the Banking Union if the new supervisory authority is effectively put into practice and specific implementation guidelines for the joint resolution system are formulated[115]. The European Union found no way out and endorsed the delay of direct funding from the ESM until 2014, arguing that meanwhile they will formulate a more ambitious project with stronger standards.

During the next two summits in Luxembourg and Brussels the main subject of discussions was the SRM. Initial concerns over the legal basis were neutralized through the separation of state aid and private bail – in[116]. However, Germany continued to express strong opposition due to the threatening possibility of a central institution deciding over their banks. In addition, the problem of a moral hazard continues to preoccupy them. According to Angela Merkel, Germany will be willing to settle for a compromise, if the European Union agrees upon setting up the pan – European resolution agency on the basis of Article 114 of the EU Treaty[117]. This would minimize the number of banks over which the ECB would have supervisory power, an option which the European Commission does not seem inclined to accept. There is already general agreement that the link between bank and sovereign has to be broken, therefore an incomplete supervisory system would be inefficient and could create catastrophic short term consequences to the market confidence that the EU has struggled these past five years to restore[118].

[114] Bloomberg 09.2013
[115] Bloomberg 09.2013
[116] IIEA, 08.2013
[117] Reuters 10.2013
[118] Faull, J. (2013), p. 5

After heavy discussion, during the second round of negotiations in Brussels, the member states finally reached an agreement over the terms of reference according to which ailing banks will be entitled to direct recapitalization only after the European bank resolution law enters into force[119]. Directly after, the European Commission officially publishes the rule book on state aid. The SRM would finally be adopted, starting its operations from the beginning of 2015. "*After months of drawn-out negotiations, European finance ministers formally approved* ***mid of October*** *the first pillar on Tuesday (15.10.2013). The ECB will therefore officially be responsible for the overall functioning of the SSM, supervising big private banks*"[120]. One of the most important components of the Banking Union has been adopted, despite the scepticism of powerful member states and national government officials. Especially the concerns of Germany were difficult to overcome and many deals had to be made in order to ensure full cooperation. Eventually, despite slight changes to the initial EU Commission´s proposal, the ECB will assume its supervisory task twelve months after entry into force of the legislation, subject to operational arrangements[121]. The banks which will be subject to ECB´s supervision will first have to undergo a stress test, as the European Union does not want to inherent financial liabilities. Who will pay for this trouble banks and take responsibility is still a matter up for discussion. Germany´s Finance Minister Schäuble is concerned about the fact that if the banks receive funds from the newly established ESM, home governments will escape any kind of duty. [122] Southern European member states, led by France mentioned the possibility of the tax payer taking some of the burden, thus creating even more opposition from Germany, which insisted that this would go against the main goal of a banking union.

In the next period, EU leaders need to agree on the following two steps of the banking union: **firstly** clear rules have to be imposed regarding how to deal with failed banks and **secondly** which authority should be responsible for the liquidation and dissolution of bankrupt banks. Especially in the case of the third pillar, the European Commission has already formulated its intention of putting the European Council in the front seat. Germany is again one of the strongest opponents, saying that it does not comply with EU law[123].

[119] Blooberg 09.2013
[120] DW Akademie 10.2013
[121] IST EIN, 10.2013
[122] EuroActiv, 10.2013
[123] DW Akademie 10.2013

5.3. The position of central actors

In this chapter I will present the position of the central actors in the integration process that according to previous theoretical argumentation can be expected to be strongly involved in shaping the negotiation outcome of the Banking Union. I will start with the relevant actors for liberal intergovernmentalism – the member states, which pose significant bargaining power in order to be able to steer the negotiations and pursue their domestic interests. In this process, I will look for the issues domestic actors are arguing for and establish in what way these are aggregated on the state level. Based on previous experiences with the EMU and on the readings about the Banking Union I could easily conclude that France and Germany appear to have compelling incentives in raising critical issues with regard to the Banking Union.

Also I will include the view of vital European institutions, like the EP, COM, ECB and international actors, like the IMF, which, under neo-functionalist presumptions are able to heavily influence member states in accepting the Banking Unions´ provisions.

5.3.1. National actors and their domestic interests

The question I will be addressing in this chapter reflects upon the factors that determine the preference of member states. By analysing the statements of elites and chief executives in the media as well as the position of parties within ruling governments I will be able to identify the position of member states regarding the European debates over the Banking Union. Usually, within the framework of international dialogue, the decision-making power is transmitted through the national leadership, therefore also acting on the ground of individual interests. In this, ideological beliefs, general economic status and the public opinion play a great role in creating as well as steering government leaders´ or states position.

The chapter will be structured in two parts, covering the position of the big players, Germany and France on the European arena. I will start by presenting the position of the public while relying on statistical data from official publication. Afterwards I will look into the ruling parties and the policies they have decided upon or put forward. The discussions are structured chronologically and confer an overview of the national debates in the drafting and implementation phase of the Banking Union´s components.

Germany

The leading figure in the debates is Germany´s Chancellor Angela Merkel, one of the most powerful political and public figures, not only in her home country but also within the European Union. In country surveys assessing the national leader´s way of handling the crisis, Angela Merkel occupies the first place, surpassing her counterparts from France and England[124]. Her position towards the rapid responds to the crisis and later towards the proposal of the Banking Union show a complex construct of several national interests.

The prolonged financial and sovereign crisis has created a diffuse European public opinion, influencing greatly the way in which countries have acted on policies in this area. Generally the support for the EU has shrunk drastically from 60% to 45%[125], across member states countries; however there have been cases in which minor changes occurred, the public maintaining the support of EU measures in the struggle against the crisis. In the case of Germany, statistics show that despite a slight drop (between 2012 and 2013: -4%) more than half of the population are in favour of giving up power to Brussels and fostering a closer economic and fiscal cooperation[126]. Germany´s response to the financial crisis focused on the strict application of the SGP to avoid a debt crisis and ultimately the demand for bailouts. Due to its longstanding structures and strict nature, Germany is attached to rules and discipline. Thus, in a declaration, Angela Merkel "*insisted on austerity measures to cut Euro zone´s public debt and overcome the crisis"*.[127] A sustaining argument for this position, was also the fact that these methods were proven to be quite efficient in the reconstruction phase after World War II: "*We have been taught over the last twenty years that consolidation works, and we have come to believe in it*"[128]. There was however, a delicate matter which kept, especially Germany under a lot of pressure. When Greece was in danger of defaulting, Germany agreed to help them under punitive terms. But, as it turned out the situations continue to repeat themselves causing severe declines in German public support for bailouts to weaker countries, as a survey shows us: almost 40 % of Germans believe it wouldn´t be right to continue with the financial aid, whereas 32 % couldn´t decide themselves[129].

[124] Notre Europe (2012)
[125] The Guardian (05.2013)
[126] Pew Global Attitudes Project (05.2013)
[127] Reuters (05.2013)
[128] The Telegraph, 04.2012
[129] Financial Times (06.2013)

On the background of re-elections, the German government has always shown precaution in the way they handled their statements and position towards the Banking Union. Public opinion was vital for Chancellor Merkel if she wanted to maintain her position in office. Apart from that, the national elections were also close and political parties needed to be able to count on public support. CDU, the leading party, also called the `Europe party` saw "*fiscal indiscipline as the main cause of the sovereign debt crisis and was therefore in favour of ´austerity measures´ and ´fiscal surveillance´*"[130]. Furthermore the strong ideological and legal background led party members wanting a mutualisation of debt only accompanied by a treaty change, which would reduce the political leverage. Their concern was the "*doubtful legal basis on which the project rested*"[131] saying that before the Member States move forward, a treaty change should take place and only then could the Banking Union be implemented. Some even speculated that Germany´s terms were drastic and entailed the creation of an entirely new constitution. As a member of this party, Merkel represented these believes and also pursued this matter in her debates, as she needed to strike a good deal for herself and the leading party. Also, the German population oce again needed to be convinced of the benefits of maintaining the mutual currency and proceeding with deeper integration. Even though more than 70 % of the German population believe that their national economic situation is very good, only half of it (50 %) perceives the European integration as being a decisive factor for this trend[132].

With reference to the elements of the Banking Union, Germany was never reluctant in arguing that as the largest and most powerful euro zone country, they worried about being "*forced into a situation of having to contribute with more funds to the ESM in order to bail out banks in other countries*"[133]. Germany managed to remain on a stable economic ground despite the crisis, reaching the lowest unemployment rate since nearly two decades. Hence, the ´Bundesbank´ played a vital role in fostering stability and rescuing troubled financial institutions. Looking at the German banking sector more carefully, we notice that there is a strong interconnection between small and medium to large saving banks and the state, which already have strict rules regarding credit guarantees and long – term bond holding. For this reason, both

[130] Dullien, S. et al (2012), p.5
[131] Reuters (05.2013)
[132] Notre Europe, 2012
[133] Horvath, D. & Quaglia, L. (2013), p. 112

local authorities and the banks themselves oppose the ECB supervision and would prefer to be subject to national supervision.

With regard to fiscal policy transfer and strengthening the role of the ECB, most member states have scored poorly in the rating of the ECB by citizens. Apart from the fact that there are great disparities between southern nations and Germany and France, the numbers show a worrying trend within the most powerful countries in the bargaining process. Around 50% of the German population sees the ECB in an unfavourable light[134] and party support on this matter does not seem to be significantly better. CDU has expressed its reluctance regarding the ECB bond purchasing on several occasions, whereas the CSU, a rather Euro-sceptic party in Germany, published a `Five – Point Plan` opposition to further European integration in June 2011[135]. In the light of these actions, Germany released a non-binding resolution against the ECB´s euro rescue fund in October 2011. Hence, policy wise, we can trace the domestic opinions back to the strong ideological background as well as the desire of not only the German population put also of political parties to maintain a healthy economic union and impose more regulatory mechanism. Both Merkel and the political parties see that the country is deeply dependent on the export – oriented structure as well as peripheral loans[136], which in case the situation worsens it could cause the collapse of the German banks. Therefore, Germany´s highest priority since the outbreak has been decided to rescue the currency.

Strong opposition has also come from Germany´s two most powerful financial institutions, which, differently from any other European country, have an increased importance for the population (more than a half having accounts there) and significant political ties. Lobby groups representing the ´Sparkassen´ and ´credit unions´ have addressed their concerns regarding the protection of the German savings against centralized supervision and questioned the collectivization of European debt: "*The DSGV (German Savings Banks Association) president, Georg Fahrenschon and his counterpart at Germany's credit unions, Uwe Fröhlich, fear that the Banking Union, and especially the joint deposit insurance scheme, will serve to redistribute risks and burdens within the Euro zone*"[137]. Bigger banks, predominantly within the Southern Coalition (led by France) but also from Germany (Deutsche Bank), believe that there shouldn´t

[134] Pew Global Attitudes Project (05.2013)
[135] Notre Europe (2012)
[136] Le Monde diplomatique, 05.2012
[137] Spiegel 09.2012

be an exclusion, because the responsibility is equally shared in times of crisis and therefore no exception should be made. The Bundesbank, has also criticized the German government of not handling negotiations properly, fearing that direct recapitalization form the ESM could "*force Germany to take on potentially sizeable risks*"[138]. Also, the fact that Germany did not continue to insist on stress-tests for all European banks was perceived negatively by domestic actors and considered dangerous for the further steps taken towards the Banking Union. Given this, it may seem that Germany´s lobby groups could greatly influence the position of the country within the Banking Unions´ negotiations. However the German government has pursued its own political agenda, trying to prioritize its interests rather than letting itself be influenced by lobby groups. Altogether, Angela Merkel, did promise to have "*a willing ear for the savings banks' concerns*"[139], which could be seen in the minimization of mutual liability, bargained during the last discussions.

On a general note, it can be argued that the German ideology and policy pursue render to be successful in excluding Eurobonds, reducing the role of the ECB, introducing automatic sanctioning mechanisms and more importantly reaching a treaty change on such a short notice. In an official declaration of the German Minister of Finance, he expressed the conditions under which Germany will agree to a Banking Union: *"… the independence of monetary policy may not be compromised. Conflicts of interest between monetary policy and bank supervision must be avoided. Countries that don't belong to the euro zone, and are thus not members of the ECB Governing Council, must be able to equally participate in banking supervision. And the banking supervisory body should be independent of the ECB Governing Council"*[140].

Judging by the position of Germany towards limiting the power of institutions in the integration process, we may conclude that this is favouring the (liberal) intergovernmental assumption. Moreover, its counterpart in the bargaining process, France seems to represent the same position, with the exception so key aspects that are still under debate. We will see in the following chapter the matters over which Germany and France disagree and where the strategic manoeuvre leads Germany, based on "*a political cost – benefit calculation*"[141].

[138] Spiegel 09.2012
[139] Financial Times 12.2012
[140] Spiegel 12.2013
[141] Spiegel 07.2012

France

Looking carefully into the historical background of the French society we can notice that they have different perceptions regarding monetary and financial matters. In the light of the financial crisis, France failed in managing its national budget correctly and its national debt significantly exceeded the limit imposed by the SGP. Thus, it exposed French banks to "*sovereign bonds and went down the path of supporting the principle of mutualisation of risks*"[142] looking for support in powerful economies like Germany. France´s public sector indebtedness reached worrying levels and it represents not only a danger for the countries themselves but more importantly for the entire Euro zone[143]. Recently, forecasts have been made, that France may slip into recession, having to reach out for bailouts. In the fear of ending up like Greece, France saw the solution of all its problems in the implementation of the Banking Union project. Despite having put their hopes in the last elections, there is a lot of scepticism regarding effective structural reforms which could help the country regain their position on the international market.

There has been no other country with as drastic a change in public opinion as France. Recent polls have shown that, since the crisis hit the country, the public mood dropped dramatically with 91 % in 2013 saying that the economy is doing badly, a raise of almost 10 % since the previous year[144]. Also, only 22 % (a drop of almost 15 % since the year before - 2012) of the population thinks that economic integration helps to strengthen their economic performance and 41 % favour the European project[145]. Most of the concerns the French have, evolve around inflation and employment, as over 10 % of the population is unemployed, the national debt is 90 % of the GDP and the public spending has already reached 57 % of the GDP[146]. Based on this factor we can definitely see that such a country is in need of reconstruction.

Apart from that France has been considerably sensitive because of the change in leadership, thus its response to the crisis has also undergone significant changes. The former president Sarkozy, "*managed to make himself the Fifth Republic´s most unpopular president*

[142] Reuter 05.2013
[143] Global Post 04.2013
[144] The Guardian 05.2013
[145] Pew Research Center 2013
[146] Spiegel 12.2012

during his own term in office"[147]. Part of his agenda was to introduce an `active state` in the economy[148] by reducing the fiscal burden, liberalising the labour market and stimulating investment. However, his measures were not at all popular among the citizens. The extreme tax raises, the raising of retirement age from 60 to 62, the enforcement of higher tuition fees caused strong hostility and negative reactions. Despite the election of Hollande, the public perception over the way in which national leaders handle the crisis, has not improved, on the contrary it has worsened, with 67 % in 2013 of the population thinking that they are doing a bad job, from 43 % in 2012[149]. During his campaign, Hollande often talked vaguely about ´recovery´, omitting on purpose the words `austerity measures` in order not to cause much public disillusionment. After his election, instead of choosing immediate action, he preferred to call for different reviews and reports on how to boost France´ competitiveness. In the light of the reports´ results, recommending "*relieving employees of € 40 billion worth of contribution to social spending.*" [150] Shorty after, the socialist party expressed its reluctance, causing the president to change his mind and remove his support for this project.

Interestingly enough, before the crisis in 2007, 62 % of the French were in favour of giving up more power to Brussels, whereas in 2013 just 41 % still judge this positively. However, both France and Germany seem to agree on a European – based crisis management, with 42 % of the German population and 40 % of the French being in favour[151]. With regard to the financial assistance, it looks like the partisan split in France is not that big, 53 % of the left, 44 % of the centre and 40 % of the right – party members are approving bailouts for countries with financial problems[152]. Thus, the French position in the negotiations focused on no automatic sanctioning, pursuing mutual solidarity, an early introduction of the rescue mechanism and loosening regulatory measures. Preserving the Euro continued to be part of their motivation, with 69 % of the French supporting it[153], however they have trust issues with regard to the ECB (only half of the population perceive it as favourable[154]) and Germany.

[147] Spiegel 12.2012
[148] Lakin, M. (2012)
[149] Notre Europe 2012
[150] Spiegel 12.2012
[151] Pew Global Attitudes Project (05.2013)
[152] Pew Global Attitudes Project (05.2013)
[153] Norte Europe 2012
[154] Pew Global Attitudes Project (05.2013)

Generally, French banks are favouring the Banking Union and pushing for an immediate commitment. Because of the difficult situation they are currently facing, Eurobonds and European supervision would help them to deal with the problems before they get out of control[155]. Not only will the banks be able to look into the future with optimism but also reduce the pressure over returns that the majority are facing.[156] Having said that, it could be argued that banks and their lobby groups have had a role in influencing the position of France within the negotiations; however it is still the governments which have generally acted in the name of its voters and ob behalf on their political parties.

The ideological motivation of France in fostering the movement towards a Banking Union lies perhaps once again in their determination of securing Germany´s support for the resolution framework, hence tying the most powerful economy in Europe to agreement and assuring its relative position. The two countries have been ´partners´ of EU Integration since the launch of the EMU project showing most of the time divergent political preferences. In the case of the Banking Union, especially France seems unable to decide on which side it wants to position itself. Despite sharing preferences with Germany regarding the tighter banking and budget rules it also joined the southern European countries for a strong and real Banking Union[157]. With regard to the specific elements of the Banking Union, "*the national supervisory system of France seems to be of high quality*"[158] and wouldn´t suffer drastic changes with the moving of supervisory power to the supranational level. Moreover the French government assures the support for a banking union because they see it as "*relieving market worries over unstable banks in the euro zone periphery holding huge quantities of their governments´ sovereign debt*"[159]. French policy preference in favour of the banking union also comes from the fact that they would be able to set up a mechanism of supporting indebt banks which resembles the ´lender of last resort´ policy they proposed during the European Economic and Monetary Integration process.

Who of the two powerful countries will eventually come out as the ´winner´ is still a matter of discussion, since the events around the negotiations on the Banking Union have

[155] EurActic (10.2013)
[156] The Wall Street Journal (02.2014)
[157] The European Sting (06.2013)
[158] IMF (2012)
[159] Horvath, D. & Quaglia, L. (2013), p. 111

evolved rather slowly and there seems to be an ongoing interplay between France and Germany. The following section will further discuss this topic.

5.3.2. Supranational and international actors

One of the main supporters of a Banking Union is the ECB, which has published several assessments since the release of the Commissions´ proposal. Basically what they criticize about the current regulatory and supervision system is the little cooperation for such diverse financial sector policies[160] ECB officials stretch the need for harmonization, particularly after the experience of the crisis and the worrying situation banks were put into. Moreover, they perceive the three proposed pillars as essential for the good functioning and recovery of the internal market and monetary system. The Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM) are indispensable elements of a Banking Union, which "*will rebuild the confidence in the banking sector and break the vicious circle between sovereigns and banks*".[161]

Apart from the institutional framework, the ECB expressed its support for the inclusion of non – euro countries in the Banking Union. If the crisis has shown us anything, it´s the dependability cross – border relations can create among national banks. Prevention and adjustment mechanisms have been tried out but none of them delivered the desired result that the European banking system so desperately needs.

The European Parliament also seems to favour a Banking Union, as more than 60 % of the main political groupings have shown their support in a survey addressing current negotiations[162]. Their major concern relates to the accountability of the ECB and the impact this will have on national regulators. As the only body which incorporates the legitimacy of EU´s decision processes, the EP put forward several possibilities to strengthen the position of the newly established supervisory authority in front of credit and public institutions. There is a possibility of amendments from the side of the EP, which will then be able to question certain decisions and conduct investigations. To this extent, a Board of Appeal could be created, where national authorities as well as citizens would have the chance to ask for further review on the supervisory decision the ECB has taken. Furthermore, in order to ensure the complete legality of

[160] ECB (11.2013)
[161] ibed
[162] EP (02.2013)

ECB´s actions, the EP asked for the European Court of Justice (ECJ) council on matters of higher importance that could bring severe consequences[163].

The European Commission (COM) has been the main initiator of the Banking Union. Since the release of the proposal in September 2012, it pushed for fast implementation and tried to meet the requirements of the member states in order to achieve a final result by the end of 2012. From the shared view regarding the separation of the supervisory and monetary tasks of the ECB to the accountability issues and the SSM jurisdiction, the Commission carried out its main goal of completing the road towards a fully working Banking Union.[164]

One of the external authorities that were involved in the regulatory programs since the beginning of the crisis is the IMF. On various occasions it emphasized that "*Europe must move quickly towards completing its banking union with a credible common backstop or risk undermining its new single bank supervisor.*"[165] Not only did the IMF approve the COM´s proposal but it actively supported all three components, mentioning that they are absolutely necessary for a successful implementation. Otherwise it might result in "an architecture that is inferior to the current nation – based one"[166]

Both Brussels and the international level perceive a tighter control over member states public finances and a greater fiscal disciple as the most probable solution which could lead to a healthy recovery of our markets.[167] . There are certainly difficult sacrifices that member states are expected to make but we will see in the next chapter, how great their political power is influencing the institutional design of the Banking Union.

[163] Archick, K (2014), p. 4
[164] COM (07.2013)
[165] Financial Times (02.2013)
[166] ibed
[167] Mike Shedlock (02.2013)

6. Theory testing

In the theoretical section I have formulated the hypotheses of neo-functionalism and liberal intergovernmentalism based on previous experience with the EMU project. Now I will continue by analyzing step by step what these predictions would mean for the Banking Union and compare them with real events.

6.1. Neo-functionalism

This section focuses on the institutional reform proposed by the Banking Union project with regard to the financial sector and supervision mechanism. It looks at the different neo - functionalist factors, according to which functional interdependence arose between the single market and common currency, nurturing negative effects in the light of the crisis and eventually leading to functional necessities for further integration steps. As already mentioned in the theoretical part, the subsequent chapter will not only analyze the ´traditional´ neo-functionalist assumption of functional spill – over effects but also introduce two key aspects, according to which it will be easier to determine how functional pressures affect political actors' behaviour – functional dissonance and political discourse.

Functional pressure & dissonance

From the perspective of ´**functional spill over** ´, due to functional interdependences between several policy areas, an original objective can only be secured by a further integration of other policy sectors. In our case, there were several objectives: the successful implementation of the single monetary policy and the financial stability of the EMU[168]. These were interconnected with a more general EU objective of completing the single market[169]. Thus a possible explanation for a Banking Union can be the structural incentives an incomplete EMU created in the face of the crisis or the necessity to break the link between banks and sovereigns.

Let us consider the **first structural incentive** - the incomplete EMU. After the Maastricht Treaty policy makers kept on stumbling on bottlenecks whenever they wanted to engage in further integration. "*The introduction of the common currency and single market has greatly amplified the interdependencies between the euro area member states, especially in*

[168] Niemann, A. et al (2013), p. 7
[169] Padao-Schioppa, T. (1996)

capital markets, be they government or corporate bonds, stock markets or the banking sectors".[170]Discrepancies between supranational and national policies put a lot a pressure on the fiscal and economic framework. In time of economic boost, national policy responsibility and the insufficient institutional adaptation didn´t raise concerns, so one could argue that therefore no sufficient pressure was exercised in order to set off a functional spill over. Yet, in the light of a crisis, more incompletion came to surface, especially in the area of crisis management and the national prudential supervision. Therefore the pressure became more evident, amplifying the functional necessity for broader institutional integration and crisis management tools. Looking at the institutional development that unfolded in the area of financial supervision this process can be explained as steps taken in order to diminish the functional pressure that was created due to the incomplete framework. However it can still be argued that the issues associated with national supervision were supposed to be solved by the introduction of the Lamfalussy framework and after that the creation of the EBA. These events would suggest that the Banking Union, more precisely the SSM is not likely to result from of a functional spill over from an incomplete EMU in the area of financial services, thus rejecting the neo – functionalist assumption.

Looking at the **second structural incentive** – the link between banks and sovereigns, scholars such as Barry Eichengreen and Charles Wyplosz (1998) have speculated on how a sovereign crisis in the euro area would spill over in the banking system and the other sovereigns. The nation–based supervisory structure was evolving rapidly and the crisis likewise, therefore the interconnected fiscal and financial developments revealed the deep link between banks and their sovereigns. Due to the functional inconsistencies that have build up during the last years, the crisis showed the strong nature of the so called `**financial trilemma**` of which I have talked in the previous sections. Schoenmaker (2011) mentions the theoretical foundation of this concept in his article and states that ´the three policy objectives – maintaining global financial stability, fostering cross-border financial integration and preserving national authority – do not easily go together:[171]

> "Any two of the three objectives can be combined with relative ease, but it is difficult to achieve all three. The financial trilemma forces policymakers to make a choice. Maximizing global welfare means considering global financial stability and other global objectives, such as reliability of financial contracting

[170] Niemann, A. et al (2013), p. 9
[171] Schoenmaker, D (2011), p. 5

> and efficiency of global allocation of funds. As cross-border financial integration progresses, policy makers will have less scope for independent policy-making, including fiscal independence. Ultimately, the trilemma boils down to the issue of sovereignty. At one extreme, policy makers can hand over part of their sovereignty to foster global banking and global financial stability. At the other extreme, policy-makers can choose to impose restrictions on cross-border banking to preserve their full sovereignty (see Cerutti et al (2010) on the costs of ring fencing). The extensive international reach of European banks suggests that resolving the trilemma is most urgent for Europe"

They came to the conclusion that the efficient policy response would be to tighten supervision and inspection of European bankers rather than placing fiscal authorities in a straightjacket.[172] The European Union have had this type of reforms on the agenda for almost 10 years now and have every since tried to review the prudential supervision mechanisms. As previous events have shown, the nation state and the banking sector are strongly dependent on each other: on the one hand, there is the state whose banks need to be rescued for the sake of protecting the economy, whereas on the other hand there is the banking sector which needs state recapitalization to continue functioning. Member States believe that sharing the same currency and having states in the Euro Area with severe national debts could create irreparable damages to the Euro currency and may trouble the economic stability of all countries. Thus, they begin developing strong incentives for protecting the single currency and the already existent EMU. Neo – functionalism believes that member states get trapped into institutions during the integration process and because they have the power to take a life of their own, it is difficult for states to change or even remove them. The only option is therefore further integration to secure the survival of the single market. Hence, reaching a consensus represents a necessity to reach the original objective of a well–functioning single market with a financial stability.

A functional spill over would have to happened over all economic policy areas, reflecting the intertwining of policy demand and the different markets[173]. First, the public and private indebtedness and extreme macroeconomic imbalances have been tackled with tighter fiscal and economic institutional instruments like the `Six – Pack´ and the ´Fiscal Compact´. Apart from that, European funding will be provided through the EFSF and the ESM, completing the

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[172] Eichengreen, B. & Wypolsz, C. (1998), p. 15
[173] Niemann, A. et al (2013), p 11

governance structure and acting as first response to a crises. Second, a unified EU supervision and SSM could provide for a secure functioning of the Euro currency and offer the possibility of shared liability through the ESM when it comes to rescuing ailing banks. Apart from this the ECB could play the role of a central supervisor and decision – taking body in case of licence withdrawals of credit institutions and enforcement of regulatory standards. Third, the multidimensional framework of the crisis calls for broader institutional reform, as an SSM alone wouldn´t be able to assure the objective of financial stability. Thus, the concept of the Banking Union has been proposed, consisting of unified rules, a banking recovery and solution mechanisms as well as a common deposit guarantee fund[174].

As a conclusion, neo – functionalism seems to explain the creation of the Banking Union as a necessary step in order to secure the stability of the Euro currency and break the link between the banks and sovereigns. It also sees the situation as extremely urgent, due to the dangerous situation in which the banking sector finds itself and the pressure under which member states are because of their high national debts. Neo-functionalism would expect that member states deliver a short- term solution by accepting all components of the Banking Union.

But in what way do these predictions coincide with the real events? Based on the findings from the negotiations outcomes so far we see that the member states managed to first reach an agreement on the SRM and only recently decided upon the introduction of the SSM. Direct recapitalization through the ESM remains in the stage of a long – term negotiation process, as there are still certain uncertainties with respect to the accountability of the measure and the possible need of a Treaty change. Besides this, the crisis is still continuing, while none of the already agreed components have entered into force. We can therefore conclude that the temporary arrangements raise important questions regarding the explanatory power of neo – functionalism, as according to it, the functional demand for ´short – term integration´ is not provided by the member states.

Relating to the delay in the transition period, neo – functionalism cannot really provide a suitable explanation, as normally integration should happen automatically. Nevertheless, it is possible that the pressure from supranational actors diminished after reaching an agreement on the SRM, leaving the member states sufficient time to adapt to the new structures. However, neo – functionalism does not see any other option for the member states, as it believes that the single

[174] Buch, C.M. et al (2013)

currency is putting such a strong pressure until it force them in accepting any step of integration as soon as possible.

Still I would not completely exclude the neo – functionalist presumption, according to which the decision over the SRM and SSM might be the result of a functional spill over. Yes, there have been other possible spill overs but the step of ´deeper integration´, which is similar to the EMU, remains the BU. In the light of severe consequences from malicious links between banks and sovereign, member states are facing heavy burdens from their national markets, pushing them towards further integration. Despite not being automatic, this can still be perceived as functional incentives and therefore sustain in part the **first hypothesis.**

H1: Integration is an automatic process which occurs under functional pressure exercised on the member states.

There is certainly another question concerning the neo - functionalist assumption about the influence of supranational and international actors over the member states and their pressure to support the components of the Banking Union. As already seen in the case of the EMU, the European Commission was the main instrument in fostering the ideas of a unified European currency by undertaking several projects which led the ideological struggle to shaping the EMU. Again, the European Commission is the one who has proposed the Banking Union and has been involved in the national bail out plans and crisis resolution policies. We already saw in the previous section the position of the most important actors, the COM, ECB, EP and IMF towards pursuing a quick establishment of the Banking Union´s elements. The interest of the European side is to safeguard the single market which is endangered by the malfunctioning of member states´ economies. Their drive for further integration is that "*the simple coordination is no longer enough – closer supervision and integration is now needed at EU level to avoid future banking crises, restore confidence in the financial system and protect savers"*.[175] Another ally which was actively participating in dealing with the crisis was the ECB. Since the first effects of the crisis appeared, it pursued different methods to coordinate the responses to the critical situation by conducting stress tests, implementing new rules for banking collaterals and facilitating the creation of three new European Supervisory Authorities: EBA; EIOPA and ESMA. The motivation of the ECB to propose reforms within the financial and banking system was strongly related with the incentive of completing the single market, an objective almost forgotten on

[175] EU COM (2012)

national level but highly important for the European Union. Among the supranational institutions that formulated official recommendations to support the Banking Union, was also the IMF, which on several occasions "*warned about leaving the project half – finished, either through political compromises or a loss of momentum*, especially now, *given the urgency of financial problems afflicting the euro zone and the need to ease the pressure on the balance sheet of sovereigns*".[176] Thus, the **second hypothesis** appears to also apply, as there is strong evidence showing the position of European and international actors towards the BU.

H2: Supranational and international actors are the main promoters of integration, influencing the orientation of the member states.

Political discourse and national interests

As already mentioned in the previous sections, by looking at the formation of the political discourse within member states we will be able to better determine how the functional logic has influenced the actors´ behaviour. According to the neo-functionalist assumption, the crisis acted as a catalyst for the already existing functional spill over, therefore decisively reinforcing the incentives to pursue further integration. This is clearly reflected in the shaping of the political discourse at both European and national level, which until recently wasn´t that intense due to the largely unnoticed pressure.

The first reference we encounter in the national governments is the functional pressure from the incomplete institutional framework, more precisely the EMU and thus the functional necessity to deepen integration. Germany´s Finance Minister Wolfgang Schäuble mentioned in his speech at the `Economic Forum` several times that: "*When we created the EMU, when we drafted the SGP, no one could foresee the changes in financial markets...the Euro zone's economic and fiscal governance lacked bite in both standards and from*"[177]. In a latter discussion, he also said that "*there is certainly a risk that, in the event of a collapse of the euro – which, by the way, I don´t believe is going to happen – much of what we have achieved and become fond of would be called into question*."[178] Furthermore, the President of the Commission, José Manuel Barroso, argued that *"the financial crisis has revealed the need for a leap forward in political integration to complete the closer co-operation member states had already begun to*

[176] Financial Times (02.2013)
[177] Dr. Wolfgang Schäuble (05.2011)
[178] Der Spiegel (06.2012)

embrace, to harmonize their economic and fiscal policies"[179], thus agreeing with the functional spill – over of deeper integration to alleviate the pressure.

Important political leaders, like Germany´s Chancellor Angela Merkel have and France´s President Francois Hollande, referred to the broader objective of the European Union and the need to secure it by taking deeper integration steps.

> Hollande: "Europe is not only a budget, a single market and a single currency, nor can it be viewed as a set of rules and treaties which regulate the living together. EU should be viewed as a union of nations, each of which has come in to search for a solution for its future. EU is a political project, a balance between rules and responsibilities.[180]"
>
> Merkel: "If the Euro fails, Europe fails. We can´t let that happen! More Europe is the solution.[181]"

Thus, we can conclude that, the mostly constructed political discourse of Europe´s and ember states´ policy – makers was characterized by an increasing acceptance of the functional logic. "*Since discourses tend to restrict decision – makers´ room for manoeuvre and of course action in the political process*"[182], it means, that the amplified functional pressure, due to the crisis, appeared to be convincing to political leaders, leading to the grounded possibility that it manifested itself in the political decisions. Hence, the **third hypothesis** could be verified.

H3: The development of the political discourse is being influenced by the relevance of functional logic to member states.

With respect to the motivation of the member states in supporting or rejecting the integration process, neo-functionalism argues that the crisis, as a result and amplifier of functional pressures, has fostered learning effects.[183] Accordingly both national and European conduct has been a reflection upon the functional spill over and has begun to gradually accept the need for integration. Member States´ Heads of Government came forward and showed their concern regarding the future of the European Union and eventually admitted that "*it was an illusion to think that we could have a common currency and a single market with national*

[179] Financial Times (09.2012)
[180] EU Inside (02.2013)
[181] Bloomberg (15.2010)
[182] Jachtenfuchs, M.(1997), p. 47
[183] Niemann, A. et al (2013), p. 12

approaches to economic and budgetary policy".[184] In the section about the position of France and Germany, we can definitely depict their interest for protecting their national markets and implicitly the desire to re-establish the stability of the Euro. These interests seem to be taken into consideration my member states when forming their orientation towards the different components of the Banking Union. To conclude, I am able to say that also the **fourth hypothesis** could be verified, at least from the point of view, that the integration process met the material expectations of the member states, even though it was still not implemented.

H4: The member states´ basic motivation for pursuing further integration is to achieve their national material interests.

6.2. Liberal Intergovernmentalism

This theory rests upon three important aspects: the rational state behaviour, a liberal – theory based national preference formation and an intergovernmental analysis of interstate negotiation. Liberal Intergovernmentalism (LI) assumes that the decision over establishing the SSM and further components of the Banking Union are the result of the aggregation of domestic interests at the national level and the bargaining process between the strongest economies in Europe. To see if the previous statements apply for the case of the Banking Union four hypotheses are tested.

National preference formation

According to the model of rational state behaviour, states are able to identify in the process of preference formation "*the potential benefits of policy co-ordination*"[185] through constrained pressure from societal actors, influencing the bargaining outcome significantly. Therefore it is first important to define the factors contributing to the formation of national preference. By applying the method of process tracing, in the previous chapter on the `**National positions and domestic interests**` we were able to see that the predominant interest of member states during the crisis was their countries´ economic and financial stability rather than the pursue of foreign policy goals. The popularity of these topics was frequently present within the political arena, especially in the light of national elections, as a change in domestic balance could

[184] Barroso, J. M. in The Telegraph (09.2011)
[185] Moravcsik, A. (1993), p. 481

jeopardize their position. Based on the different national strategies and the transfer of ideological beliefs to the state level, governmental leaders have shown different opinions regarding the composition and implementation phase of the Banking Union.

Since the beginning of the negotiations on the BU´s first pillar, two coalitions have primarily coordinated the process. **On the one hand,** there are the **Southern European Countries** led by France, which have been suffering the most from the consequences of the crisis. Especially Greece, Spain and Italy are confronted with severe economic, financial and fiscal problems for which they see a resolution mechanism as a suitable solution. The French position is slightly different, as it has not yet registered any problems but is acting in a preventive manner, suspecting that it might follow the other countries´ path. Their dependency on short–term financing and the interconnection between the French economy and the economy of other peripheral countries, has determined them to join this coalition, even though they do not perceive the ESM as absolutely necessary. Still, they do seem to see eye – to – eye regarding the support for a fully fledged banking union, as this may provide them with a significant credit line and financial stability. **On the other hand**, there are the **Western European Countries** led by Germany for which the implementation of the SRM would possibly mean the burden of proper taxpayers and banks for rescuing Southern European banks. Their support for the BU resumes itself to the extent to which it will foster financial stability. In terms of shared liabilities and fiscal power transfers, the countries have shown strong opposition. Especially Germany, has expressed its concern over the consequences which would come hand in hand, if they were to accept the sharing of liabilities.

Because the coalitions were led by two powerful member states, **France** and **Germany**, I have decided to focus most of the analysis on them, as rightful representatives of the two parties. "*In the EU, Germany and France have dominated political decision-making in all years, in which their politic – economic has been dominated by ordoliberalism, in the case of Germany, while the French one by interventionist, and since WW II – Keynesian way of thinking*"[186]. During the crisis-management period, national leaders have interpreted these ideologies into bargaining positions, looking to secure the domestic interest of their respective countries, while acting autonomously in pursue of their own interests (re-elections!). Hence, former French president Nicolas Sarkozy showed his support for ordoliberal austerity measures, being

[186] Nedergaar, P. (2013), p. 10

concerned about the public deficits of France[187]. His strategy within the country was to "*implement unequivocal Rightist ideas whilst engineering a political hegemony - ´I have made Gramsci´s analysis mine: power is won by ideas*",[188] thus still trying to promote an interventionist approach. The elections of his successor, Hollande, and thus his loss of the presidency, represented the back-fire to the so called ´Sarkozyism´ and the change to a growth – based policy landscape of Left ideas. The new approach towards the crisis management toolkit, including the BU, was "*a greater financial stability among member states and a collective economic revival*".[189] French Finance Minister Pierre Moscovici, mentioned in his interview with the Financial Times, the direction in which the negotiations on one of the BU´s most debated components were going, showing that France is one of its most loyal supporters: the new scheme would involve a "*single resolution fund and a role given to national input*", accentuating that both EU´s (central fun) as well as Germany´s position (a network of national funds) were taken into consideration.[190]

In the case of Germany we witness a certain consistency, since the ordoliberal tradition has been a counter stone in the strategic thinking of all German political parties, as an article stipulates: "*the SPD has not gained any traction against Angela Merkel, because more than any other social democratic party in the west, it has brought into the neoclassical economic policy consensus*"[191]. German Chancellor Angela Markel´s bargaining position has been reckless, in the sense that her ordoliberal beliefs are deeply founded and transparently transposed into structural policies, on the country itself in order to be competitive, likewise influencing Europe´s construction[192]. In her speech on the Euro zone crisis this is once again reflected: "*The lessons are very simple: rules must be adhered to, adherence must be monitored, and non-adherence must have consequences*"[193]. With respect to Germany´s vehement opposition to collective liabilities and their fear of an increased uncertainty and thus reduced credibility, Angela Merkel argues the following: "*First of all, the euro zone should assume joint responsibility for only 130 banks out of 6,000, including no more than 30 German firms. Secondly, in case of emergency,*

[187] Manuel Sarkozy (2011) in Lakin, M. (07.2012) , Politics in Spires
[188] Lakin, M. (07.2012) in Politics in Spires
[189] Robin, J.P. (08.2012) in The European Institute
[190] Financial Times (10.2013)
[191] Cohen – Setton, J. In Bruegel (09.2013)
[192] Leisering, L. (2013)
[193] Nedergaar, P. (2013), p.19

shareholders and creditors must assume responsibility themselves in compliance with predetermined payment schedules. And third, national parliaments must approve government aid"[194]. Thus, we can conclude that Germany and Angela Merkel have shown persistence in pushing for measures and tools, which reflect the ideas of ordoloberalism, characterizing strictness and regulative rules.

Based on the matter discussed above I am able to support the liberal intergovernmentalist assumption, regarding the aggregation of domestic interests at national level and their reflection upon the support for the elements of the Banking Union. Herewith the **fifth hypothesis** is not rejected. It is nonetheless difficult to establish with certainty in what way national governments are interpreting these domestic interests and how far their manoeuvre can affect the position towards the Banking Union. Thus I conclude that the fifth hypothesis can be accepted with some restrictions.

H5: The formation of member states´ preferences is the result of the aggregation of the domestic actors´ interests.

Interstate bargaining

Out of the elements of the proposed Banking Union, only a few were agreed upon, mainly with a more significant delay than initially predicted. The reluctance to move forward on the remaining issues is largely rooted in the several requirements raised by the member states and their fear of losing national influence[195]. Despite having reached a common position on the SSM, it has been mentioned on several occasions that in order for the project to render effective and reach its initial goal, all institutional features have to be put in place simultaneously, as the European Commission President José Manuel Barroso explains it: "*With this proposal, all the elements are on the table for a banking union to put the sector on a sounder footing, restore confidence and overcome fragmentation in financial markets*"[196].

At the level of interstate bargaining, member states´ strategic interaction defines the possible political responses of the EU to the pressures from the national governments[197] and domestic interests are used to achieve proper economic objectives. Furthermore, liberal

[194] Press Europe (10.2013)
[195] Krahnen, J.P. (2013), p.31
[196] EP (07.2013)
[197] Moravcsik, A. (1993), p. 477

intergovernmentalism argues that in order to be able to establish how the negotiations between the two coalitions will evolve it is important to analyze the bargaining power of the main actors. Herein, the theory also emphasizes the need to establish the character and strength of national preferences by looking at the unilateral policy alternatives, the possibility of an alternative coalition and the potential to compromise (issue linkages) and thus determining which coalition is more likely to achieve its interests.

As we could already see in the previous chapter, these coalitions differ in size and economic power. This is reflected by their strong vs. weak economies, population size and level of sovereign debt. Due to the fact that economic power represents a determinant factor in the liberal intergovernmentalist theory, we are soon able to establish among the two coalitions that Germany (Western Coalition) and France (Southern Coalition) - in this order - stepped into the negotiations with the highest economic strength. Germany, the strongest economy among the EU member states, could have jeopardized the bargaining process and create serious consequences for the Southern coalition, by putting in place the issue linkage of withholding their agreement on financial assistance and settling for the status – quo. Thus its strong bargaining position, enabled Germany to make changes to the draft on the ESM. They argued for a limitation of funding through bail–in measures in exchange for direct recapitalization of banks through the ESM. The other coalition wasn´t left with little options because of its minority and not having other alternatives, but the countries were nevertheless more than satisfied with the result. This course of action can also be explained by the liberal intergovernmentalist assumption, according to which decisions are based on rational choices, even if it sometimes means making sacrifices and accepting the second – best option. The best example for this is Germany´s decision on the ESM. According to Merkel, her actions "*followed a political cost – benefit calculation, as a Germany victory over an Italian technocrat government being crushed by interest rate burdens would have been more expensive than this defeat*"[198]. After all, they still came out victorious as the precondition for their vote was the formulation of strict conditions under which banks can access this funding and the introduction of the SSM before the resolution framework.

In the case of the SSM the potential to compromise and linkage should be examined more closely. We have on the one side the Western Coalition, represented by Germany, for which we already established a strong bargaining power, pursuing stringent regulatory and supervisory

[198] Spiegel (07.2012)

rules. Whereas on the other side, there are the Southern countries, led by France, whose bargaining power hasn´t pin out as strong as Germany, whose priority is to obtain direct funding. Even though Germany accepted the risk of mutual liability, it managed to push for a long – term implementation of the resolution framework and early commitment to the SSM. It also appears that the final outcome of the institutional arrangements is getting even closer to the German perception. Based on the negotiations from June 2013, the amount of money available for the ailing banks has been reduced and the national authorities are asked to first review the possibility of stepping in for recapitalization of their banks. Also, as soon as the SSM will be activated in 2014, it will be able to reduce the uncertainty about the quality of banks´ assets and assure a thorough financial supervision. Still the recent arrangements reached on the SRM leave room for discussion, regarding the "*accuracy of the present deals of working on breaking the link between banks and sovereigns*"[199].

We can conclude that in the bargaining process both coalitions turned out with gains and losses. From the beginning the primary reason of domestic actors was to reinstate the stability of the Euro area, meaning that a collapse would have extremely negative effects on the economies. Moreover due to the fact that many Greek, Spanish and Italian bank creditors are mainly German, it was sometimes in Angela Merkel´s interest to compromise. Having struggled for such a long time to push for austerity programs in failing economies, Germany cannot continue pursuing this goal without the support of the EU member states. Thus, being the only opponent would have left them in an uncomfortable position. Up until now, the Western Coalition has been more efficient in using its bargaining power to its benefits: they managed to steer the negotiations over the order in which the BU elements will be implemented, they argued successfully for the limitation of the ECB supervision scope and deliberated constraints for the usage of ESM funding. France on the other hand, was at the beginning part of the Southern European coalition; however it switched sides from time to time, deciding that it was more favourable for them to preserve good relations with Germany. Still this coalition had its share of success in convincing the Western countries to enable direct recapitalization through the ESM and determine that all banks will at some point be subject to ECB supervision.

If one had to establish which of the leading countries in the bargaining process came out as the biggest winner, few would question that this was Germany. Apart from significantly

[199] Merker, S. In Bruegel (01.2014)

influencing the shape of the most important pillar of the BU (the SSM) it also reached its domestic goals. Having been concerned about the sharing of liabilities, it managed to reduce the ESM funding to a minimum through the bail – in measures. Also, its ordoliberal orientation has been fully supported by the introduction of strict rules on the fiscal policy. France´s main objective was that Brussels would be in charge of triggering a bank closure and have access to a common fund to share the costs of closing failed banks[200]. However, only part of their initial plan could be achieved, as they had to compromise for no financial transaction tax.

Institutional choice

According to liberal intergovernmentalism, institutions help states reach a collectively superior outcome by reducing the transaction cost of determining a common solution[201]. The extent to which they are willing to give up sovereignty is balanced against the functionality of the institutions. In the case of the ECB, the independent EU institution has been given more power within the BU - SSM framework because of the difficult situation into which the crisis has brought the member states economies and insufficiency of their nationally-based supervisory rules. Thus, as the theory predicted it, by transferring sovereignty to the EU level, national government effectively removed issues from varying influences of domestic politics and prefer a credible institution, such as the ECB to carry out supervisory tasks[202].

Conclusion

At this point we are able to say that **two countries stuck out during the negotiations**. The positions of France and Germany don´t seem to suggest that the functional demand for establishing a Banking Union is the reason why they are supporting the project, but rather their behaviour corresponds to a political trade-off, in which the only way out is reaching an agreement. By heightening the demands on the ESM and thus preventing the automatic transfers of funds, Germany forced the hand of France in giving in to a three-fold form of security in exchange for a quicker implementation of the resolution mechanism funded by the ESM[203]. Furthermore, both countries have been negotiating on the role the European Commission should

[200] Financial Times (12.2013)
[201] Moravcsik, A. & Schimmelfennig, F. (2009) in Wiener, A. & Diez, T. (2009), p. 66-87
[202] Moravcsik, A. (1999), p.493
[203] Donnelly, S. (2013)

play within this mechanism while pursuing their own national interests. If French demands would have come through, Germany would probably not have agreed on extending the EMS funds to failing institutions[204]. Government leaders needed to reach a compromise in order to achieve a fully fledged European single market and ultimately protect their economies, as the France´s Finance Minister Pierre Moscovici suggested: "*there has to be both a single resolution fund and a role given to national input*"[205].

The Fiscal Compact, tighter supervisory rules and minimum mutual liability was a clear win for Germany, which had already dropped the objections on the European Commission becoming the main authority for winding up the banks (a key demand of France)[206]. The negotiations over the SRM were particularly difficult, though both countries managed to make a deal: Germany obtained the restriction of ECB´s supervisory power over the 200 biggest banks in Europe, the rest remaining under national jurisdiction, whereas, France pushed for ECB´s right to "*override national regulators and assume control for a troubled small bank*"[207].

The pattern shows that despite having strong positions on certain issues, both Germany and France took the road towards some kind of agreement, even if this meant lowering their expectations. Ultimately, they entered the negotiations following the objective of completing the financial and economic architecture.

Hence, it could be clearly distinguished between the different approaches neo – functionalism and liberal intergovernmentalism have towards the role of supranational institution. According to neo – functionalism, they are able to influence member states preferences in favouring integration; whereas liberal – intergovernmentalism believes that their involvement is circumstantial. Previous events concerning the adoption of law to turn the ECB in the sole supervisory power, supports LI argumentation, as EU institutions gave in to Germany´s requirement in order to pursue the Banking Union project. For the time being, they seem to be subject of the bargaining process, unable to actively exercise pressure over the member states, though assuring a quick establishment of the first pillar. Thus I am inclined to say, that liberal intergovernmentalism has more explanatory power in pointing out the possible outcome of the BU´s negotiations. I conclude, based on the empirical findings and personal observations, that

[204] Wordpress (12.2013)
[205] Euobserver (12.2013)
[206] Policy Review (12.2013)
[207] Fidelity (02.2013)

the **last two intergovernmentalist hypotheses** could be verified and can best explain the BU´s institutional outcome so far.

H6: Integration is the result of negotiations between those member states with the highest bargaining power.

H7: Member States will reach an agreement only if this will allow them to preserve their domestic powers.

7. Conclusion and Outlook

The aim of this thesis was to identify what determined the bargaining on the Banking Unions. The two theoretical paradigms were used to better understand the negotiation flows and the factors that eventually led to the outcomes of integration. With the help of the sub-questions formulated in the methodological part, I was able to structure the analysis of the three hypotheses and systematically look for similar elements.

We saw in both cases that the **prevailing actors** were on the one hand, the influential member states, France and Germany which tried to achieve their domestic policy goals, maximise national material interest and converge their individual ideas; whereas on the other hand, their supranational counterpart, the European Commission, acted as a mediator and promoter of integration, pushing their own objectives as well as making compromises for the sake of reaching consensus.

Looking at the **outcome of the negotiation processes** we see that in both cases significant elements were missing, which were part of the Commission´s initial proposal. The establishment of some kind of fiscal union was during both periods a strong objective of the European Union; however it failed due to the member states´ reluctance, which opted for ´lighter´ alternatives. In the case of the EMU, the actors decided for an implementation of the SGP as the controlling arm for market discipline. Since 1992 the euro area has had an integrated monetary system however up until today it hasn´t been able to integrate its banking counterpart that is still being managed nationally. National bank resolution regimes and the home country bias in banks´ government-bond holdings imply that there is a lethal correlation between banking and sovereign debt crisis.[208] The **consequences of this model** became critical when southern European countries had to rescue their banking system after having lost a significant amount of money from the credit boom. The situation reached its highest peak when Greece was threatening sovereign banks holding government's bond portfolios. This exposure makes public finance within the euro area particularly vulnerable to liquidity and solvency crisis, as we have already witnessed in the last years. The fact that in the EMU each country was responsible for its own crisis management and adjustment measures led to fatal consequences during the financial crisis: "*the crisis struck followed by the costly rescue of the banks, recession and more debt for*

[208] Darvas, Z. (2012), p. 5

governments"[209]. Turning our attention to the Banking Union, once again the tighter measures proposed by the Commission were either turned down from the beginning or postponed in their implementation. Germany´s demands for credibility and a legal basis for a fully functional Banking Union as well as France´s strong desire to directly start the recapitalization of troubled banks were the main components of the trade – off on the SSM.

To be able to accurately establish, which are the prevailing factors in the integration process towards the Banking Union I have tested several hypotheses based on the two grand theories. **Neo – functionalism** paradigm perceives the functional pressure from an incomplete EMU as the incentive for Member States to automatically respond to further integration. However I could show in my analysis that these pressures have spilled over in previous integration projects in the hope of changing the situation. For the member states to proceed with a Banking Union, a catalyst had to come into play – the banking and sovereign crisis – accentuating the already existing functional pressure. It is therefore, difficult to establish if the Banking Union was a `second choice` in the light of the poor regulatory mechanisms put in place until then, or if the recent events were actually the needed trigger to convince countries that deeper integration is the solution. Moreover, neo – functionalism is also expecting an automatic response, not being able to explain integration drop-down or delays, thus sustaining by presumption that the Banking Union is not a functional spill over, as other integration steps have been taken before that.

Liberal intergovernmentalism, on the other hand explains the negotiation outcomes of the Banking Union on the basis of a bargaining process and states interests. According to it, domestic preferences are being transferred to the national level, forming the position of member states within the bargaining process and influencing the institutional choice. Following this, the outcome of the Banking Union is being determined by the bargaining power of the coalitions respectively the states engaged in the negotiations. Depending on the economic power, they are able to influence the negotiation in their benefit. Based on my analysis I was able to establish the strong bargaining power of Germany and France and their ability to lead their coalitions in the negotiations over the Banking Unions elements. In the current outcome powerful countries´ pressures seem to matter most, as the decision over the single supervisory mechanism could be

[209] VoxEU (10.2012)

reached to the expense of great compromises from the Southern coalition and relative gains of the Western one.

From this point of view we can conclude that although functional spill over could represent a logical explanation for the need of integration, real events have demonstrated that national interests and bargaining power are dominant in the decision making process. Furthermore, the policy choice patterns in the case of France and Germany seem to be consequent in both negotiations. There is a parallel between the implementation of the EMU and Banking Union as both have had a ´rocky´ start, achieving in the end an incomplete model. The everlasting dispute between ´monetarist´ and ´economist´ ambassadors is reflected in the amendments and structural changes to the initial blueprints.

At the point of writing my thesis the implementation of all Banking Unions´ components has not occurred. The first step had already been taken by establishing the SSM and the ESM. The preliminary discussions over the SRM were recently closed but there is still an important debate regarding the inclusion of a federal deposit insurance system. According to Bruegel (2013, 3), "*the latter has been considered not a priority, but the simple harmonization of national deposit insurance regimes may not be enough, especially in light of the outcome of recent discussion on the backstop for resolution*". All components seem to play a key role in breaking the vicious link between banks and their sovereign, having to pass on any of them could seriously jeopardize the credibility of the European financial sector. Time will most probably tell us how things turn out.

Recently there has been an ongoing debate around the effectiveness of the institutional framework provided by the BU´s components and how crisis management would actually function in the case of a second crisis. "*Beyond who is in charge, the question of how crisis management will be financed is at least as important. In this respect, the Commission's proposal falls short*". [210]

Apart from powerful politicians, many academics have also raised serious doubts concerning this matter. Previous decisions mostly regarding the first pillar have been a trade-off between the quality and strength of the banking union and the time taken to reach it.[211] A significant number of arrangements had to be made in order to achieve a final result, but is this

[210] Esharp (09.2013)
[211] The Conversation (07.2013)

collective bailout mechanism the right solution? Germany and most of the Western European countries already doubt that. Critics even say that in case of a new crisis, countries are "*likely to refuse to pay for bailouts by themselves as they would –rightly– blame the financial turmoil on European errors in regulation and supervision*"[212].

The project of a European Banking Union has a bold design relying mostly on the solidarity between member states. How can the Banking Union assure a long – lasting collaboration in an area that has always been under national jurisdiction: "*Currently, there is no clarity whatsoever on how such a collective public bailout would take place in the Banking Union—both in terms of financing and decision-making"*.[213] Some fear regulatory arbitrage and financial instabilities due to the decentralized coordination and insufficient harmonization across national borders.[214]

I would like to conclude by saying that even though many have tried to provide theoretical argumentation about the negotiation outcome of the Banking Union, we already witnessed in the case of the EMU, that everything is possible. So I suggest we should keep our minds open to new beginning and challenges.

[212] Esharp (09.2013)
[213] Esharp (09.2013)
[214] The Conversation (07.2013)

8. Appendix

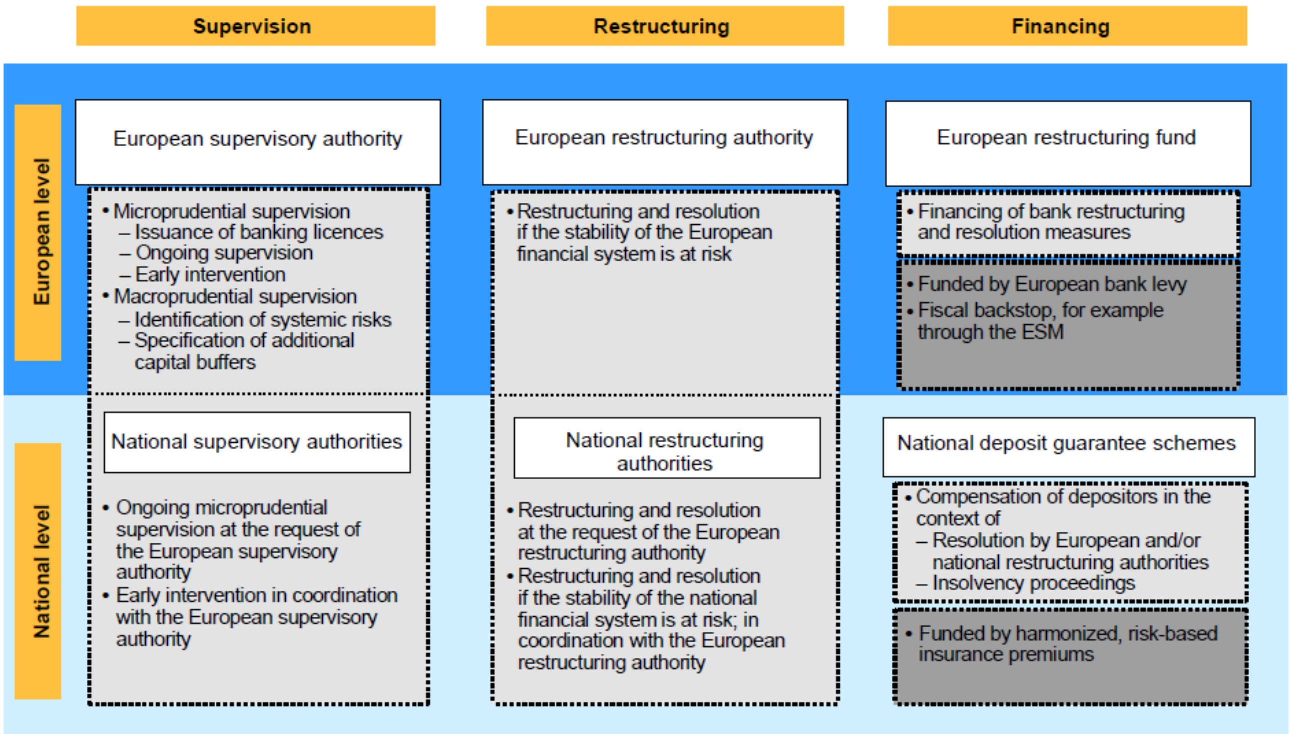
Figure 1: The liberal intergovernmentalist framework of analysis

Liberal theories	Intergovernmental /Bargaining theories
(International demand for outcomes)	*(International supply of outcomes)*
Underlying societal factors	**Underlying political factors**
Pressure from domestic societal	*Intensity of national preferences*
Actors as represented in political institutions	*Alternative coalitions*
	Available issue linkages
↓	↓

National preference formation → Configuration *of state preferences* → **Interstate negotiation** → *Institutional choice (outcome)*

Source: Moravcsik, A. (1994)

Figure 2: The Banking Union Model



Source: Buch, C.M. et al (2013), p. 22

Figure 3: German parties´ adherence to the traditional German position in the euro crisis debate

Figure 4

Decline in Support for the European Project

	Economic integration strengthened economy			Favorable of EU		
	2012 %	2013 %	Change	2012 %	2013 %	Change
Germany	*59*	*54*	*-5*	*68*	*60*	*-8*
Britain	30	26	*-4*	45	43	*-2*
France	36	22	*-14*	60	41	*-19*
Italy	22	11	*-11*	59	58	*-1*
Spain	46	37	*-9*	60	46	*-14*
Greece	18	11	*-7*	37	33	*-4*
Poland	48	41	*-7*	69	68	*-1*
Czech Rep.	31	29	*-2*	34	38	*+4*
MEDIAN	**34**	**28**	***-6***	**60**	**45**	***-15***

PEW RESEARCH CENTER Q9f & Q31.

Source: Pew Research Centre (Mai 2013)

Figure 5

Darkening Mood in France Separates It from Germany

	% Bad economic conditions			% Unfavorable of EU			% Economic integration weakened economy			% Own leader* bad job handling crisis		
	2012 %	2013 %	Change	2012 %	2013 %	Change	2012 %	2013 %	Change	2012 %	2013 %	Change
France	81	91	*+10*	40	58	*+18*	63	77	*+14*	43	67	*+24*
Germany	27	25	*-2*	31	35	*+4*	39	43	*+4*	19	25	*+6*
Diff	***54***	***66***		***9***	***23***		***24***	***34***		***24***	***42***	

* In France in 2012, asked about President Sarkozy and in 2013, asked about President Hollande. In Germany, asked about Chancellor Merkel.

PEW RESEARCH CENTER Q4, Q9f, Q31 & Q32b,c.

Source: Fraser, B. (2013)

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