

# **Power Politics, Voting Rules, and the non-EU components of Europe's financial stability architecture**

Prepared for the European Union Studies Association meeting,  
Denver, CO, 9-11 May, 2019

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Very first draft, under construction

Please follow up with suggestions and requests for subsequent drafts

## **Abstract**

This paper builds on Jones' (2018) theory of European integration and disintegration to explain why some European institutions are built outside the EU rather than inside. Whereas Jones expects that states may move to disintegrate when the costs of integration outweigh the benefits, I argue that we should expect (Europe's) great powers to establish non-EU institutions that manage interdependence with their neighbours on different terms than the EU would allow, so that power politics prevails over compromise making. This paper elaborates a theory called realist institutionalism with this purpose in mind and illustrates it regarding Germany's reordering of EMU and Banking Union, in part through non-EU institutions. Europe's Financial Stability Architecture has thus adopted a set of German preferences that sets it apart from more broadly international norms.

## **Problem**

The eurozone crisis that started in 2010 led to strong demand for new institutions and financial facilities to ensure financial stability. Given the strong interdependence of the European financial market, and disagreement within the EU over how to react, this led in part to the establishment of economic institutions outside the EU legal order that reflected German preferences. The Treaty on Stability, Coordination and Governance (TSCG), the European Stability Mechanism (ESM), and the European Resolution Fund (ERF) reinforced the responsibility of national governments for ensuring financial stability in their respective economies. EU rules and institutions then reinforced this trend. The European Financial Stability Architecture today, encompassing both EU and non-EU

institutions, prevents the establishment of a federal European budget and other forms of financial transfers or risk sharing to ensure financial stability in the eurozone, as advocated by the IMF, the OECD, the US government, France, and Southern Europe. Instead, it reinforces national responsibility for when it comes to paying for financial stability, and creates common rules and institutions to minimise future costs, and thereby future pressure on Germany to consider transfers to keep the eurozone together.

How should we adjust our understanding of European integration, disintegration and displacement by non-EU institutions? This paper takes first steps toward conceptualising and demonstrating a theory of how great powers seek to re-institutionalise interdependence on their own terms, in light of recent European developments. Its version of realism expects great powers to prefer some form of institutionalised order that sets out expectations for others over uninstitutionalised anarchy. “Own terms” encompass the range of countries they wish to interact with, the scope of issues they wish to permit interdependence to develop, and under what conditions. It is also meant to include more abstract conceptions of whether states are preferably sovereign, stand-alone entities that deal with each other at their own discretion, or are more heavily integrated into international structures, including institutions and networks that guide the behaviour of countries in the international system. The framework offered here therefore contrasts with both classical and structural forms of realism (which downplay interdependence and institutions), and with neoliberal institutionalism, which expects greater institutional persistence.

The framework is applied to the partial abandonment of EU law and institutions by Germany in the process of salvaging the continent’s single currency (to illustrate the principles in general), with significant portions outside the realm of EU treaties, law and institutions. This reform of Europe’s financial stability architecture shows Germany ramping up institutional solutions to problems of interdependence, but not necessarily using established institutions to do so. In each case, EU institutions have been eschewed for intergovernmental ones that better serve the interest of the great power behind the initiative.

## **Theory and EU Institutions**

In the European case, questions of what national governments want and how they go about trying to achieve it are typically circumscribed by the assumptions built into European integration and governance theory. Liberal intergovernmentalists and principal-agent theorists see EU institutions and integration as the result of rational cost/benefit calculation: acts of delegation, periodically recalibrated, by national governments that listen to domestic constituents and macroeconomic policy ideas (Moravcsik 1993, Howarth & Quaglia 2013). Neofunctionalists see EU institutions and integration as the product of an ongoing process of managing interdependence through supranational and transnational collaboration (Riemann and Ioannu 2015, Epstein and Rhodes 2016). Historical institutionalists more recently contend that intergovernmental talks take place in an inherited institutional setting that conditions the interests and freedom of manoeuvre of the member states and institutions involved (Verdun 2015, Schimmelfennig 2018).

However, some institutions have arisen outside the EU, for which integration theory does not account. Germany attempted and failed to establish new institutions within the EU's legal framework, using the EU's decision making procedures to stabilise EMU (Laffan 2014) and Banking Union, and resorted to creating them outside the EU instead. While (new) intergovernmentalists (particularly Bickerton, Hodson and Puetter 2015) and neofunctionalists gloss over the legal status of these institutions, international lawyers have not, underlining that the new institutions are the product of international law and negotiations, not European ones (Asimakopoulos 2018). Where legal analysis has been friendly to the use of international law in Banking Union, it has underlined that the use of such tools create a fissure in the EU's legal structure for EMU members and the rest (De Witte 2015). Fabbrini (2014), in contrast, maintains that using international law to steer the EU circumvents and does violence to the principles of how the EU expects its member states and other institutions to work together. The bypassing of votes in the Council and the Parliament are the most obvious. Finally, he notes that while the European Parliament and Commission approved these measures to ensure that something was agreed before the 2014 Parliamentary elections, they effectively threw away their capacity to prevent mission creep and institutional change outside the EU framework in the future, even though their own laws and institutions would depend on it (Fabbrini 2014). This puts the entire EU, particularly the Eurozone, in much the same position as a EEA member state when the EU passes legislation. It is affected but without a vote.

The extra-EU institutions in question are therefore not subject to any of the procedural and legal obligations for scrutiny and control that apply to EU institutions, including scrutiny by the Court of Justice for the European Union (CJEU) or any other court of an EU member state. There is furthermore no evidence that a change of their status to EU institutions is forthcoming, subject to a future renegotiation of the Treaty on the Functioning of the EU (TFEU). Although clauses in the international treaties establishing the European Stability Mechanism (ESM), the Single Resolution Fund (SRF), and the Treaty on Stability, Cooperation and Governance (TSCG) refer to the possibility of revisiting their incorporation into the TFEU in the future, starting in 2018, no actual progress has been made toward fulfilling those options, given domestic German resistance. To the contrary, Franco-German negotiations on EMU reform have stalled after the Meseberg Declaration due to domestic political resistance on the German side and Dutch-led opposition outside (Economist 2018).

Together, these observations lead to the conclusion that the institutions developed are properly seen as non-EU institutions in which new EU institutions, policy and procedures are nested. The latter distinction means that the EU institutions, policy and procedures (covering the European Semester, Excessive Deficit Procedure, the Single Supervisory Mechanism and the Single Resolution Mechanism) are the product of regular directives, regulations and procedures, subject to the usual bargaining that accompanies the legislative process. However, the legislative procedure takes place within parameters set outside the EU that restrict debate and place

obligations on the negotiating bodies in an unusual way. Furthermore, the functioning of the European Semester, the Excessive Deficit Procedure and the Single Resolution Mechanism depends indefinitely on non-EU institutions. French proposals in 2017 and 2018 were designed to both change this legal status, and to alter their missions and decision-making processes to allow the agreements and institutions to be subject to EU law, and to upgrade the institutions in line with a broad spectrum of advice on how to complete the stabilisation of the single currency.

Recent difficulties with backlash (EMU and Italy), threats or acts of withdrawal from EU law and obligations either in whole (Brexit) or in part (Hungary and Poland on rule of law), and even of excluding countries from the EU's core institutions (Greece in EMU, and Article 7 proceedings against Hungary) have brought the integration bias of integration theory to the forefront of critique, inspiring valuable innovations into theories of disintegration. Vollaard (2014), following up on Zielonka (2014) frames the EU as similar to empires that have been integrated and fallen apart in the past, which provides a means of understanding how dissatisfaction of a diverse policy with common rules and centralised authority might be best thought of as a natural course of events. But it is unclear when one might expect centralisation or decentralisation and under what conditions institutions might persist.

Jones (2018), in contrast, offers a clearer and convincing theory that predicts integration or disintegration based on the expected payoffs that member states are confronted with. Integration works best, has the broadest basis of support, in the long term as well, when new institutions and competencies come with a welfare benefit to the members. This is a well-known premise shared by both neofunctionalists and liberal intergovernmentalists. But it also works in reverse, by predicting an increasing risk of disintegration when costs start to pile up, and when the same countries are called on repeatedly to pay the price of a common good from which others benefit. In this way, one can determine in advance where the risk of disintegration is likely to rise. In this, Jones' work builds on a venerable set of works in international and comparative political economy that asks what happens when economic fortunes improve or deteriorate. Coalitions in particular, and the ideas they use to unite their followers, underpin willingness of countries to be open or closed, to accept costs of cooperation or reject them (Gourevitch 1978, Hall 1987, Rogowski 1987)

Jones' insight is a critical one that informs this paper as well. But I take it one step further to ask how countries powerful enough might pursue new institutions to replace old ones, or fill a void in managing their relationships with others. I make two key elaborations that attempt to follow the way that he calculates who is losing, and what the form of what happens next is likely to take. It is fairly easy to see discontented governments in Southern Europe about the way that EMU's architecture is set up and the way it is governed, for example, and that they might be a source of disintegration. This can take the form of putting membership and compliance into question, or withdrawing entirely. It is also fairly easy to calculate in objective ways that these countries are worse off economically and, by implication, socially as a result of the way that EMU is structured

and operated. Dissatisfied and unable to get what they want through bargaining, some may choose to leave or stop complying with the rules, so that integration comes under pressure. However, not all countries have the resources and alternatives to make alternative institutions. Larger countries that think they can get away with it are expected to try to set up alternate institutions that suit their needs better rather than simply exiting.

The approach taken here extends the principle that the perceived losers of integration push against existing institutions to the likelihood that the EU's largest powers demand and get different institutions that better reflect their preferences. EU voting rules mean these new institutions are at least as likely to be outside the EU order, provided the great power sees itself as a loser in existing institutions or proposals.

The section below outlines a theory of realist institutionalism, that is then applied to two cases: EMU reform and the European Intervention Initiative.

### **Theoretical Approach**

The paper posits five broad theoretical propositions, unpacked below:

1. Great powers seek to institutionalise interdependence on their own terms.
2. Great powers seek outcomes that favour distributive gains as seen by domestic coalitions, or their perception thereof.
3. Great powers exercise economy in institutional change, leading to incremental adjustments and bricolage.
4. Willing followers support future and current payoffs from the great power's institutions.
5. Relative power/vulnerability determines the ability of great powers to bring others (fence sitters and rivals) to accept its institutions.

*Proposition 1* reflects the significant overlap between realist approaches to understanding how global governance manages interdependence in ways that reflect power (Drezner 2007, Koppell 2010, Krasner 1976, Donnelly 2014), and liberal, network-and institution-oriented approaches (Kahler 2015, Hafner-Burton, Kahler & Montgomery 2009, Keohane & Martin 1995), that expect rule-based institutions to shape and constrain the behaviour of states over time. The overlap is found in the expected tendency of international institutions to evolve over time to reflect the preferences of its most powerful, engaged members (Slaughter 2004). While realists recognise that international institutions are a common means by which great powers can pursue their interests with other states, liberal institutionalists and network theorists recognise the role that power plays in those networks and institutions in determining outcomes.

In this context, both institutions and interdependence are understood to cover a broad spectrum of situations. Institutions are seen here as not only rules and organisations that guide state

behaviour, but norms and values that set out expectations on which actors and actions are legitimate in global governance. A world in which national governments dominate international relations, bilaterally or in clubs, as anarchic as it might seem, posits fundamental understandings of what states are, what their legitimate rights are, what the interaction between them looks like, and whether other institutions matter very much, much as English School theorists envisage such commonly shared understandings as primary and secondary institutions of world society (Buzan 2004). Further along the spectrum are found the formal international institutions and organisations imbued with legal personality and capable of issuing international law, by virtue of their negotiation and ratification by the states who voluntarily surrender portions of their sovereignty for the greater good. Even further, and more ubiquitous now, are institutions that set international standards in a practical and straightforward way, that are also widely used, without the benefit of being recognised as legal entities that can produce legal obligations (Buthe & Mattli 2011, Pauwelyn, Wessel & Wouters 2012). The European Union, which is the object of investigation in this paper, falls primarily into the second of these institutional groups.

Interdependence, meanwhile, is understood to cover a spectrum of situations ranging from economic interdependence, in which there is constant exchange and a clear ability to calculate benefits and their distribution, to situations involving externalities or a global commons (such as environmental pollution and protection), to situations in which action-reaction effects are inescapable (such as security dilemmas and their effects).

A key implication of Proposition 1 is that while great powers are expected to want institutions that set out the terms of interdependence, they may very well want different ones than the institutions they have. The nature of such institutional demands may vary significantly depending on what the Great Power's preferred mode of managing interdependence entails. But they are expected to take seriously the possibility of institutions that are outside the legal and rule structure of incumbent institutions. They are not expected to self-limit themselves to evolution within the old order. If perceived benefits are greater outside that order, they are expected to create new institutions that better serve their (perceived) needs).

In the EU context, preferences may clash with the ability to secure them under EU voting rules, meaning that the great power is likely to block new EU institutions and resources (Jones, Keleman & Meunier 2016). In this case, the Great Power is likely to seek institutions outside the EU order (see also proposition 3).

*Proposition 2* underlines a traditional realist expectation that states pay attention to relative gains in their interactions with other states (Krasner 1991), or the perception thereof (Mastanduno 1991). The latter accounts for moments when governments may perceive their countries as losing from standing institutions and agreements when this might not be the case. Examples include the United States' stance toward trade (WTO, NAFTA) and defence institutions (NATO & other) under the Trump administration, to the United Kingdom's stance toward its membership of the EU after

2016, and to Germany's perception of its losses, both real and potential, in proposals for EMU reform and Banking Union.

Due to the costs to the great power seeking to institutionalise the terms of interdependence, Proposition 2 does not speak in favour of overtly imperial ambitions in a world of many states, nor of supranational institutions that the Great Power might lose control of, but rather a system of institutions that guide national governments in exercising responsible sovereignty—whereby the tasks national governments are expected to do are set out by international institutions and regimes that the great power plays a critical role in determining. This can apply in a wide variety of policy areas, ranging from the regulation of the economy (Story and Walter) to the provision of collective defence. Beyond the calculation of terms of trade, or finance, or contribution to any collective endeavour, relative gain concerns should lead to rules that favour national governments paying a considerable part of the costs as nominally sovereign states, but embedded within rules and arrangements set with the GP.

But how should national calculations of interest be expected to develop within the GP? For the purposes of this theoretical approach national governments will be seen as aggregating an articulating a standpoint that is supported by a dominant coalition at the national level. In international economic relations, this should be most visible, but the principle applies as well to other areas of international relations. While we should normally expect the great power that is engaged in international affairs to be winning from this arrangement, Hall's (1986) and Gourevtich's (1977) work on comparative political economy, coalitions, and international trade (see also Rogowski 1989), provides us with insights into when this coalition sees itself losing from trade. When trade is increasing the coalition should be broadly international. To the extent that it played a part in creating incumbent institutions or following the leader willingly, it should continue to support them. When it is decreasing however, the coalition can turn against the current forms of interdependence and toward rejection of international trade and investment on existing rules. This connects with Jones' expectations of disintegration. The persistent weakness of particular regions and segments of society within great powers, and their political size relative to the winners provides a lens through which we can better understand America's turn to America first, and the importance of the English regions, in voting for Brexit. In both cases, regional discontents from deprived areas proved an important part of the vote to break with open trade, investment and migration. In the United States, the negative assessment of America's existing economic interdependence by the Trump coalition transferred relatively easily to rejection of its broader military commitments to the EU.

If we turn to the positive side of integration, even where an economic side is not so readily apparent, we can see cases in which great powers seeking to amplify their status in world affairs advocate the establishment of institutions that organize others into working collectively on its own terms. In EMU, internal dynamics regarding respect for fiscal rules had relaxed and pressure built to move to a new stabilising mechanisms — federal budgets above all— that Germany would

have to pay for. Pressures for adjustment emanating from EMU therefore put the country in the position of (potential) loser, for which a solution had to be found. Reinforcing responsible sovereignty provided a way for Germany to win its distributional conflict with Southern Europe in particular, but also with France in the context of its continued attempts to win German concessions for further fiscal commitments. For German domestic politics, the country was the victim, which EU decision-making institutions made possible. Non-EU institutions provided a means to turn the tables.

Under this proposition, the conditions for decay of an open system should be met when domestic coalitions shift to losers from open trade and investment. They should seek new rules that shift costs onto others. In EMU, internal dynamics regarding respect for fiscal rules had relaxed and pressure built to move to a new stabilising mechanisms — federal budgets above all— that Germany would have to pay for. Pressures for adjustment emanating from EMU therefore put the country in the position of (potential) loser, for which a solution had to be found. Reinforcing responsible sovereignty provided a way for Germany to win its distributional conflict with Southern Europe in particular, but also with France in the context of its continued attempts to win German concessions for further fiscal commitments. For German domestic politics, the country was the victim, which EU decision-making institutions made possible. Non-EU institutions provided a means to turn the tables.

*Proposition 3* makes use of the literature on incremental change in political economies posited by Streeck and Helen (2005), which has a palette of mechanisms to designate change through displacement, redirection, layering, drift, conversion, and exhaustion. Displacement refers to the creation of new institutions to take over the functions of older institutions, but with new priorities. Conversion refers to the recalibration of old institutions to pursue new ends. Layering refers to the nesting of old institutions in newer ones that set the parameters, and thereby redirects what the old institutions do and perhaps displaces some of their functions. Exhaustion refers to the inability of existing institutions to fulfil critical functions, leading to demand for replacement. This contrasts with a punctuated equilibrium model of institutional change, which pays little attention to smaller but meaningful changes.

Great powers should be expected to attempt repurposing old institutions first, before moving on to establish other institutions that complement or displace the old ones.

*Proposition 4* future payoffs—absolute gains ease the capacity of other governments to sign on—resulting in coalitions of the willing big initiatives come from GPs. Together with proposition 5, proposition 4 explains the ability of great powers to collect followers for new institutions outside incumbent arrangements. This allows them to pursue a new point on the Pareto curve. Voluntary followers are those likely to enjoy gains from following the leader, but within the context of terms that the great power sets out for them. The setting up of a regime with benefits determines the

core support for a great power in establishing a regime. In the EMU context, the readiest followers have been those with similar profiles as countries with high capital intensity (and therefore have the same considerations as Germany), and countries with lower capital intensity that want very badly to catch up through foreign investment (Baltic countries, Spain).

*Proposition 5* considers relative power and vulnerability (alternatives to the existing institutions—ability to go it alone for a period of time), to draw others into another institution. Ensuring compliance despite unwillingness to do so is provided by great powers blocking alternative institutions that would help vulnerable countries dealing with the interdependence in question. In an EMU situation, for example, blocking moves to establish common fiscal facilities.

## **Methodology**

The rest of the paper tests these propositions by examining the international preferences and behaviour of Germany on Europe's Financial Stability Architecture, with a focus on EMU reform and Banking Union. Not everything can be handled here due to space constraints (such as monetary policy, or the European Systemic Risk Board). The cross-section of stakeholders analysed involves German *preferences* vs. those of other negotiating parties, then on the *capacity and willingness* to agree on the basis of *voluntary agreement* within the EU, and then on the use of *power politics* leverage, whether inside the EU or outside. It is applied first to changes discussed within the context of EU laws, institutions and voting procedures, and then on changes discussed outside that context.

## **Applying the Theory: EMU Reform and Banking Union**

The application undertaken here is Germany's use of power politics to create non-EU institutions in Europe to force a reorganisation of Europe's institutional architecture to reflect its own priorities. During the Eurozone Crisis of 2010-2016, Germany came under enormous international pressure from the United States, IMF, OECD and elsewhere to agree to the establishment of a large EU federal budget to stabilise the Eurozone. Instead, it started with establishment of emergency funds and international treaties outside EU law and the reach of EU institutions that pushed back demands for assistance onto individual member states. The creation of this Shadow Europe, including the ESM, the TSCG and the SRF, with the Eurogroup steering it all, demonstrates German concern for distributional gains (Proposition 2), an inability to use existing EU institutions to achieve its objectives, and its success in subverting the organising principles of the EU legal and institutional order through bricolage to achieve those ends (Propositions 1 and 3).

In the context of EMU/BU this means

1. Germany as anchor seeks institutions that anchor macroeconomic orthodoxy / self reliance.
2. Redistributive gains lead to each country responsible for finances/minimal EU funding commitments
3. EU change where possible/international institutions where necessary, but international institutions and deals where it is not. Each as alternative to breakup of interdependence.
4. Baltic states and other German allies experiencing economic upswings after painful reforms, while others slide down into stronger defection. Critics isolated.
5. Strong vulnerability (to financial markets) of others leads them to comply, especially the small ones.

The eurozone architecture becomes a political issue starting with the GFC (Ireland in 2008, then Greece in 2010, with the introduction of the TSCG and the EFSF), but in earnest by 2011, when financial distress had begun to spread throughout southern Europe (European Semester), leading Italy to appoint a technocratic government. Further reforms begin in 2012 with the use of ESM funds to facilitate restructuring of the Spanish banking sector, and are politicised the following year when Cyprus refuses to willingly accept the Eurogroup's conditions for financial assistance.

The first steps toward a Banking Union are taken as financial distress for banks is met with rules, institutions and procedures for minimising losses (supervision), and restructuring and closing down banks (resolution) with a minimum of shared financial responsibility (seen in the lack of common deposit insurance). Investors are made responsible for bank losses (bail-ins), followed by national governments (bail-outs) within the means available to them (EMU budget rules and no bail-out clauses remain intact).

Stress to eurozone coupled with internal divide between governments, and between Eurogroup and the IMF.

### **Proposition 1: Germany restructures institutions to support interdependence**

Interdependence within the single market came under strain due to the negative feedback loop between banks and states in the EU, and the eurozone in particular. Capital-rich countries found themselves in a fairly resilient state, able to provide state aid to banks, while capital-poor countries found themselves cut off from financial markets and unable to provide assistance to banks. However, the inherent and rising risk of investing across borders under these conditions led to a renationalisation of national financial markets and an ever-extending delay of economic recovery in southern Europe. This section discusses responses in three areas: fiscal policy; banking union; and monetary policy. In these areas, German financial resources are key to seeing which institutions get built and where.

#### *Fiscal policy*

The lasting instability of the eurozone, particularly in the South, led to calls for various forms of fiscal transfer, with a preference for institutionalised, indefinite transfers between EU member states, through EU-level institutions. The options on offer included a fiscal union, bazooka, automatic stabilisers from academics, the US government, the OECD and the IMF (Donnelly 2018). In the absence of institutionalised transfers, discussions of ad hoc transfers were tabled as well. Such talks extended to issues of debt forgiveness to some extent during the Greek negotiations, in which the IMF asserted that the Greek-Eurogroup agreement of 2015 left debt at unsustainable levels.

There were three options in principle. This choice was between allowing interdependence to fail (no deal on improvement of EMU architecture, leading several countries to exit as they collapse financially); choice 2: upholding interdependence within existing institutional environment of the EU (a deal which would have upgraded EU resources and institutions to keep the eurozone together—along the lines of the calls issued above); or choice 3: a deal based on institutions outside the EU, and pushed along by power politics, where EU rules and procedures would not hold sway. Of these options, the first appears to have been preferred by no one. The second was preferred by southern European countries, and was the only alternative to no deal within the context of EU institutions. The third was preferred by Germany, plus the Netherlands and Finland.

Ultimately, the difference between choice 2 and 3 was the importance of compromise within EU institutions (or the lack thereof). The decision-making structure requires compromises between countries to secure majorities in the Council and Parliament. These in turn constrain the ability of the German government to secure its preferred outcomes, with the result that the EU develops in the direction of common institutions, budgets and legal obligations. Choice three, in which institutions are created outside the EU to stabilise the euro, upholds interdependence, but without EU-style compromises on the core financial issues. Given Germany's priorities, national responsibility for financial stability dominates instead of common responsibilities with regard to financial responsibility for fiscal policy and state aid.

Wolfgang Schaeuble claims that Germany first attempted to get Eurozone rule architecture adjusted to reinforce national responsibility and failed. Other governments were focused on stabilising their countries first and sought financial assistance. To provide this Germany offered financial assistance outside the EU tied to conditionality that reinforced responsible sovereignty. The European Financial Stability Facility (EFSF) was developed to provide loans to distressed governments. Then the TSCG followed in 2010 which made movement toward balanced national budgets a precondition for future support, both by the EFSF and later by the ESM. The Spanish request for assistance for its banks in summer 2012 underlined the broader financial backstop function of the ESM for European financial stability, in the private and public sectors. This institutional fix provided ongoing leverage for Germany's demands for loan agreements that pushed national governments (if required) into assuming responsibility for the costs of their own

problems. This simultaneously rejected calls for a different kind of reform that would have stabilised EMU with a common budget.

The non-EU institutions were then followed up with reforms inside the EU that reinforced the onus on national governments and authorities to reduce financial risk on their own, and in the case of Europe's largest banks, increased monitoring and control. The first is the European Semester in 2011, directed at national governments. The Six-Pack introduced new measures to enhance budget overview. Reversed QMV within the Excessive Deficit Procedure (EDP) provides a corrective mechanism sought by Germany in principle. However it was never used and the Juncker Commission continued to prefer lenience and management of public finance problems over rule enforcement. The European Semester was also extended to include the Macroeconomic Imbalances Procedure, which moved beyond fiscal policy to cover all manner of structural policy. Data would be collected on a much wider set of prices in the economy, and like the European Semester, possibilities were opened to sanction countries doing too little to adjust to so-called imbalances that might cause a country to seek financial assistance during a crisis. Originally intended to capture asset bubbles as a source of financial instability, as took place in Spain before the crisis, or to identify labour market rigidities that might impair restructuring of the economy, or drive inflation, it was used selectively, if at all, as is seen by the inability of the EU to sanction countries with large current account surpluses (Germany and Netherlands in particular), which were accumulated at the expense of deficits in other EU countries, and then defined as weak.

A consequence of this was that although German priorities had led to formal institutional changes that moved in its preferred direction, the enforcement powers consistently remained below what German governments wanted to see. This was different for countries receiving assistance from the ESM. The Two-Pack was created to provide an EU legal framework for supervision of countries receiving financial assistance through the ESM, which effectively outsourced the European Semester and allowed its administration to deviate from EU norms for the period of ESM assistance, during which the country in question would be known as a Programme Country. A consequence of this bifurcation of oversight is that the EU effectively outsourced its fiscal governance control functions so that they could be as stringent as Germany preferred, provided that the country in question had been forced to seek assistance from the ESM.

### *Banking Union*

The second major area, of Banking Union, was meant to stabilise the eurozone in the absence of fiscal transfers, in the context of continued economic weakness, and of a negative feedback loop between financially distressed banks and the national governments who provided lender of last resort facilities to them.

is the introduction of the Single Supervision Mechanism in 2014 that allowed the ECB to take over supervision of the Eurozone's largest banks, to force them to raise capital, and reduce their exposure to toxic assets.

Further steps in resolution were hybrid affairs in which national authorities remained intact, in which a nominally strong Single Resolution Board for the Eurozone in Brussels would initiate the closure and/or restructuring of insolvent banks, and in which a small communal resolution fund would be built up over 12 years (55 billion euros, compared to the estimated 350 billion needed to undertake an average intervention involving several banks), but controlled and regulated by intergovernmental agreement outside the EU. This EU-IGA hybrid ensured that Germany's moral hazard concerns would remain contained into the future.

### **Proposition 2: distribution and domestic politics**

Remarkable in German politics, but also visible in Dutch, Finnish or Austrian politics, is the broad similarity of preferences across the mainstream political parties. In Germany and the Netherlands, for example, social democratic parties regularly campaigned on EMU and Banking Union reforms that were even more hawkish on fiscal transfers at the EU level than their conservative or liberal counterparts. This was also true whether they found themselves in opposition or in a grand coalition government (straight social democratic/labour governments did not occur during the period in question). Common to their narrative was that these countries should not pay for problems created in other states, particularly when they must have been their own fault. The only party consistently aligning with calls for EU measures that would cost money were the European and German Greens. Other parties to the right and the left were notable for their rejection of the EU per se, and therefore their lack of interest in the matters at hand.

Similarly, social democratic, liberal and conservative parties in Southern Europe and Ireland found themselves in favour of EU financial capacities across the board, and found it acceptable to sign on to increased oversight provided the quid pro quo of financial assistance was mutualised. At the end of the day, however, they signed on to even harsher terms provided by the ESM (Donnelly 2018) for lack of alternatives that would make financial market speculation evaporate.

### *Fiscal Policy*

German calculations of the costs and benefits of EMU, and then of Banking Union have remained remarkably stable over time. Germany's concern going back to EMU's design moment in the late 1980s and early 1992 was to ensure that the euro is a strong currency without any significant inflation, and that member states in the eurozone fulfil three main conditions to keep this so in the future: that inflation rates remain low; that government deficits be limited to 3% of GDP in any given fiscal year; and that overall public debt be limited to 60% of GDP. Member states are to

remain individually responsible for attaining these goals. Commission and Council flexibility over how much time national governments have to live up to these standards have not significantly altered the position of German political parties and interest groups on the necessity of “complying with the rules”. These rules were designed to ensure that euro membership for Germany would entail no distributive losses to “weak currency” countries in Southern Europe and Belgium through inflation.

This attachment to responsible sovereignty increased after the Eurozone crisis of 2010-2015 when a coalition of France, Southern Europe, the IMF, OECD and US Government proposed a European federal budget to stabilise the weakest links of the Eurozone. This applied both to the prospect of direct fiscal transfers in the public sphere (fiscal union) and collective resolution and deposit insurance funds in the private sphere (as part of banking union), in which richer countries like Germany would be net payers. Fairly uniform critique from mainstream parties outside the Greens underlined that moral hazard made such common financial commitments unthinkable. As soon as fiscal union and common banking insurance funds would introduce, national responsibility would recede and Germany would pay, as it was dragged down itself, without a means of forcing “defectors” to reverse course. While interdependence had to be managed, responsible sovereignty remained the only feasible means of assigning rules of behaviour into the future. To prevent the financial system from collapsing under periodic stress, the European Stability Mechanism was designed and deployed to prevent catastrophes. Loans, tied to conditions for fiscal, social and other reforms would provide a better alternative distributively than transfers. Germany therefore had what it believed was a credible alternative means of institutionalising interdependence based on self-reliance by Eurozone member states, reinforced by more centralised EU procedures and institutions (European Semester, SRB, ECB as centre of SSM) (together responsible sovereignty).

### *Banking Union*

SSM- no mutualised cost. Some of the precautionary recaps are costly, but that is on an individual basis.

SRM- costs, involved, kept small, integration/sharing of liabilities gradual, IGA, plus retained discretion from the SRB, and the Commission as well on how to prevent resolutions being taken out of the hands of national authorities. So far it has not cost anyone anything, despite some

EDIS- costs involved, plus future risks, to be contained. IGA. But probably will never be realised.

**Proposition 3: incremental change: EU if possible; international if necessary**

### *Fiscal Policy*

The German government, particularly through Finance Minister Schaeuble, made proposals for reinforcing responsible sovereignty through EU law and procedures before it embarked on institutions outside the EU. Some of those proposals bore fruit, but they made headway years after the Great Financial Crisis commenced, after the TSCG had been signed, and after the EFSF became a permanent arrangement, and slated to become the ESM. particularly the enhancement of the European Semester, the introduction of the macroeconomic imbalances procedure, the oversight by European Semester Officers, and the introduction of semi-automatic reverse qualified majority voting on sanctions for non-compliance with debt and deficit criteria. But other proposals, such as a European finance minister to control national finance ministers under certain conditions flopped. What remained was not really effective in shaping the behaviour of national governments, or of reducing systemic economic weakness, leading to further German initiatives outside the EU structure where compromises would not have to be made.

So it is not as if the German government sought to manage EMU interdependence entirely outside the EU, or that it led with these demands. EU innovations in fiscal policy, for example, were steps in the right direction as far as Germany's preferences were concerned, but they lacked the credibility of commitment and enforcement required to meet with German expectations. That expectation was that public sector risks (budgets) and private sector ones would be so conservatively managed that in future a financial crisis they would prove resilient, and therefore unlikely to be source of pressure for financial transfers as in 2008 and the years following.

The ESM, in this context, provides two benefits to German organisation of the EU's financial system: it created pressure on EU institutions and governments to introduced new mechanisms for demonstrating their commitment to eurozone rules; and it provided tools for dealing with countries that had run into financial distress. This could be considered a consequence of failing to observe and live by the new mechanisms. It is this institution, then, that remains the 'shotgun behind the door' for countries during normal times, and ensuring German leverage over programme countries in time of financial difficulty. EU governance on fiscal policy and structural policy, can therefore be rightly considered to be nested within intergovernmental institutions.

### *Banking Union*

The situation in Banking Union is somewhat different. In this case, negotiations generated a strong Single Supervisory Mechanism within the EU, and with statutory powers. This outcome was not only strongly preferred by Germany to expose weaknesses in the banking sectors of other countries, but also to avoid moral hazard into the future. This was a precondition for negotiating further aspects of banking union—resolution powers and funds—and deposit insurance—that were considered essential to financial stability. The demand for strong

supervision was fairly uncontroversial and accepted by others, as it was not the primary problem. The main problem was what to do next.

Talks to establish a Single Resolution Mechanism were fraught with financial and jurisdictional concerns that allowed for the establishment of a Single Resolution Board, but limited its financial and administrative power. Financially, talks on the SRM were coupled with discussion of funds that could be used during a resolution to prevent further financial contagion. The latter proved to be controversial for Germany and like-minded countries like the Netherlands, which saw any sharing of resolution funds across national borders to be another form of semi-automatic financial transfer. For this reason, although eurozone governments eventually agreed on a Single Resolution Fund, which could theoretically be used in a resolution coordinated by the SRB, but would itself be by an intergovernmental institution outside the EU. Far more important to the German camp was the introduction of investor bail-ins during a resolution, so that the private sector would contribute the lion's share of a resolution, rather than local governments or the SRF. This was provided, and could only be provided in detail through EU legislation, which was passed fairly early in the form of the Bank Recovery and Resolution Directive (BRRD, 2014), which entered into force in January 2016.

Likewise, on an administrative level, the SRM coordinates the resolution of systemically-important banks as defined by the ECB, rather than doing everything itself as a strong institution. The ECB as Single Supervisor also makes the decision that a bank is failing or likely to fail. The Board works first with national authorities on the fate of the bank involved. It then makes a recommendation to the European Commission on whether to initiate resolution and how. Where this has worked smoothly, as in Spain's Banco Popular, national authorities effectively presented a *fait accompli* to the Board, which then approved it. In 2018, the Board also showed in the Veneto and Vicenza cases that this recommendation might be that the bank should be wound up by national insolvency law, where bail-ins are not required. The result of this receptiveness is that the negative feedback loop between governments and banks remains in the Italian case.

Overall, then, on resolution, we once again see a mix of EU and non-EU institutions continuing to be part of the evolving financial stability architecture. EU institutions and law do not necessarily contain the behaviour of member states. The Board based on EU institutions was promoted as well by Germany, but in an intergovernmental way reminiscent of the European Banking Authority that provides considerable room for abuse and circumvention. Germany had a recent chequered history of poorly run banks with strong political connections and weak public will to shut them down. It shared reluctance of other states for any EU institution to have too much power, and for its own institutions to be sidelined. In Europe there was common ground across national governments preferring national solutions to weak banks, given the weakness of the domestic banking systems.

On deposit insurance, where it is mostly money involved, we again see Germany's capacity and willingness to leverage that relative power to get EU institutions introduced and reconfigured to align with its preferences. See the banking package, designed to reduce risk in European banks. The Commission introduced this package of 6 directives and regulations in the midst of negotiations over EDIS, given the German demand that it would only discuss EDIS in the context of greatly reduced risk that it would actually be needed. This extended then further to issues of supervision and capital standards again, which Germany showed to be extremely important for its own cooperation with other EU countries.

Note the idea of the ESM as a backstop to national deposit insurance systems has been brought up, which would merely formalise something that has been in existence since the 2012 programme set up to assist Spanish banks. This can be seen in the debate over under what conditions national banking systems should contribute to a system of Eurozone-wide deposit insurance for banks. Germany's position was that it could only consider participating if moral hazard were reduced in Southern Europe, by having the latter agree to German priorities in how banks lent and invested money. The Commission relented in 2017 with the Banking Reform Package to do precisely this, and postponed its push for a European Deposit Insurance System in the process.

#### **Proposition 4: future payoffs (including side-payments)**

The pre-strategic preferences of other EU countries naturally vary, and future payoffs appear to have played the most important role in calculating their responses to the German proposals. Some fully supported Germany's initiatives with the same distributive goals in mind (Netherlands, Finland, Austria). These were relatively rich EU countries that would be net payers into the system. A second group of countries, particularly the Baltic countries, but also Spain, chose to ally with German proposals as a means of securing the confidence of financial markets, particularly under periods of stress. Each of these countries saw the pain of budgetary restraint as a real cost, but looked toward the economic recovery that they hoped would follow as the payoff that would make bandwagoning with Germany worth it. In each of these countries, the fact that the economy turned around relatively quickly after a sharp recession exacerbated by budget retrenchment and internal devaluation in accordance with German expectations, meant that when discussions about Europe's options were at their most intense, that payoffs for following Germany had already risen substantially. When later confrontations came with Cyprus and then with Greece, that they were firmly on the German side. France's attempts to push against German policy with a counter-coalition simply failed to attract followers as a result.

*Fiscal Policy*

- Balanced budgets seen in Germany, Netherlands in particular as a crucial component of EU-wide financial stability. Greens are only pro-EU voice in budgetary matters. Less vocal or deviant on issues of the annual budget rules, unless attached to energy transition.
- Moral hazard an intrinsic risk of providing a common budget within Northern Europe.
- Baltic countries side with Germany after their own internal devaluations when the Eurogroup negotiates with Greece. Ad hoc transfers would negate the hard work they had put in, and be domestically explosive with voters.
- Southern European political parties across the board support EU budget and more flexibility with regard to fiscal rules. Spain remains closer to German preferences than others.
- Exception is the far right, and the far left, which is consistently anti-Europe.

### *Banking Union*

- Supervision, resolution and deposit insurance issues in Northern Europe are wrapped up with the cost of bailing out banks. Like EMU fiscal policy issues, political parties are against transfers. Supervision is very important to Germany and Netherlands as a pre-condition of discussing resolution and even deposit insurance.
- Supervision is uncontroversial in Southern Europe, but brings problems in Italy, where it has been behind the curve for a long time.
- Resolution also appears to be uncontroversial as an issue (in both Northern and Southern Europe), but not in practice when banks get into trouble. All want to break the negative feedback loop between banks and sovereigns. But none want to cut off small investors. This is a particular problem in Italy, with many retail bondholders who are also depositors.
- Northern Europe is particularly concerned about costs of resolution, pushes
- Conclusion: Germany able to insist and get terms for supervision and resolution (according to the intensity of its wishes), but implementation of these EU agreements falls behind expectations. This means that the shotgun behind the door remains the ultimate power resource for Germany, as the SRF remains small, and the ESM remains the only game in town to provide financial assistance during resolutions if the costs exceed what national governments can provide.
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### **Proposition 5: Relative Power/Vulnerability**

Countries that were less inclined to go along with German proposals eventually did so to secure access to financial markets in the future. Although Italy had clear preferences for fiscal unions various forms, and a reluctance to apply the criteria that Germany demanded, it complied in 2011 through the Monti government after being cut off from financial markets. The desire for different priorities remained ultimately curtailed by the government's desire (and that of the electorate) to stay in the euro. While the cases of Cyprus and Greece were much more dramatic, due to the strong rejection for German priorities, and the refusal of ESM/IMF/Commission conditionality in

exchange for loans, they found no substantial support for their claims either. They could choose to copy or leave. Given both country's desire to remain in the euro, this meant that they had no other alternative than to comply with the demands of non-EU institutions under Germany's control. This would have been far more difficult, or probably impossible however, had Germany not secured solid backing in the ESM to push forward with robust demands and brinkmanship against the countries that put up the biggest resistance to the rules set.

### *Fiscal Policy*

- blackmail clause in TSCG-ESM, followed up by European Semester, MIP reforms
- pushing Greece and Cyprus to the brink
- Baltic eurozone member states support Germany after undergoing their own internal devaluations, leaving Socialist French President isolated
- New Hanseatic League confirms this—also that there should be no increased EU budget. Not even a blocking minority in the Council for annual budgets, but enough to be taken seriously, particularly in MFF negotiations
- As a result, Macron's proposed Eurozone budget remains modest, effectively promoting structural reforms in the eurozone with money that was already there (sub-set of the EU budget).

### *Banking Union*

- supervision not a great concern, reason for contention for most countries
- resolution is a problem in particular for Italy, where voters are bondholders and likely to be hurt by restructuring
- banking package support in exchange for EDIS support

## **Discussion and Conclusions**

This paper began with the search for a framework for studying the strategies of great powers for international order, and then applying it in the case of Europe's financial stability architecture. It made 5 main propositions:

1. Great powers seek to institutionalise interdependence on their own terms
2. Great powers seek outcomes that favour distributive gains, or the perception thereof
3. Great powers exercise economy in institutional change, leading to incremental adjustments and bricolage
4. Relative power/vulnerability drives success at institutional change.
5. The willingness and ability of all countries to align with the wishes of the great power depend on future payoffs. economic trends (upward or downward) more than asset specificity under the institutional terms of engagement.

The paper then examined the move toward new European institutions, whether they were inside or outside the EU, and their continuing relation to EU institutions. It confirmed that the new European institutions underpinning the European financial stability architecture were the product of German initiatives, coupled with the direct support of a few allies (Netherlands, Finland, Austria) with similar objectives. In all of these cases, the countries, and their main political parties, saw the prospect of an EU-wide budget as a burden on voters. This meant that IMF, OECD and US government proposals raised the prospect of these countries being the losers from integration in the narrow sense, and in the short term. Appeals to the longer term, and on the broader sense of financial stability, fell on deaf ears.

The institutions established within the EU are more subject to side stepping, arena shifting, selective abandonment, displacement, replacement, and repurposing within the context of these extra-EU institutions. Great powers go elsewhere in order to get what they want. A key way we know this is happening, even if the old institutions have not withered away, is that there is a reliance on institutions that have a different legal status, based on different treaties, with different decision-making mechanisms, memberships, voting rights and establishing different legal obligations than the incumbent institutions. This could extend into old institutions continuing to exist, but under new conditions imposed from the outside, by new, alien institutions.

This paper remains a very preliminary sketch, and can be built out with more depth into the cases investigated, and to international relations more broadly. It hopes to provide a new synthesis to the (largely comparative) literature on institutional change, particularly incremental change and literature on international relations, institutions and world order, in Europe and elsewhere.

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