The London School of Economics and Political Science

Explaining the Creation of the EU Banking Union: The Interplay between Interests and Ideas

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Declaration

I certify that the thesis I have presented for examination for the MPhil/PhD degree of the London School of Economics and Political Science is solely my own work other than where I have clearly indicated that it is the work of others (in which case the extent of any work carried out jointly by me and any other person is clearly identified in it).

I declare that my thesis consists of 82,346 words.

Abstract

How do we explain the outcome of the EU banking union negotiations? Still in 2011, a majority of governments opposed the banking union. They suddenly reversed policies and agreed the creation of a joint supervisor at the Euro Summit in June 2012. This thesis invokes liberal intergovernmentalism to explain the creation of the banking union. Yet, the negotiations pose two major puzzles. First, no clear predictions can be derived from liberal intergovernmentalism for the preferences of arguably the most powerful member state: the German government. Interest groups were divided, public opinion contradictory, and macro-economic preferences unclear. With no clearly most powerful interest, more than one policy was a rational course of action (Folk theorem). To solve this puzzle, the thesis argues that worldviews based on the principles of *Ordnungspolitik* influenced German policy-makers. In the absence of a unique equilibrium, these worldviews tipped the scale towards a policy of realigning control and liability. The outcome of the interstate negotiations poses the second puzzle for liberal intergovernmentalism. Its power-based theory of interstate bargaining cannot account for German concessions on several issues. Drawing on an account of rhetorical action, the thesis argues that a coalition of Southern European countries used the collectively stated goal to 'break the vicious circle between banks and sovereigns' to prove German preferences as unsuitable for achieving this goal. While exposing the weaknesses of the German government's policy responses, the Southern coalition framed their own preferences for risk-sharing as the most effective solution to the problem. The German government was forced to acquiesce in considerably more risk-sharing than it had initially deemed acceptable. The thesis draws on 84 interviews with negotiators from Germany, France, Italy, Spain, the Netherlands and the EU institutions. The analysis provides several generalisable insights into the role of ideas for domestic preferences and interstate negotiations.

Foreword

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Chapter 1: Introduction

> 'It was a tense situation. Van Rompuy's sherpa opened the meeting, and said 'We are here to agree on direct recapitalisation by the ESM.' And you could see that a lot of people around the table were quite surprised and shocked, particularly our German friends who didn't want to hear about it. They immediately asked for the floor, but Frans [van Daele, sherpa of van Rompuy] didn't give them the floor. He first gave the floor to France, Spain, Italy, Ireland, who immediately jumped on the idea and said, 'This is exactly what is needed,' and gave it one hundred percent support. And this created a momentum in favour of this thing. And so when Germany came up, when he finally gave the floor to Germany, there was already a momentum in the other direction.' (CPEC2, 2015)

The recent history of the European Union has been pervaded by crises. Rarely, however, the European project was as close to the abyss as in the spring 2012. The above-quoted member of cabinet of the president of the European Council Herman van Rompuy recalled the tense dynamics in a decisive meeting of the sherpas at the Euro Summit in June 2012. In an environment marked by mounting pressure at financial markets, the heads of state or governments settled on a far-reaching agreement: the creation of a mechanism for the direct recapitalisations of distressed banks as well as the establishment of a single bank supervisor in the euro area. These decisions did not only prevent the immediate break-up of the single currency, but resulted in an unprecedented shift of sovereignty to the European level. The agreement from June 2012 arguably constituted the single biggest overhaul of the eurozone's governance since its inception. It resulted in establishing the banking union for the euro area.

This thesis seeks to analyse how this most recent grand bargain of European integration came about. It devotes attention to the three critical sequences of the process: first, the Euro Summit in June 2012 with a high-level agreement on a mechanism for direct bank recapitalisations and joint supervision. Second, the negotiations on the Single Supervisory Mechanism (SSM) in the Council between September 2012 and April 2013. It led to the establishment of a joint banking supervisor for the eurozone and potentially other EU member states willing to join. The third phase is the negotiations in the Council on the Single Resolution Mechanism (SRM), a joint institution for resolving banks that are failing or likely to fail. It was negotiated between July 2013 and April 2014. Besides the SSM and the SRM, a full-fledged banking union comprises two additional elements: first, a Single Rulebook to implement the same financial regulation across the euro area, which remained unfinished; second, a deposit guarantee scheme (European Deposit Insurance Scheme, EDIS), which is being negotiated at the time of writing, but not making much progress. These two latter pillars are not part of the analysis because of their unfinished state and their lower relevance for the immediate crisis resolution.

The banking union is the result of several steps and developments from the summer 2012 to the end of the year 2014. It is best understood against the background of the economic developments during the euro crisis and spring 212 in particular. In order to safeguard financial stability, many governments in the eurozone intervened in the financial crisis and bailed out failing banks in their country. In turn, several member states incurred large amounts of public debt.[1] Bank failures ruined public finances. As their fiscal position deteriorated, the value of their sovereign bonds decreased. Since many of these bonds were held by banks from the same country[2], the devaluation of the sovereign bonds ruined bank balances. Thus, the crisis spilt back to the banking sector (given the lower value of sovereign bonds on their balance sheets). This created the need for another round of bail-outs (Pisani-Ferry, 2012; Pisani-Ferry and Merler, 2012; De Grauwe, 2011a; Véron, 2011a; Véron, 2011b). Sovereigns and banks had started a 'hazardous tango' (Pisani-Ferry and Merler, 2012) and a 'deadly embrace' (De Grauwe, 2013a, p. 3; see also Véron, 2011b; De Grauwe, 2013b). Portugal and Greece it was the sovereign which tore down the banks; in Ireland the banks tore down the sovereign, and the crisis of the latter fed back to banks (De Grauwe, 2011a, pp. 6–7). 'If one of the two falls off the cliff the other one is pulled down also' (De Grauwe, 2013a, p. 3). A new idea made sense of these developments: the *vicious circle between banks and sovereigns*[3].

In order to break the circle, the eurozone heads of state or government agreed on the creation of a mechanism for direct bank recapitalisations at the Euro Summit on 28 and 29 June 2012. These payments directly inject joint eurozone funds[4] from the European

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[1] As the thesis will show below, weak public finances in some countries were mainly caused by a current account deficit. Yet, this different cause does not change the consequence, which is central to the analysis, namely the fact that countries were torn into a vicious circle.

[2] The vicious circle also worsened because several governments pressured domestic banks to buy even more of their sovereign debt in order to bring down their lending costs (Gros, 2013a; Pisani-Ferry and Merler, 2012, p. 208).

[3] Other terms synonymously used for the same phenomenon include: bank-sovereign nexus, bank-sovereign doom loop.

[4] The eurozone provided mutual support through bilateral credits, the European Financial Stability Facility (EFSF) and the European Financial Stability Mechanism (EFSM) and the European Stability Mechanism (ESM).

Stability Mechanism (ESM) into failing banks. As a result, these injections do not increase the home government's public debt. However, directly recapitalising banks is risky. Financial losses for the creditors are likely. Furthermore, using mutualised funds to bail-out banks in single member states is a de facto transfer within the currency union. It raises issues of moral hazard. To address these issues, the German government put as a condition for direct recapitalisations that eurozone member states surrender bank supervisory powers to an independent European authority. Subsequently, member states chose the European Central Bank (ECB) for this role. This choice was motivated by the credibility of the institution and its independence. Both factors were expected to be safeguards against the influence of national governments, which was proven to have a detrimental impact in the crisis. However, a system with European supervision but national resolution faces a number of problems. It creates adverse incentives and even risks falling behind purely national arrangements in terms of resolution efficiency. For instance, a European supervisor could delay resolution action to avoid tapping national funds. Furthermore, the use of national resolution funds would be difficult to justify if their use was the consequence of a supervisory failure on the EU level. As a consequence, a European system of supervision created strong incentives[5] towards European resolution powers, which were eventually agreed by the governments of the eurozone member states by means of the SRM. Hence, the agreement on direct bank recapitalisations from June 2012 paved the way for the banking union to materialise at the end of a longer causal chain (Nielsen and Smeets, 2017).

It should be noted, however, that the Euro Summit was only the first step towards the creation of the banking union. The governments had reached an agreement on the broad direction of future policy, but the legislative negotiations still lay ahead. The European Commission spent the summer 2012 preparing the SSM legislation. It presented two proposals for regulations and one communication on 12 September 2012. After tense yet quick negotiations, the Council reached a General Approach on 13 December 2012 and the European Parliament adopted the regulations on 19 March 2013[6] (European Commission, 2016a).

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[5] As will be shown below, these incentives were very important, but as such not a sufficient condition for a resolution framework to come about.

[6] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions; Regulation (EU) No 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking

Negotiations on the resolution mechanism proved even more difficult and protracted than those on supervision. The European Commission published a legislative proposal for the SRM regulation on 10 July 2013. The Council agreed on its General Approach for the negotiations with the European Parliament on 19 December 2013. After several rounds of negotiations, the compromise proposal was accepted by the European Parliament on 15 April 2014[7]. The legislative package included the Bank Recovery and Resolution Directive[8] (BRRD) establishing bail-in rules as well as an intergovernmental agreement[9] between the eurozone member states, which all member states ratified by 7 December 2015.

Beyond triggering the institutional innovation of the banking union, the agreement from the Euro Summit in June 2012 was instrumental for other measures that should effectively put an end to the crisis. ECB president Mario Draghi admitted the day after the summit that the decisions taken by the heads of state or government were 'the game changer we need' (Draghi, cit. in van Rompuy, 2014; see also Véron, 2015, pp. 14–19). Shortly afterwards in July of the same year, he announced that the ECB was ready to 'do whatever it takes to preserve the euro' (Draghi, 2012). This announcement of the ECB's Outright Monetary Transactions programme (OMT) was the 'big bazooka' that ended speculation at the financial markets about the demise of the single currency.

An important disclaimer applies: It is one of the ironies of the Euro Summit that what seemed to be the most important part of the agreement was degraded to a side note over the summer in 2012: direct bank recapitalisations. They were pitched as the magic bullet to break the vicious circle between banks and sovereigns. Yet, they ran out of steam after

Authority) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) No 1024/2013.

[7] Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010.

[8] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council Text with EEA relevance.

[9] Agreement on the transfer and mutualisation of contributions to the Single Resolution fund, ST 8457 2014 COR 1.

the establishment of a resolution mechanism essentially took over their job. Direct recapitalisations were

> 'supposed to cut the link between troubled banks and sovereigns. However, it soon became apparent that the remaining building blocks of the banking union would most likely achieve this aim without the need for DRI [Direct Recapitalisations Instrument] to provide substantial amounts of funds' (ESM, 2014a).

For failing banks, the resolution mechanism was supposed to take over, diminishing the need for the direct recapitalisations instrument. As a result of this lack of political will, the negotiations on the mechanism dragged on unexpectedly long and lasted until 10 June 2014 (Merler, 2014).[10] It was concluded too late to be of any help in the crisis. The Spanish government eventually accepted in October 2012 it would have to recapitalise its banks *in*directly. In contrast to its previous stance, it took out an ESM loan for this purpose, notably without a major reaction from post-crisis financial markets (Financial Times, 2012a).

Table 1: Legislative key steps to the banking union

Date	**Event**
28-29 June 2012	**Euro Summit:** Agreement on joint banking supervision and direct bank recapitalisations
12 September 2012	**SSM Legislative Proposal:** European Commission publishes legislative proposals for SSM
13 December 2012	**SSM General Approach:** Council agrees on General Approach for SSM
19 March 2012	**European Parliament:** adopts SSM legislative package
10 July 2013	**SRM Legislative Proposal:** European Commission publishes legislative proposals for SRM
19 December 2013	**SRM General Approach:** Council agrees on General Approach for SRM
15 April 2014	**European Parliament:** adopts SRM legislative package
10 June 2014	**Direct Recapitalisations:** Council adopts direct recapitalisations instrument
8 December 2014	**ESM DRI Instrument:** ESM Governors adopt direct recapitalisations instrument, becomes operational
7 December 2015	**Intergovernmental Agreement:** The intergovernmental agreement on the transfer and mutualisation of contributions to the Single Resolution Fund is ratified

[10] The mechanism became operational on 8 December 2014 (ESM, 2014b). A range of conditions imposed by the German, Dutch and Finnish finance ministries render its use unlikely (e.g. Finance Ministries, 2012).

1.1. The Research Question

How do we explain the outcome of the EU banking union negotiations? This thesis seeks to uncover the drivers behind the creation of the EU banking union. As late as 2011, a large majority of member states still rejected the idea of creating a joint European banking supervisor. The German government objected to it because of fears of creating fiscal liabilities for foreign banks (Howarth and Quaglia, 2013, p. 112). The French government opposed joint supervision as it wanted to maintain control over the national banking system (De Rynck, 2016, p. 130). The United Kingdom aimed to protect the City by preventing a two-speed Europe in financial market policies (Howarth and Quaglia, 2013, pp. 114–117). Eastern European governments rejected a joint supervisor on grounds of concerns about losing control over foreign banks in their countries (Spendzharova, 2012; Spendzharova and Bayram, 2016). The European Commission president José Manuel Barroso warned of a single supervisor to 'avoid a heavy-handed, top down approach where it isn't necessary' (Barroso, 2009). Given that it 'fundamentally contradict[ed] the perceived interests of many member states' (Epstein and Rhodes, 2014, p. 7), the creation of the banking union poses a puzzle.

Against the background of the crisis pressures and the incomplete institutional design of the currency union, neo-functionalism could reasonably be expected to provide an explanation for the creation of the banking union. Neo-functionalists would predict that crisis pressures force governments to take action (Haas, 1958). These functional pressures lead to a genuine EMU (Niemann and Ioannou, 2015) or at least 'failing forward' (Jones *et al.*, 2016), i.e. a piecemeal approach of a range of incomplete policy responses which in their sum constitute significant integration steps and create pressures for further reforms (Jones *et al.*, 2016, pp. 1015–1017). The empirical analysis confirms that the crisis increased the pressure on governments to act. However, crisis pressures do not explain what measures governments were going to take. While crisis pressures as such explain *why* governments react, but not *how* they act to respond to these pressures. Furthermore, it does not provide a convincing explanation why the negotiations did not break down when crisis pressures faded away swiftly after the ECB President Draghi announced in July 2012 to do 'whatever it takes' (Draghi, 2012) to safe the euro. The neo-functionalist approach offers important insights into the creation of the banking union, but it remains incomplete.

More particularly, two puzzles underpin the creation of the banking union. The first puzzle concerns the preferences of the German government as arguably the most powerful actor in the negotiations. Liberal intergovernmentalism is the self-proclaimed 'baseline theory' (Moravcsik and Schimmelfennig, 2009, p. 67; see also Moravcsik, 1999a) for European integration. It uses a liberal theory of preference formation, which predicts governments to follow the material interests that '[help] governments achieve certain political economic goals' (Moravcsik, 1999a, p. 42), i.e. re-election. It suggests that domestic interest groups or the 'macro-economic preferences of the ruling governmental coalition' (Moravcsik, 1999a, p. 3) influence the preferences of a government. The latter follow these groups to align with powerful societal interest groups that increase their chances of re-election. Among the private interest groups, the two most relevant ones for the banking union in Germany were the public banks on the one hand and the private banks on the other. The public banks opposed the banking union and more generally any European interference in their business (BVR/VÖB/DSGV, 2012; BVR/VÖB/DSGV, 2013). The private banks include large transnational banks, such as Deutsche Bank or Commerzbank. They were favourably inclined towards the banking union (BDB, 2012; BDB, 2013a). Thus, the most powerful domestic interest groups were divided on the banking union. If domestic interests are diverse, liberal intergovernmentalism predicts the most powerful group to influence the government (Moravcsik, 1999a, p. 36). Since both private and public banks are of vital importance to the German economy, neither group can be seen as clearly more powerful than its counterpart. Hence, no clear predictions can be derived from private (i.e. commercial) material interests.

To complicate matters further, the 'macro-economic preferences of the ruling governmental coalition' were not conclusive either. Schimmelfennig suggests deriving the macro-economic preferences of the German government from its fiscal position. As its fiscal position was favourable compared to other eurozone members, one would expect it to primarily pursue the goal of preserving this position and prevent becoming the paymaster of the eurozone (Sinn, 2012a; Open Letter of Economists in FAZ, 2012). A rational strategy based on the fiscal position would imply the rejection of financial transfers and attempts to shift the adjustment costs to the periphery (Schimmelfennig, 2015).

However, trade patterns were an important macro-economic characteristic of the German economy. Given that a project such as the banking union is not limited to the area of fiscal policy but has manifold implications for trade as well, it is reasonable to also consider the potential influence of trade patterns on macro-economic preferences. The German economy is highly export-based. The eurozone is an important export-market and the single currency contributes significantly to German trade surpluses. Yet, these benefits cannot be taken for granted. Many economists agree that a currency union without at least some mutualisation and risk-sharing is inherently unstable and prone to collapse at some point (De Grauwe, 2013a; Asdrubali *et al.*, 1996; Van Beers *et al.*, 2014; IMF, 2013a; Farhi and Werning, 2017). If one derives the macro-economic preferences from trade patterns, one would expect the German government to pursue a policy of making EMU sustainable. This, however, would require fixing its institutional flaws, including the acceptance of at least some mutualisation. It would stabilise EMU, the backbone of the export-based German economy.

While both strategies are rational, the effect of uncertainty obscures the expected consequences. *If* there are reforms in the South and *if* it turns out a currency union can in fact be viable without significant risk-sharing, it would lead to the high payoff for Germany, i.e. solving the euro crisis without incurring additional costs. However, this strategy can fail and result in the demise of the euro area. Likewise, *if* a currency union can only be sustained with a certain degree of risk-sharing, introducing these mechanisms could achieve a very high payoff as it would stabilise EMU and avoid its break-up. However, risk-sharing could put the German government in a position of the paymaster for the eurozone, leading to sizeable and permanent transfers.

Since the veil of uncertainty obscures the calculation of costs and benefits, it is a difficult endeavour to identify the most rational policy. In fact, given this level of uncertainty, none of the courses of action can be assessed as unambiguously more rational than its alternatives. Policy-makers are faced with a situation characterised by the absence of a unique equilibrium (Garrett and Weingast, 1993): more than one policy appears rational; different courses of action cannot be distinguished along their utility function. As it is not clear which policy increases the chances of re-election the most, no unique prediction can be derived from liberal intergovernmentalism.

At this stage, public opinion could potentially settle the conflict between both strategies, not least given the reputation of the incumbent German chancellor of following public opinion very closely on eurozone issues (Featherstone, 2011, pp. 201–202; Paterson, 2011a, pp. 69–70). Yet, public opinion data can only partially explain the preferences of the government. Most importantly, it cannot bridge the divide between the scenarios. On the one hand, the data shows that German voters reject assuming the costs of financial assistance in the crisis. 64% were opposed to a further extension of the bail-out funds which can reasonably be taken as a proxy for further financial transfers in the eurozone (Forschungsgruppe Wahlen, 2011). These numbers would indicate that the government needs to shift adjustment costs to increase its chances of re-election. On the other hand, public opinion is strongly in favour of the single currency, providing evidence for a course of fixing EMU. At the height of the crisis, two out of three Germans (66%) wanted to keep the euro (Pew, 2012, p. 64). 59% of Germans think that their economy has been 'strengthened' by economic integration in Europe (Pew, 2012, p. 24). Support for the EU and EU membership remained largely unaffected by the crisis and polled at 65% (Pew, 2012, p. 24; see also Eurobarometer, 2017). Germans are also aware of interdependence. 71% of German respondents accept that 'the economic problems of countries like Italy and Greece pose a major threat' to the economic well-being in Germany (Pew, 2012, p. 32).

These numbers permit two conclusions. First, they indicate that Germans feel at unease with transfer payments. Second, support for the euro is strong, pointing to a limited willingness to shift adjustment costs. Put differently, Germans do not want to assume adjustment costs, but want to keep the euro. This is potentially contradictory because if policy-makers wanted to satisfy public opinion, they would have to stabilise EMU without incurring any costs. Public opinion poses a very similar dilemma to the one that arises from the duality of the fiscal position and trade patterns. German preferences remain a puzzle.

The literature on the banking union does not yet provide a convincing response to the challenges posed by the fragmentation of interests. Howarth and Quaglia argue that 'German government concerns over the fate of the *Sparkassen* determined the contours of the banking union agreed between December 2012 and March 2014' (Howarth and Quaglia, 2014, p. 131), but there was no consistent link between the interests of the *Sparkassen* and the preferences of the government (see Table 38). At several instances, German preferences – including core elements such as the change to a bail-in policy – are not explained by the interests of the savings banks. This renders an explanation solely based on the interests of the *Sparkassen* unsatisfactory. Epstein and Rhodes focus on the importance of the internationalisation of the European banking sector to explain the preferences of governments (Epstein and Rhodes, 2014; Epstein, 2014). However, there is no consistent match between the government's preferences and the interests of transnational banks either (see Table 38). Therefore, the existing explanations remain unsatisfactory at the empirical level. Glöckler *et al.* (2017) explain German preferences at the Euro Summit in June 2012 with the interests of the German taxpayer. While there are consistent matches between the interest of the taxpayer and German preferences, the authors shy away from the question why these particular interests were more influential than competing powerful interests. Their contribution is highly valuable, but can only serve as a starting point for the analysis as it does not address the particular puzzle posed in this thesis.

Situations as described are no rare occurrence in international negotiations, given the pervasive effect of uncertainty. Conceptually, game theoretical approaches have made sense of these situations by classifying them as a 'Folk theorem' (Friedman, 1971; Fudenberg and Maskin, 1986). In brief, the theorem describes situations where two (or more) different strategies result in roughly the same payoff. As the utility function does not suggest a single course of action, actors can pursue more than one rational strategy. This thesis develops a framework that permits for predictions of state behaviour even in situations of a Folk theorem (see Chapter 2: Theoretical Framework). As independent variables, it relies on material interests as well as ideas as worldviews.

Table 2: Sources of German preferences

	Macro-economic preference: fiscal position	**Macro-economic preference: trade patterns**	**Private material interests: public banks**	**Private material interests: private banks**	**Neo-functionalism**
Stance towards BU	No fiscal transfers fear of moral hazard => against BU	Sustaining EMU, fixing institutional flaws => in favour of BU	Inward-looking, no EU interference => against BU	Level-playing field => in favour of BU	During acute crisis: strong preference for fully-fledged BU; after acute crisis: no preference for BU
Source/ power	Fiscal position; supported by large part of German economics profession (e.g. Economic Experts Council)	Trade pattern; supported by international economics profession, international institutions	Savings and regional banks; well connected to politicians	Big private banks, including transnatio nal banks such as Deutsche Bank and Commerz bank	Crisis pressures (pressure on sovereign bonds of weakest link in EMU/ peripheral countries)

The concessions by the German government in the interstate negotiations pose the second major puzzle of the banking union negotiations. Germany is often described as the EU's new hegemon (Paterson, 2011a; Bulmer, 2014; Schoeller, 2017). The size of Germany's GDP, its population and its economic resources make it the most powerful member state in terms of aggregate power. Its material resources are based on 'extremely strong fundamentals' (Bulmer, 2014, p. 1251). The issue-specific power is no smaller, considering the importance of German resources for an effective resolution of the crisis.

The government was furthermore supported by financially powerful allies. One does usually distinguish between two coalitions during the euro crisis: one coalition of Northern and one of Southern European governments. The Northern coalition was mainly composed of Germany, the Netherlands, Finland and to some extent Austria. France, Italy, Spain and some other mostly Southern member states, as well as on most occasions the EU institutions, comprised the Southern coalition. The non-euro member states only play a minor role in this analysis.[11]

The coalitional pattern is historically consistent. Throughout European monetary integration, the Northern coalition has set the terms of agreements (Tsoukalis, 1977, pp. 90–92; Dyson and Featherstone, 1999; Chang, 2009, p. 23). In the banking union negotiations, they were held together by aligned material interests as well as ideas as 'coalition magnets' (Béland and Cox, 2016) (see section 3.4). As a result of its own material bargaining power and the support from a powerful coalition, the German government was essentially a veto power during much of the euro crisis management (Howarth and Quaglia, 2013; Beach, 2013). This translated to successful negotiation outcomes throughout the crisis:

> 'At each step of crisis decision-making, Germany was able to shape the terms of integration in return for giving up its opposition to bailing out insolvent EA members. Germany prevented the introduction of Eurobonds or any other formally mutualized sovereign debt. (…) For the same reason, Germany successfully rejected bank licenses for the EFSF and the ESM. In addition, Germany was able to link financial assistance to strict austerity conditionality, the strengthening of the EU's monitoring and sanctioning of national budgets, and the adoption of the Fiscal Compact, including a balanced budget rule to be enshrined 'preferably' in domestic constitutional law.' (Schimmelfennig, 2015, p. 187)

The German government left its mark on all significant measures to fight the crisis. The ESM enshrined the German mantra of 'no solidarity without conditionality' (Bulmer, 2014, p. 1254); the fiscal compact reinforces fiscal constraints on national governments, shaped by the German government which 'enjoyed substantial power in the negotiations and was able to dictate the terms of the agreement to other states' (Beach, 2013, p. 113). This leads to the bigger picture of German hegemony in the euro crisis (Schoeller, 2017; Schäfer, 2013; Link, 2012).

The banking union does not fit this pattern (Epstein and Rhodes, 2014; Schäfer, 2016). It is a project the German government never wanted (Véron, 2008) and only agreed to under severe pressure (Glöckler *et al.*, 2017, pp. 1144–1145); the German government crossed

[11] Their impact was limited, not least because the crisis management was by many considered 'eurozone business', with most of the regulations and directives being restricted to the eurozone (Howarth and Quaglia, 2013, pp. 114–117). Similarly, the European Parliament was confined to a minor role. The analysis will recognise whenever it was an important actor, but overall its role in the banking union negotiations is considered fairly limited (Bressanelli and Chelotti, 2016).

the lines of what it had previously deemed acceptable (Epstein and Rhodes, 2014, p. 17). In the banking union negotiations, 'France pushed Germany further than it ever wanted to go' (Hollande, cit. in Le Monde, 2017). To be sure, it is not claimed that the German government had to cross literally all red lines and ended up being defeated. However, it consistently punched below its nominal weight as the most powerful member state in the negotiations. It rejected a mechanism for direct bank recapitalisations, but was forced to concede it in June 2012. It managed to backtrack from its commitment to direct recapitalisations, but had to acquiesce in the creation of a resolution mechanism with joint resources. Based on concerns about a conflict of interest between monetary policy and banking supervision, it opposed making the ECB the single banking supervisor, but failed to prevent it from getting these powers. It sought to exclude its savings and regional banks from European supervision, but had to concede an integrated system with ECB oversight over less significant institutions as well. It aimed to adopt strong and automatic bail-in rules in the eurozone, but could not prevent around 150 loopholes and exemptions to bail-ins. Against German preferences, the resolution fund will eventually be fully mutualised. It sought to obtain veto rights over bank resolutions, but had to back down and effectively concede. The German government did, for sure, obtain concessions as well. Putting in place a bail-in policy and preventing a fiscal backstop to the resolution mechanism corresponds to German preferences. However, on balance, the number and depth of these concessions do not correspond to the predominance of Germany's material bargaining power (Epstein and Rhodes, 2014; Gros, 2013b).

Table 3: Comparison between German preferences and negotiation outcome

Contentious issue	German preference	Outcome
1: Direct recapitalisations	Against direct recapitalisations (moral hazard)	Summit agreement on its application + mechanism created
2: Joint supervision	Reluctant advocacy (conflicts with interest in shielding public banks from European interference)	Mechanism agreed
3: Role of ECB in supervision	ECB excluded from supervision (moral hazard)	ECB as supervisor
4: Scope of mechanism	Excluding small banks	Integrated system including small banks
5: Bail-in	Automatic bail-in	Loopholes and significant discretion
6: Resolution fund	National funds instead of joint funds	Mutualised joint fund
7: Resolution decision-making	National veto rights	No national veto rights

A plausible power-based explanation explains these concessions as the result of benign hegemony (Snidal, 1985; Layne, 1996; Eichengreen, 1996; Ikenberry, 1998). A benign hegemon 'has greater incentives to provide benefits to subordinate states in order to preserve its legitimacy' (Snidal, 1985, p. 588). It can be rational for a hegemon to forego gains in the short-run as a means to secure gains in the long term. This strategy suggests that the German government conceded on minor issues to get the upper hand on the more important parts of the agreement. Yet, there is little evidence that these concessions were minor in nature. At the Euro Summit in June 2012, the German government did not only agree to direct bank recapitalisations – as such an important concession – but gave way to the banking union, a big overhaul of the euro area, neither desired by the German government nor a minor concession. The German chancellor Merkel was considered the 'big loser' (Reuters, 2012a) and Der Spiegel analysed '[h]ow Italy and Spain Defeated Merkel at EU Summit' (Der Spiegel, 2012a). The outcry in the domestic media was accompanied by an open letter of 282 renowned German economists (FAZ, 2012) and a hostile reaction of interest groups (BDI, 2012). The government had 'gradually given way to a more expansive notion of ECB banking supervision than it had originally deemed acceptable' (Epstein and Rhodes, 2014, p. 17). Therefore, 'German authorities have not been dissimulating in trying to preserve national sovereignty in the face of momentum towards a European Banking Union' (Epstein and Rhodes, 2014, p. 24).

Gros' assessment of the SRM negotiations is similarly unfavourable to the German government. He describes the core elements of the SRM agreement as the result of a 'big concession' (Gros, 2013b, p. 2) by the German government. Across all three major sequences, the outcome of the negotiations does not correspond to what the German government aimed to achieve (Nedergaard and Snaith, 2015). Repeated attempts of backtracking[12] in the months following the agreement demonstrate the unease of German negotiators with the banking union that came about (e.g. Finance Ministries, 2012). On balance, the German concessions were not minor but costly. They exceed what one could view as part of benign hegemony.

Another plausible power-based hypothesis would explain the concessions with an asymmetrical distribution of the break-up costs. The dissolution of the euro would have been much worse for Germany than for its Southern European counterparts. This asymmetry, the argument goes, undermined the German government's situational bargaining power, and it gave in, eventually. Yet, the evidence does not support this claim of asymmetry. According to a study by UBS, euro break-up would have resulted in a GDP loss of 20-25% in Germany and of 40-50% in countries in the periphery (Deo *et al.*, 2011). It goes without saying that these numbers are highly speculative and hardly reliable, but they underline that if there was an asymmetry, it did rather increase than decrease German bargaining power (Fisher and Ury, 1983). This falls in line with Schimmelfennig's argument that the immediate consequences of eurozone break-up would have been worse for highly indebted countries than for solvent ones (Schimmelfennig, 2015, p. 185). This leaves us wondering still why the unfavourable outcome materialised.

Glöckler *et al.* (2017) partially address the puzzle in their explanation for the outcome of the Euro Summit in June 2012. In their reading of the events, the risk of eurozone break-up increased the readiness for compromise on both sides. This led to a package deal. The Southern European member states successfully imposed direct bank recapitalisations on

[12] As a result of backtracking, the German government successfully imposed additional constraints on direct recapitalisations. Yet, it did not prevent the creation of a bank resolution mechanism as a substitute to the former. The financial resources for direct bank recapitalisations would have been taken from the European Stability Mechanism which consists of European taxpayers' money. The Single Resolution Fund in the Single Resolution Mechanism is filled by the contribution of banks. Thus, the German government did not significantly reduce the extent of mutualisation, but shifted the costs of mutualisation from its taxpayers (ESM) to its banks (SRF).

the German government, but the latter obtained a concession on the creation of a joint European bank supervisor (Glöckler *et al.*, 2017, p. 1136). Yet, this perspective overlooks that German governments have a decade-long history of opposing European supervisory powers[13] (Véron, 2008, pp. 1–2). The government only warmed to the idea of a joint supervisor once the prospect of direct recapitalisations materialised. This renders it a measure of damage control. While there is an element of a package deal, the question remains why the terms were so disadvantageous for the German government, which did not obtain more than a concession serving as damage control.

In sum, there is no obvious answer to the puzzle of German concessions. This thesis seeks to increase our understanding of the main events and the drivers behind the German concessions. The implications of this puzzle are in principle not limited to the specific case either. The literature has established very convincingly that the terms of agreements are in many cases set by the most powerful actor (e.g. Waltz, 1979). However, it is no rare occurrence that the government with the highest material bargaining power is seen making concessions. In line with these cases where superior material bargaining power does not translate into favourable negotiation outcomes, there is scope to generalise the explanation from this case to similar cases in other policy areas.

1.2. The Argument

The responses provided in this thesis to the two main puzzles are anchored in the ideational literature. This literature offers valuable insights into the formation of preferences and the outcome of interstate negotiations. These insights can be used to solve the puzzles and provide a more complete explanation of the banking union.

Within the existing scholarship on ideas, one can distinguish between three groups. First, rationalists have made sense of ideas as devices to increase the efficiency of preferences. Ideas are either road maps, focal points, or worldviews (Goldstein and Keohane, 1993). Road maps reduce uncertainty and guide actors towards specific solutions. Focal points (Garrett and Weingast, 1993) help actors choose one equilibrium in situations with

[13] The domestically powerful savings banks *Sparkassen* and the regional banks *Landesbanken* are inward-looking (Hardie and Howarth, 2013; Glöckler *et al.*, 2017, pp. 1144–1145; Howarth and Quaglia, 2014, pp. 128–132) and staunchly opposed European influence in the German banking market, for long influencing the government on this issue (Seikel, 2014).

multiple equally rational equilibria. Similarly, policy learning is another ideational process that serves to maximise efficiency. Several authors have argued that policy-learning informed the responses of policy-makers to the eurozone crisis and helped them cope with uncertainty and unforeseen developments (Véron, 2015; Dunlop and Radaelli, 2016). Ideas can also influence policies as worldviews. Worldviews are often internalised by actors and 'sit in the background as underlying assumptions that are rarely contested' (Schmidt, 2008, p. 308). While actors are still gain-maximising, their worldviews influence which policy appears rational (against the internalised worldview) (Goldstein and Keohane, 1993).

The second group of scholars from the constructivist school has conceptualised ideas as being constitutive for preferences (Checkel, 1998; Lewis, 2005; Wendt, 1992; March and Olsen, 1998). Agent and structure are mutually constitutive and ideas influence behaviour by means of prescribing appropriate behaviour. In the area of economic policy-making, there is a rich literature on the policy changes as the result of an emerging consensus on specific economic ideas or paradigms – such as monetarism (Hall, 1993) or neoliberalism (McNamara, 1998). While some common ground exists between 'thin' constructivists and 'bounded rationalists', constructivists contend that actors do not strive to maximise gains (which underpins approaches based on (also bounded) rationality), but follow standards of appropriateness.

The third group assumes gain-maximising behaviour, but acknowledges that actors are constrained by an institutionalised normative environment (Schimmelfennig, 2001). International institutions are 'social environments' (Johnston, 2001). Interactions change the normative characteristics and identities of actors. Ideas matter in this framework as they are strategic devices. They are used to manipulate the social environment to gain advantages in negotiations. For instance, Jabko showed how the European Commission used the idea of 'the market' to pursue further integration and liberalisation (Jabko, 2006; see also Howarth and Quaglia, 2016a). This thesis considers the ideational literature in its breadth an excellent resource for providing insights into state behaviour, as will be specified further below. It does not only solve the two puzzles, but enhances our knowledge on broader questions of international relations.

Domestic Preferences

The (thin) rationalist literature on ideas provides useful insights for the puzzle of German preferences. Following the conceptualisation of ideas as worldviews (Goldstein and Keohane, 1993), these worldviews can underpin the considerations of actors and their assessment of the policy choices that are available. The worldviews held by actors can influence what these actors perceive as the most effective policy choice for maximising gains. However, as theorised in the rationalist literature by Goldstein and Keohane (1993) (and in contrast to the constructivist literature), worldviews do not modify actors' goals, but influence their view of the world. Therefore, worldviews are particularly suitable to situations of a Folk theorem where actors face a choice between various equilibria that all appear equally rational (Friedman, 1971; Fudenberg and Maskin, 1986). Worldviews tip the balance in favour of one particular of the rational strategies that actors can choose from.

Applied to the case under consideration, this thesis argues that the worldviews based on the ordoliberal notion of *Ordnungspolitik*[14] among German policy-makers underpinned their assessment of the situation and possible policies. These worldviews influenced and guided the German government throughout the banking union negotiations. A large body of literature recognises the importance of ordoliberalism for government policies (McNamara, 1998; Heipertz and Verdun, 2010; Nedergaard and Snaith, 2015; Bonatti and Fracasso, 2013). It is a diverse set of ideas that revolves around the idea of a strong state that sets the framework for efficient markets. In the context of the euro crisis, setting the right framework meant realigning control and liability as a means to prevent moral hazard. This principle is at the very core of ordoliberalism. Its founders established it as the so-called *Haftungsprinzip* or 'principle of liability' (Eucken, 1951, pp. 279–285).

As the German government was faced with at least two rational strategies, namely shifting adjustment costs (fiscal position) or fixing EMU (trade patterns), internalised ordoliberal ideas tipped the balance in favour of shifting adjustment costs. Ordoliberal policy recipes have much in common with policies based on the fiscal position. Both seek to restrict mutualisation and risk-sharing in the eurozone but suggest structural reforms at the domestic level as well as tight and automatic fiscal controls. Thus, ordoliberal ideas resonated with these fiscal policy considerations. Because of this similarity, ordoliberal

[14] *Ordnungspolitik* and ordoliberalism are used synonymously.

ideas consistently motivated the German government to base their preferences on the fiscal position and not alternative interests. A policy based on trade and geared towards stabilising EMU through a completion of the currency union is more difficult to bring in line with ordoliberal ideas. It would require risk-sharing and mutualisation, which ordoliberals have consistently rejected for any state of integration that falls short of a complete political union.

At this stage, one might wonder why for the sake of simplicity it is not claimed that the German government simply followed the fiscal position. Yet, such an explanation would remain incomplete. Liberal intergovernmentalism provides no theoretical justification why the fiscal position would outweigh competing interests. The regulatory impact of banking union on the financial sector is massive, which liberal intergovernmentalism puts as a condition that businesses mobilise (Moravcsik, 1999a, p. 37). Besides regulation, because of the important role of bank intermediation for the supply of capital in (European) economies, businesses were fundamentally affected by the creation of the banking union. This suggests that it transcends the narrow area of fiscal considerations. Lastly, the trade sector – and especially the politically powerful export industry – can reasonably be expected to pressure the government to contribute to a stabilisation of the currency union. Considering these factors, explaining the German preference for a strategy of shifting adjustment costs is a worthwhile endeavour. German preferences in the banking union negotiations deserve a closer look.

On a theoretical level, this framework offers a novel contribution by suggesting an ideational extension of liberal intergovernmentalism. On the one hand, it makes best use of the strengths of liberal intergovernmentalism by incorporating its main explanatory factor, i.e. material interests, very centrally. It underpins the research design for domestic preferences in this thesis. However, a weak spot of liberal intergovernmentalism is its dealing with fragmented material interests. The influence of the various groups is 'weighted only by their size and the intensity of gains and losses' (Moravcsik, 1999a, p. 36), but overall the framework 'abstracts away from complex sectoral splits' (Moravcsik, 1999a, p. 36). Yet, sectoral splits do occur and governments potentially do find themselves in a Folk theorem situation. The ideational extension of liberal intergovernmentalism as suggested in this research design helps to solve these issues. It contributes to the rich literature on the interplay of ideas and interests (Parsons, 2015; Jupille *et al.*, 2003; Hall, 1993). According to Jupille *et al.* (2003), the most common research design employs both factors in a competitive testing framework (e.g. Parsons, 2002). These studies have provided very useful insights into the role of ideas, but also have their own limitations. Not always do actors either follow interests or ideas; also, the precise 'how much' question is sometimes difficult to answer (Parsons, 2015). Henceforth, the account chosen for the analysis in the case under consideration refrains from the claim that ideas were necessarily more important than interests. Instead, it specifies and tests the scope conditions under which ideas determine which policy among several rational courses of action is selected. The framework seeks to shed light on this interaction between both factors, to arrive at a parsimonious framework for the analysis of domestic preferences. It is claimed that in particular uncertainty, an urgent crisis situation as well as cognitively complex negotiations are scope conditions for ideas to matter for policies (see section 2.2).

Interstate Negotiations

The solution to the puzzle of German concessions in the negotiations invokes the third strand of the ideational literature that focuses on the strategic use of ideas (Schimmelfennig, 2001; Krebs and Jackson, 2007). It assumes that actors are utility-maximisers and use rhetoric instrumentally (Bevir and Rhodes, 2006). Framing contests among actors set the terms of the negotiations. Ideas underpin the rhetoric, and powerful ideas provide for a distinct rhetorical advantage in negotiations. As actors are constrained by an institutionalised normative framework, dragging negotiations to a favourable normative and argumentative terrain can help actors to impose their preferences on their counterparts (Krebs and Jackson, 2007, p. 38). Actors use rhetoric in negotiations to 'maneuvre each other onto more favorable rhetorical terrain and thereby to close off routes of acceptable rebuttal' (Krebs and Jackson, 2007, p. 45). Governments attempt to silence their opponents and deprive them of the means to contest a particular preference. Common strategies of manipulative rhetoric are selecting or highlighting facts that serve one's interests, and downplaying others which do not (Riker, 1996). However, actors are bound by the verdict of the audience. Their rhetoric is only successful if it is plausible in the judgment of a particular audience and its social context (Laffey and Weldes, 1997; Dryzek, 2010, p. 322). Governments undermine the preferences of their opponents if they can plausibly show that they are ill-suited or ineffective as regards a problem all actors professed to solve.

This thesis argues that rhetoric enabled a coalition of Southern European governments to punch above their weight and force the materially more powerful German government to make significant concessions. Two analytical steps can be distinguished in the process leading to these concessions. The first step is the collective recognition of the problem frame. In June 2012, all governments agreed that the vicious circle between banks and sovereigns was the most pressing problem of the euro area. They acknowledged the problem and professed to solve it. This shifted the negotiations onto a different terrain. Having agreed on the diagnosis of the problem, all actors were now bound by their commitment to solve it. They established an ideational framework from which they could not deviate. This limited the realm of possibilities; solutions considered not suitable to this frame were effectively taken off the table.

In a second step, the negotiations proceeded to discussing solutions to the problem. The German government advocated structural reforms to make sovereigns less vulnerable towards the vicious circle. However, Southern governments stressed the weaknesses of this solution frame. They effectively cornered the German government rhetorically by showing the unsuitability of their solution frame to the problem frame of the vicious circle. By contrast, the Southern European proposal for measures of risk-sharing gained considerable support among experts, international institutions and other member states. This allowed governments and policy-makers from Southern Europe to frame it as a more effective solution to the problem under consideration. They won the causal argument and forced the German government to acquiesce in their preferred solution.

Since rhetorical processes are part and parcel of all negotiations, understanding the causal mechanism that links argumentative behaviour to the outcomes of negotiations contributes to the literature on interstate negotiations more broadly (Schimmelfennig, 2001; Krebs and Jackson, 2007). The two-step explanation laid out in this thesis is potentially applicable beyond the case under consideration. Almost all international negotiations are structured into discussions of the problem and discussions of solutions. The argument made here shows the link between both, and the constraining impact that an agreement on the problem can have. Furthermore, the focus on causal ideas represents a slight shift of emphasis since most studies of rhetoric in interstate negotiations have focused on normative ideas. Seminal studies by Schimmelfennig (2001) and Krebs and Jackson (2007) have focused on how normative ideas (here: human rights standards,

standards of fairness) were used in negotiations. This study enters less well-charted territory as it shows that causal ideas can be used to manipulate negotiations. To give an example of these possible generalisations, the recent discussions on a 'haircut' for Greece made the headlines in newspapers worldwide. While the Greek side wanted to achieve debt relief, the German side opposed its demands. The negotiations ended with a failure, once again postponing the question of a debt relief. The Greek government considered its debt pile unsustainable; the German government did not back down from its analysis of Greek debt as being sustainable, given the low interest-rate payments to European financing institutions. The framework used in this thesis would identify the failure to agree on a problem frame as the decisive cracking point in the negotiations. The German side successfully guarded against recognising Greek debt as unsustainable. This prevented it from being forced to agree to a solution frame built around debt relief. Other cases offer similar opportunities to apply the framework, making it generalisable to other situations and negotiations.

1.3. The Research Design, Methodology and Case Study Selection

The Research Design

Having established the puzzle and introduced the reader to the main contours of the argument and contribution, the remainder of the chapter will introduce the research design and the methods. This section discusses the research design, explains the case study selection and lays out the research methods.

To arrive at an answer to the research question, the thesis employs a positivist methodology. It aims at causal inference by isolating specific factors as causes. In terms of terminology, the cause is the explanatory or independent variable; the outcome is the explained or dependent variable (King *et al.*, 1994, p. 77). The preferences of governments are the first dependent variable. With regard to independent variables, liberal intergovernmentalism suggests that material interests explain domestic preferences. It distinguishes between commercial interests on the one hand and the 'macro-economic preferences of the ruling governmental coalition' (Moravcsik, 1999a, p. 3) on the other.

The framework introduces ideas as worldviews as an alternative independent variable. However, it sets a scope condition for their impact. We only expect worldviews to influence the choice of governments if material interests do not suggest a single rational course of action. This is the case in situations where interests are fragmented and cause a situation as described in the Folk theorem: there is no unique rational course of action, as more than one policy could reasonably be assessed as a rational choice. If this scope condition is met, ideas as worldviews are considered as an independent variable. The scope condition is of high importance to this framework (Mahoney, 2007, p. 128). It ensures the parsimony of the framework and allows us to make clear predictions on which independent variable is expected to explain the value on the dependent variable. It is a precondition to identify and empirically test the impact of each independent variable. Furthermore, it provides for a 'domain of application' approach to make sense of the interplay between interests and ideas (Jupille *et al.*, 2003, pp. 22–24).

Two outcomes would prove the analytical framework unsuitable. The first one is a mismatch between a clearly most powerful material interest and the preference of the government. A constellation with a clearly most powerful interest entails that the scope condition is not triggered. In this case, we would expect this most powerful interest to explain the outcome. If it is proven wrong, the framework would produce misleading predictions. Second, if there is a Folk theorem situation and the government's preference does not correspond to an idea as worldview, the framework is not capable to explain preferences satisfactorily. In this situation, the scope condition for ideas as worldviews is met, but ideas do not account for the preference. The framework would be proven unsuitable.

Table 4: Research design for domestic preferences

Dependent variable	Scope condition	Independent variable(s)	Hypotheses
Preferences of governments	Low fragmentation of material interests	Material interest: private interests	Gov. pursues the most powerful material interest (most helpful for re-election)
		Material interest: macro-economic preferences	
	- High fragmentation of material interests AND - one interest clearly more powerful than competing interests	Material interests: the most powerful material interest	Gov. pursues the most powerful material interest (most helpful for re-election)
	IDEATIONAL EXTENSION: - High fragmentation of material interests AND - no interest clearly more powerful than competing interests	Worldviews	Gov. pursues the material interest that is matched by ideas as worldviews
	- - - - - - - -	Crisis pressures	The existence (or absence) of crisis pressures determines the preferences of governments.

The second dependent variable is the outcome of the interstate negotiations. The term outcome refers to the creation and the specific institutional design of the banking union. The first independent variable to explain this outcome is material bargaining power. Liberal intergovernmentalism predicts that the outcome corresponds to the preferences of the government with the highest material bargaining power. The material bargaining power is determined by asymmetrical independence as the crucial determinant of a country's best alternative to a negotiated agreement (Fisher and Ury, 1983).

The present framework suggests causal ideas as an alternative independent variable. The mechanism between the independent and the dependent variable is rhetorical action. Rhetoric is part of all negotiations and since governments act in an institutionalised normative environment, we expect them to be bound by the audience's verdict on their arguments. If governments cannot craft a rhetorical justification for their preferences, we expect them to be forced to concede as they fail to gain support from the audience. The rhetorical battle is expected to take place in the two-step process described above: first, governments establish the frames of reference in the negotiations. Second, the causal argument takes place, won by the government which deprives the other side of effective means of rebuttal. To be sure, rhetorical action does not render material bargaining power insignificant. It is unlikely that the outcome of interstate negotiations fully aligns to the argumentative strengths of the actors involved in the negotiations. While minor concessions of the most powerful actor could be explained with the power-based hypothesis (benign hegemony), major concessions are taken as evidence for the rhetorical action hypothesis.

Table 5: Research design for interstate negotiations

Dependent variable	Independent variable	Hypotheses
Outcome of negotiations	Material bargaining power	Outcome corresponds to preferences of most powerful actor (no or only minor concessions)
	Ideas (rhetorical action)	Outcome corresponds to the preferences of those actors who can justify their demands with reference to collectively professed ideas (major concessions of most powerful actor)

The Methodology

This section lays out the methodology for the analysis. It is composed of two different methods: the method of congruence as well as process tracing (Bennett and George, 2005, pp. 181–232). Both methods are conducive for drawing causal inferences. They are complementary, because combining them mitigates their respective weaknesses. The method of congruence suggests that a specific variance on the dependent variable is congruent to a corresponding variance on the independent variable (Bennett and George, 2005, p. 181). To this aim, it assesses the fit between a set of observable implications of a hypothesis and the observed outcome. To give an example, a match between a specific material interest in a country and the observed preference of the government would suggest that the material interest explains the preference of the government – as the two are congruent.

However, while a match is a necessary condition for causality, it is not a sufficient one. Congruence does not necessarily imply causality (Jervis, 1994). This caveat of the method of congruence is particularly important for cases with identical observable implications. In these cases, a match does not isolate a factor as cause. To refer back to the example above, if two different material interests match the preference of the government, the method of congruence alone cannot clarify which of the two interests was the decisive driver behind the government's preference. For this reason, the method of congruence is supplemented with process tracing so as to uncover the causal chain between two variables. Understanding the causal mechanism between two variables is a prerequisite for having proven causality (Bennett and George, 2005, pp. 206–207; see also Checkel, 2005a, pp. 4–5; Mahoney, 2007, p. 132; Collier, 2011). While the method of congruence can still result in congruence between the dependent variable and more than one independent variable, careful process-tracing provides further evidence to exclude certain independent variables and support others. It leads to a more thorough and more reliable testing of the established hypotheses (Njølstad, 1990, pp. 240–244). In the analysis of the banking union, processes at both the domestic and the interstate level are traced. The evidence provided by this method contributes to uncovering the foundations of preferences, identifying shifts and crucial events in the interstate negotiations, and accounting for the role of policy entrepreneurs on the two levels. In the light of the chosen hypotheses, particular attention is devoted to rhetorical processes as they are indispensable for the analysis of the ideational factors. This evidence will result in a thick description of the events unfolding over the course of the negotiations. In order to take this methodology seriously, each empirical chapter begins with a section that establishes which evidence would be needed to claim causality. Causal inferences are only drawn if – beyond a match – the evidence gained from tracing the process suggests causality between the independent and the dependent variable.

Process-tracing requires a large amount of empirical data to fully make sense of processes (Checkel, 2005a, pp. 3–4; Checkel, 2008). This thesis relies on the data gathered in 84 semi-structured expert interviews. The interviewees were recruited across all professional and ministerial levels to match the complexity of the negotiation process, which took place on various levels. The interviewees include members of the European Council and finance ministers to cover the political level; European Council sherpas and the deputies of finance minister to cover the top level of civil servants; directors, heads of unit and technical staff in the relevant ministries, central banks and EU institutions to cover the working level. The interviewees were selected from various administrative units to also cover for intragovernmental factions. The interviews were semi-structured. A similar line of inquiry was followed throughout all interviews, but in contrast to fully-structured interviews the interaction remained sufficiently open to allow for situational adjustments. Preferences of the interviewees, such as a particular emphasis on specific sequences, were given ample room and taken up as an analytical statement by itself (Robson, 2011, pp. 278–280). While this procedure carries the risk of getting 'carried away' by the interviewee, it has proven to stimulate the memory of the interviewees and increase the amount of data collected. A weakness of these interviews is the risk of a low validity (Houtkoop-Steenstra, 2000) and potential misrepresentations of the real events (by the interviewee) or of the interviewees' views (by the researcher) (Tansey, 2007, pp. 766–767). This problem cannot be fully solved, but the triangulation with other data and methods should provide for a sufficient safeguard against a potential lack of validity (Tansey, 2007, pp. 766–767). The backbone of the data collection against which interview material can be triangulated is governmental and institutional position papers, manifestos, policy papers, speeches, press statements and media and news agency articles. The salience of the banking union negotiations in the media facilitates the analysis of preferences and negotiation positions. These safeguards should provide for filtering out factual misrepresentations.

The data is gathered for primarily two purposes. The first one is collecting information on 'what happened'. The banking union was negotiated behind closed doors. Obtaining detailed information about the negotiations is difficult if based exclusively on publicly accessible information. The interviews helped overcome informational restrictions in the analysis. The second purpose was to obtain information on the key considerations of actors, i.e. 'why happened what happened'. For instance, to evaluate the importance of rhetorical processes, it was necessary to gather information on how negotiators evaluated the impact of specific arguments in the negotiations. Did they matter for the negotiations? Were they just ignored? Interviews were a suitable method given these goals. This data was analysed with qualitative content analysis in the sense of a 'qualitative data reduction and sense-making effort that takes a volume of qualitative material and attempts to identify core consistencies and meanings' (Patton, 2002, p. 453).

However, the many efforts for the data collection produce another risk: losing sight of the big picture because of the sheer amount of data (Checkel, 2005a, pp. 19–20). To prevent this pitfall of process-tracing, the analysis was confined to the member state governments in Germany, France, Italy, Spain and the Netherlands as well as the relevant EU institutions, i.e. the European Council and Council, the European Commission, European Parliament and European Central Bank. The selection of the above-mentioned five member states and the institutions was guided by two considerations: they were involved in the process to a significant extent, and they represent the main lines of conflict, which were drawn first and foremost between a coalition of Northern European member states and a group of Southern European member states (see section 1.1). The combination of these sources and methods provides a thorough analysis of the events. These data are sufficiently thick to answer the research question and test the main explanatory factors.

The Case Study Selection

The theoretical propositions of liberal intergovernmentalism and the ideational approaches are empirically tested in a 'within-case' research design (Bennett and George, 2005, pp. 178–179; Mahoney, 2007, pp. 131–133). Case studies enable us to identify the causal effects between the variables, which makes them an essential part of theory testing (Achen and Snidal, 1989, pp. 168–169). More specifically, 'within-case comparisons are critical to the viability of small-n analysis' (Collier, 1993), such as the negotiations of the banking union. However, due to the limited number of observations, King, Keohane and Verba warn of their limited ability to draw causal inferences (King *et al.*, 1994, p. 209). To mitigate this problem, this thesis tests the hypotheses separately in each of the seven contentious issues of the negotiations. This creates a reasonable number of observations and takes into account the criteria put forward by King *et al.* (King *et al.*, 1994, pp. 213–217).

The first phase encompasses the Euro Summit in June 2012 and comprises two contentious issues: the agreement on the creation of a mechanism for direct bank recapitalisations as well as of a joint supervisor. Direct recapitalisations were contentious because the sharing of liabilities of bank debt met with resistance of several governments in the eurozone; others considered this pooling of resources indispensable to stabilise the currency union. As the former group of member states insisted on a safeguard against moral hazard, the creation of a joint European supervisor became another contentious issue in the negotiations. While some governments advocated its establishment, another group was more hesitant as it was to go along with a significant loss of sovereignty over a fundamentally important part of the economy.

The second phase of the banking union negotiations centres on the SSM negotiations from September 2012 to April 2013. Two further issues were very contentious during this period: the role of the ECB in the new mechanism, and the scope of the mechanism. Regarding the former, some governments feared a conflict of interest between the ECB's monetary policy and banking supervision. This led to protracted negotiations on the role of the European Central Bank in the new mechanism. Negotiations on the scope of the mechanism reached a similar level of contention, essentially dealing with the question of which banks the eurozone banking supervisor should assume responsibility. While some governments preferred EU supervision only for transnational banks, other wanted all banks to be subject to common oversight. This issue was difficult to settle in the negotiations. It qualifies for the analysis as another contentious issue.

The negotiations on the Single Resolution Mechanism constituted the third phase of the negotiations. They took from June 2013 to April 2014. The negotiations mainly revolved around three contentious issues: bail-ins, a joint fund, and the decision-making rules. The German government insisted on a strong bail-in scheme, i.e. a mandatory involvement of investors in bearing the costs of bank resolutions. Some of their counterparts from other member states and partly the EU institutions feared that this policy could have severe consequences for financial stability. Negotiations on the bail-in rules proved difficult. A pet project of a coalition of Southern European governments was a mutualised resolution fund, but this proposal was met with dismissive responses by the German government. The last contentious issue was finding a compromise on the decision-making rules for bank resolutions. Negotiators held different preferences on the role of member states and EU institutions for initiating a bank resolution. As this question also touches upon the use of mutualised resolution funds, the stakes were high and negotiations protracted.

Table 6: Contentious issues: Within-case analysis

	Contentious because…
Creation of joint supervision	delegates sovereignty to the European level; protects against moral hazard
Direct bank recapitalisations	establishes a shared liability for bank debt
ECB as supervisor	possibly triggers moral hazard
Scope of SSM	shapes the conditions under which banks operate
Bail-in rules	serves as an instrument to protect the taxpayer; can be a source of financial instability
Single Resolution Fund	establishes private transfers between banks in the eurozone; important crisis resolution tool
SRM decision-making	affects the sovereignty of national governments

1.4. Outlook

For each of these contentious issues, concrete observable implications for each of the hypotheses are constructed. They are a precondition for the methodology to be applied consistently. While they will be explained in more depth in the next chapter and the beginning of the respective empirical chapters, the following tables provide the reader with an overview.

The two tables below summarise the observable implications for the hypotheses on the domestic preferences. Table 7 relates to the preference formation in Germany;

Table 8 to the main governments in the coalition of Southern European governments. The cells show which preference we would expect if the respective explanatory factor (as

	Macro-economic preference: fiscal position and trade patterns	**Private material interest: banking sector**	**Ideas: post-Keynesianism**	**Neo-functionalism: crisis pressures**
Joint supervision	In favour	In favour *(France: hesitant)*	In favour	In favour
Direct bank recapitalisations	In favour	In favour	In favour	In favour
ECB as supervisor	In favour	In favour	In favour	Against
All-encompassing scope of SSM	In favour	In favour	In favour	Against
Strong bail-in rules	Against	Against	Against	Against
Mutualised Single Resolution Fund	In favour	In favour	In favour	Against
Veto rights in SRM decision-making	Against	Against	In favour	In favour

specified in the top row) is causal. If, for instance, the fiscal position influences German preferences with regard to joint supervision, we would expect the government to be in favour of it (Table 7, top left cell). Section 2.2 will explain the respective tables in further detail.

Table 7: Outlook: Domestic preference formation, German government

	Macro-economic preference: fiscal position	Macro-economic preference: trade pattern	Private material interest: public banks	Private material interest: private banks	Ideas: ordoliberalism	Neo-functionalism: crisis pressures
Joint supervision	In favour	In favour	Against	In favour	In favour	In favour
Direct bank recapitalisations	Against	In favour	Against	In favour	Against	In favour
ECB as supervisor	Against	In favour	In favour	In favour	Against	Against
All-encompassing scope of SSM	Against	In favour	Against	In favour	Against	Against
Strong bail-in rules	In favour	Against	Against	In favour	In favour	Against
Mutualised Single Resolution Fund	Against	In favour	Against	In favour	Against	Against
Veto rights in SRM decision-making	In favour	Against	Against	Against	In favour	In favour

Table 8: Outlook: Domestic preference formation, Southern coalition

	Macro-economic preference: fiscal position and trade patterns	**Private material interest: banking sector**	**Ideas: post-Keynesianism**	**Neo-functionalism: crisis pressures**
Joint supervision	In favour	In favour *(France: hesitant)*	In favour	In favour
Direct bank recapitalisations	In favour	In favour	In favour	In favour
ECB as supervisor	In favour	In favour	In favour	Against
All-encompassing scope of SSM	In favour	In favour	In favour	Against
Strong bail-in rules	Against	Against	Against	Against
Mutualised Single Resolution Fund	In favour	In favour	In favour	Against
Veto rights in SRM decision-making	Against	Against	In favour	In favour

Table 9 gives an overview of the observable implications for the hypothesis on the interstate negotiations. The main hypotheses are material bargaining power as well as two sets of ideas that provide for a solution frame in rhetorical action. To give another example, for the material bargaining power hypothesis to receive support on the issue of joint supervision, we would expect the negotiators to successfully settle on joint supervision. It would be part of the agreement (Table 9, top left cell). Section 2.3 explains the respective observable implications in greater depth.

Table 9: Outlook: Interstate negotiations

	Power: material bargaining power	Rhetorical action: risk-sharing	Rhetorical action: structural reforms/ risk-reduction
Joint supervision	Part of the agreement	Part of the agreement	Part of the agreement[15]
Direct bank recapitalisations	Not part of the agreement	Part of the agreement	Not part of the agreement
ECB as supervisor	Not part of the agreement	Part of the agreement	Not part of the agreement
All-encompassing scope of SSM	Not part of the agreement	Part of the agreement	Part of the agreement
Strong bail-in rules	Part of the agreement	Not part of the agreement	Part of the agreement
Mutualised Single Resolution Fund	Not part of the agreement	Part of the agreement	Not part of the agreement
Veto rights in SRM decision-making	Part of the agreement	Not part of the agreement	Part of the agreement

The analysis will be further elaborated in the remainder of this thesis. The next chapter explains the theoretical framework of the analysis. It lays out and justifies the theory selection and familiarises the reader with the core concepts. It illuminates the distinctive logics of liberal intergovernmentalism and the ideational approaches, and sets out the hypotheses that can be derived from these two theoretical approaches. The chapter that follows establishes the observable implications, as briefly presented above. This requires a longer discussion of the main explanatory variables: domestic material interests, ideational concepts and paradigms, the distribution of material bargaining power, and the idea of a vicious circle between banks and sovereigns.

The two chapters on the theory and the observable implications together form the theoretical framework. This leads to the second part of the thesis, which comprises the

[15] Strictly speaking, joint supervision is overdetermined as all three approaches suggest that it will come about. In this case, the method of congruence does not provide for a confirmation or disconfirmation of the hypotheses (unless all three can be disconfirmed at the same time). Yet, process tracing can still discriminate between them and confirm one hypothesis while disconfirming the other two hypotheses.

empirical analysis. It is divided into three chapters. Each of them represents a crucial sequence of the process, as identified in the section above on the case selection. Each sequence will be analysed in a separate chapter, devoting particular attention to the seven most contentious issues in the negotiations. The last chapter goes back to the big picture of the banking union negotiations and evaluates the research findings. It revisits the hypotheses that were set out earlier and evaluates the explanatory power of the theoretical approaches underpinning them. These insights are used to highlight possible applications of the framework in other areas of International Relations and European Studies. Finally, the last chapter also provides an outlook concerning the implications of the research findings for the future of EMU and in particular for research on EMU.

Chapter 2: Theoretical Framework

2.1. Introduction

'When every country turned to protect its national private interest,
the world public interest went down the drain,
and with it the private interests of all.'
(Kindleberger, 1973, pp. 290–291)

Kindleberger's famous quote reminds us of one of the main questions in this thesis: how does an actor reconcile several competing interests when forming its preferences? To answer this question, this thesis takes recourse to theories in the field of International Relations. These theories enhance our understanding of a case as multi-faceted as the case of the banking union. This chapter establishes a framework which combines insights from liberal intergovernmentalism with an ideational approach to the formation of domestic preferences and interstate negotiations.

Following the 'cooperation two-step' framework (Legro, 1996), the analysis distinguishes the process of domestic preference formation and the interstate negotiations. While both steps are interrelated, the separation enhances the analytical clarity of the established causal mechanism. A thorough analysis of the formation of domestic preferences illuminates our understanding of the preferences of a government, which is an analytical value as such. In addition, it allows us to draw inferences about its best alternative to a negotiated agreement, a crucial factor for its preference intensity in the interstate negotiations. It helps the analysis of the interstate negotiations, as, once we are certain about a government's preference, we can then analytically distinguish between its ideal point before the negotiations started (the preference) and the eventual outcome of the negotiations. The proximity or distance between the two tells us about concessions a government made in the course of the negotiations. Based on these insights, we can better assess the impact of the explanatory variables, such as material bargaining power or rhetorical action, on the outcome of the negotiations. This analytical process ideally results in a compelling explanation of the case under consideration. Furthermore, it feeds back to the theory which can be evaluated based on the confirmation or rejection of its hypotheses.

The first part of this chapter is devoted to theoretical approaches on the formation of governments' preferences. The main independent variables used in this framework are borrowed from liberal intergovernmentalism and an ideational approach. The former was selected as it is the self-proclaimed 'baseline theory' (Moravcsik and Schimmelfennig, 2009, p. 67) for the grand bargains in European integration (Moravcsik, 1999a). It suggests material interests as the main explanatory variable for domestic preferences. Liberal intergovernmentalism predicts that governments follow the most powerful material interest. The framework in this thesis complements liberal intergovernmentalism with an ideational extension. It addresses the weaknesses of liberal intergovernmentalism in situations where one material interest is not clearly more powerful than competing interests. For these cases, the theoretical framework suggests that governments pursue the material interest which resonates best with the worldviews held by policy-makers (Goldstein and Keohane, 1993, p. 8).

Admittedly, the ideational extension reduces the parsimony of liberal intergovernmentalism to a certain extent; yet, the increase in complexity is modest and the gains in explanatory power significant. This applies in particular to a case as complex as the banking union, which potentially touches on a wide range of interests. The interplay of both approaches falls within the category of domain-of-application approaches (Jupille *et al.*, 2003, pp. 21–22). The scope condition is the fragmentation of (equally powerful) material interests. It determines whether material interests as such explain the outcome, or whether worldviews influence and settle the selection between competing interests. If material interests are aligned or if there is a clearly more powerful material interest, we expect the preference of the government to be aligned to this material interest (in line with liberal intergovernmentalism). Conversely, if material interests are diverse and equally powerful, liberal intergovernmentalism as such does not result in a clear prediction. We would expect worldviews to be important: they would tip the balance between the competing interests. The government would pursue the material interest which resonates best with the worldviews held by officials.

Alternatively, crisis pressures could determine the behaviour of governments. As the banking union was initiated in the midst of a fundamental crisis in the currency union, one could expect that these pressures were the driver behind the process. Therefore, this framework includes the neo-functionalist approach to cover possible alternative explanations.

The second part of this chapter establishes a theoretical framework for the interstate negotiations. The baseline theory of liberal intergovernmentalism deploys an intergovernmental bargaining theory to account for the outcome of interstate negotiations. It predicts that the outcome corresponds to the preferences of the government with the highest material bargaining power. However, ideational scholars have shown that rhetoric and the use of arguments can influence negotiations in a number of ways (Risse, 2000; Lewis, 2005; Puetter, 2012; Schimmelfennig, 2001; Krebs and Jackson, 2007). It is part and parcel of all negotiations. To account for its impact, the second approach in the framework is rhetorical action (Schimmelfennig, 2001; Krebs and Jackson, 2007). It assumes that actors use rhetoric strategically to gain an advantage in negotiations. They try to corner their opponents and deprive them of effective means of rebuttal. Actors who can drag the negotiations to a beneficial rhetorical terrain *and* win the causal argument have a distinct advantage in negotiations.

This chapter will first introduce the framework for domestic preferences. This is followed by the section on the interstate negotiations. In each of these two sections, the logics and assumptions of each approach are explained. This will lead over to the formulation of specific hypotheses. This prepares the specification of observable implications in the following chapter.

2.2. Domestic Preference Formation

A Liberal Intergovernmentalist Account

Liberal intergovernmentalism considers individuals and private groups the fundamental actors in international politics (Moravcsik, 1997, pp. 516–517). They are rational gain-maximisers and promote differentiated interests (Moravcsik, 1999a, pp. 19–24). The state is the 'transmission belt' (Moravcsik, 1997, p. 518) between the domestic and the international level (Moravcsik, 1999a, p. 22). Henceforth, Moravcsik contends that

> 'European integration resulted from a series of rational choices made by national leaders who consistently pursued economic interests – primarily the commercial interests of powerful economic producers and secondarily the macro-economic preferences of ruling governmental coalitions.' (Moravcsik, 1999a, p. 3)

The main explanatory variable for the formation of domestic preferences[16] is material interests, divided into commercial interests (i.e. interest group pressure) on the one hand and macro-economic preferences on the other.

With regard to the former, Moravcsik 'assume[s] throughout that domestic producers influence policy' (Moravcsik, 1999a, p. 36). The impact of commercial interests is issue-specific and particularly strong in all trade-related policy-areas (Moravcsik, 1999a, p. 24). Notably, liberal intergovernmentalism assumes that producers as the most powerful domestic interest group pressure the government in devising policies; in contrast to a purely economic explanation, economic gains on the aggregate level are less important (Moravcsik, 1999a, pp. 38–41). For the sake of parsimony, the interests of producers are represented by their umbrella organisations (Moravcsik, 1999a, p. 36). In situations with competing interests, Moravcsik assumes that the government will follow the most powerful domestic interest group in order to secure the highest possible support for re-election. The influence of the various groups is 'weighted only by their size and the intensity of gains and losses' (Moravcsik, 1999a, p. 36), but overall the framework 'abstracts away from complex sectoral splits' (Moravcsik, 1999a, p. 36). Applying this to the case under consideration, the relevant interest groups in the EU banking union negotiations are first and foremost banking associations. They can reasonably be assumed to mobilise because the supervision and resolution arrangements bear massive ramifications for their business environment for years if not decades to come.

The extent to which the government can follow interest-groups is constrained by demands for regulatory protection, economic efficiency and fiscal responsibility (Moravcsik, 1999a, pp. 36–37). Moravcsik analyses the structure of the industry as well as perceptions of domestic actors and political cleavages to derive the macro-economic preferences that prevail in the government (Moravcsik, 1999a, pp. 41–49). As he points out, these fiscal considerations are particularly strong in all matters related to exchange-rate coordination for which 'specific macroeconomic goals are more important, relative

[16] State preferences are defined as 'a set of fundamental interests defined across "states of the world"' (Moravcsik, 1997, p. 519; see also Moravcsik, 1999a, p. 20).

to direct commercial interests' (Moravcsik, 1999a, p. 43). The banking union clearly does have a fiscal policy dimension. Bank resolution funds – even if financed by contributions from banks – are in practice often insufficient to cover bank losses. Most resolution systems link them to a fiscal backstop, i.e. an insurance provided by the state to step in, if needed. In many resolution systems, the resolution authorities are even explicitly linked to a so-called fiscal backstop which can be activated in the event of the resolution fund running out of money. Therefore, a banking union can potentially result in large fiscal liabilities and create a fiscal union through the backdoor.

Yet, the fiscal position of governments is not the only macro-economic factor that can impact on preferences. In Moravcsik's framework, trade interdependence is another prominent source for macro-economic preferences (Moravcsik, 1999a, p. 42). Trade patterns are important as they critically influence the cost-benefit balance of European integration. As Moravcsik recognises throughout his analysis, trade has been one of the key drivers of European integration. For the banking union, a trade dimension is apparent. The banking sector is critical for almost all economic activity, in particular as European businesses are heavily reliant on bank lending through the allocation of savings on credit markets (Krahnen, 2013; Gros, 2013c). Lending levels affect investment, supply and demand. Supervision and in particular resolution systems determine the extent to which financial crises can spill over to other sectors of the economy. Given that the euro crisis affected trade activity between countries significantly – and in the event of euro break-up even fundamentally – trade patterns are in this framework taken as a second source for macro-economic preferences.

Against the background of this ambivalent nature of the banking union, the theory framework tests for material interests derived from domestic interest groups as well as macro-economic preferences. It does not include geopolitical interests. While they form part of liberal intergovernmentalism, their scope is limited to questions revolving around the security implications of integration (Moravcsik, 1999a, p. 26). Considering the limited security dimension of the banking union, the variable is not of utmost importance for the case under consideration. It is not taken up further in the remainder of the thesis.

Liberal intergovernmentalism leads to the following hypothesis on the domestic preference formation:

Hypothesis 1a:

> *The preferences of governments are determined by banks and businesses as the most powerful domestic interest groups.*

Hypothesis 1b:

> *The preferences of governments are determined by the macro-economic preferences of the ruling governmental coalition.*

The Fragmentation of Interests

We expect liberal intergovernmentalism to predict domestic preferences most successfully if there are clearly defined commercial and macro-economic interests within a country. The government is likely to act in line with these societal interests to increase its chances of re-election. The hypothesis can be tested through the method of congruence by comparing the most powerful domestic interests with the government's preference, and process-tracing. More problematic are cases with a large diversity of preferences. If the government needs to satisfy many competing interests, it is difficult to establish a testable hypothesis. Liberal intergovernmentalism predicts the government would follow the most powerful material interest, but this does not solve situations with by and large equally powerful material interests. If these interest groups advocate different courses of action, liberal intergovernmentalism risks becoming untestable. It is not possible to make a clear prediction which interest group influences the government.

The diversity of interests can have different sources. Game theorists have already demonstrated the impact of uncertainty on the evaluation of different courses of action. The Folk theorem describes repeated games in which there is incomplete information. The information deficits constrain actors in their calculation of the costs and benefits of different courses of action. Without being fully certain about the payoff-matrix, the utility calculations of actors may suggest various policies as equally rational (Friedman, 1971; Fudenberg and Maskin, 1986). The problem of incomplete information weighs in even more heavily if there is much interdependence among actors. The policies of other governments come in as another influence on the utility function, but anticipating, let alone steering their policies is difficult.

Situations as described in the Folk theorem have much relevance for governments, in the present as well as historically. Charles Kindleberger analysed trade policies in the Great Depression in a seminal study (Kindleberger, 1973). In the midst of a recession, governments had two choices: they could keep trade afloat or protect their domestic producers. They eventually adopted protectionist policies and imposed barriers to imports from other states. Yet, other governments swiftly adjusted and started to ban imports as well. The result of the seemingly rational decision to protect domestic producers was the breakdown of international trade. Eventually, each government ended up worse-off than with open trade policies: 'When every country turned to protect its national private interest, the world public interest went down the drain, and with it the private interests of all' (Kindleberger, 1973, pp. 290–291).

Governments in the eurozone are caught in a similar dilemma, especially the economically strong countries. On the one hand, it is a rational policy to shift the crisis costs to the economically weak countries. Possibly, shifting adjustment costs could be successful and lead to a sustainable EMU membership of the South at (almost) no costs for Germany. In a much less favourable but equally plausible scenario, put-your-own-house-in-order policies fail to gain traction in the periphery. In this scenario, the opportunity to put EMU on a stable footing with at least some transfers is wasted and leads to permanent instability, possibly even the break-up of the currency area. Given that it is well established in the economic literature that currency areas cannot survive without a minimum of risk-sharing across borders (Asdrubali *et al.*, 1996), the strategy of the economically strong countries to shift adjustment costs could then be captured as an attempt to square the circle, which failed. Just as during the Great Depression the rational attempt to shift crisis costs to other states led to the breakdown of international trade and caused much higher costs, the attempt to shift crisis costs to other EMU states carries a real risk of leading to the break-up of the single currency.

Yet, it is not clear either whether a more permissive policy towards risk-sharing and transfers within the euro area would yield the expected results in terms of stabilising EMU. In a positive scenario, they would ensure the long-term viability of the currency union (Farhi and Werning, 2017). In a much less favourable scenario, they trigger moral hazard, delay structural reforms and overburden economically stable member states (Sinn, 2014). Different strategies can have very different consequences for member states, but uncertainty obscures which of these scenarios eventually materialises. Deep uncertainty clouded the calculation of costs and benefits.

To add further to the complexity, it is not only macro-economic preferences that can be diverse, but also the interests of the domestic industry. Typically, inward-looking industries are likely to hold different views on liberalisation than export industries (Moravcsik, 1999a, pp. 38–39). Banking sectors have internationalised in Europe over the last two decades, but the speed of internationalisation has varied by country (Epstein and Rhodes, 2014; Lombardi and Moschella, 2016). Some countries are home to a significant number of traditional as well as of internationalised banks. This can lead to potentially contradicting preferences within the sector and makes it more difficult to identify a collective preference. This diversity of material interests has ramifications for the testability of liberal intergovernmentalism. Against the background of its weakness to predict preferences in situations with more than one rational interest, a complementary approach is introduced: ideas as worldviews.

Ideas as Worldviews

The literature suggests that the ideas held by policy-makers can influence their actions. One strand suggests that ideas can influence policies when they take the shape of worldviews (Goldstein and Keohane, 1993, p. 8). Worldviews are intertwined with the identities of people and their perspective of the world at a very general level (Goldstein and Keohane, 1993, p. 8). Worldviews act at a 'deep' level. Policy-makers rarely choose whether they are guided by a worldview or not. They are deeply embedded and often internalised. Often they are passed on from one generation to the next – but subject to change in a crisis situation, as Schmidt emphasises (Schmidt, 2008, p. 306). While they can change, they rarely do change in practice (Goldstein and Keohane, 1993).

Worldviews constrain actors because they exclude certain interpretations of the material facts or at least make them appear not worthy of further consideration. Worldviews underpin policies and programmes. They 'generally sit in the background as underlying assumptions that are rarely contested' (Schmidt, 2008, p. 306). If a suggested policy fundamentally contradicts the worldview of a policy official, it is unlikely that this policy will be pursued further.

Worldviews can help to solve the dilemma that comes with potentially fragmented material interests. As in a Folk theorem situation at least two strategies offer broadly the same payoff, the expected utility does not cause a preference for one strategy over another, equally rational one. Worldviews can in these situations guide actors to one specific strategy. As specified above, worldviews can lead actors to consider certain ideas more plausible than others. They provide 'predispositions that lead actors to notice certain things and to neglect others' (Jervis, 1976, p. 198; see also Rose, 1998). These ideas provide information which put more weight on some material facts than others and one of the available solutions appears more favourable then the alternatives. They influence what policy-makers view as the best solution among several rational courses of action. Ingrained worldviews can help to predict which course of action governments are likely to consider the most rational choice to pursue.[17]

On a conceptual level, the literature distinguishes two types of ideas. Causal ideas (Goldstein and Keohane, 1993, p. 10), by some also referred to as cognitive ideas (Schmidt, 2008, p. 306), make claims about cause and effect relationships. They reduce uncertainty by providing a road map that guides policy-makers to a better understanding of the situation. It helps them to figure out how to attain a specific objective more efficiently (Goldstein and Keohane, 1993, pp. 12–13). The second type of beliefs are normative ideas (Schmidt, 2008, p. 306), synonymously called principled ideas by Goldstein and Keohane (1993, p. 9). Their claims are value-based. They translate more abstract ideas into concrete policy choices. Normative ideas likewise reduce uncertainty and guide policy-makers by providing them with the goals to be attained (Goldstein and Keohane, 1993, p. 9). Both types of ideas operate at three levels of generality: public philosophies, programmes, and policies. Public philosophies, which operate at the most general level, contain worldviews with 'general principles of knowledge and society' (Schmidt, 2008, p. 306). Policy-makers have internalised them and rarely contest them (Schmidt, 2008, p. 306). Programmes work at a more specific level of ideas. For instance, programmatic paradigms that provide the general principles of policies fall into this realm. They define problems and set out the goals, methods and instruments of policies (Schmidt, 2008, p. 306). The most specific level of ideas is policies. They are underpinned

[17] To be clear, a Folk theorem situation is a necessary condition for worldviews to influence preferences. If there is either no fragmentation or if one interest is clearly more powerful than competing ones, ideas cannot tip the balance. In such a case, policy-makers are not caught in-between competing and equally rational options; they obtain clear guidance on what to do from the most powerful interest. That is, liberal intergovernmentalism is correct.

by broader worldviews and programmatic beliefs and lay out concrete solutions to problems (Schmidt, 2008, p. 306). Programmatic beliefs and policies and the relevant levels for this thesis. At these two levels, ideas vary between the two coalitions and potentially explain differences in their preferences.

Ideas do not influence policies merely because 'they exist'. Ideas are 'introduced' (Hall, 1989a, p. 367) or 'inserted' (Sikkink, 1991, p. 252) into the policy process by 'carriers' (Goldstein, 1993, p. 14). These carriers can be 'individuals or groups capable of persuading others to reconsider the ways they think and act' (Berman, 2013, p. 228; see also Blyth, 2002; Checkel, 1997). They act as 'advocates for proposals or for the prominence of an idea' (Kingdon, 1984, p. 122; see also Schneider and Teske, 1992, p. 737). They take recourse to an idea to provide a compelling problem-definition and develop the problem-solving capacity of an idea. The literature assumes that these carriers of ideas are recognised experts in the subject matter at stake and skilled in political engineering. They persist in the political arena for a longer time period and are able to wait for windows of opportunity to open (Kingdon, 1984, pp. 189–190; Mintrom and Norman, 2009, pp. 651–654). The concept has subsequently been applied not only to individuals but also institutions. A frequent policy entrepreneur in the field of EU politics is the European Commission (Moravcsik, 1999b, pp. 292–298; Majone, 1996, pp. 74–78; Pollack, 1997, p. 121; Copeland, 2014; Jabko, 2006, p. 43) but also the European Central Bank (De Rynck, 2016, pp. 129–131).

In EMU policy-making, an obvious carrier of beliefs is policy-makers in the national ministries as well as EU institutions. The literature has demonstrated that state administrations are more than a transmission belt (1986, p. 232). The institutional configuration of the state influences the impact of economic ideas. Institutional biases within the state condition its response to the economic ideas in a given field (Hall, 1989, p. 11). Hall identifies the different beliefs held by state bureaucracies as one of the crucial factor to explain why Keynesianism spread in some countries but not others (Hall 1989b, 11–12). National ministries and EU institutions are the breeding ground where policy-makers are exposed to institutionalised worldviews. Worldviews are often institutionalised in ministries and reproduced through effects of socialisation (Checkel, 2005b; Beyers, 2005; Lewis, 2005). They are part of the institutional culture, diffuse within an administrative unit and are collectively adhered to. These worldviews shape policies and resolve issues at stake because policy-makers are used to rely on them semi-automatically (Checkel, 2005b, pp. 812–813). Semi-automaticity implies that the causal claims of these worldviews are accepted without closer scrutiny to their validity. They 'specify policy in the absence of innovation' (Goldstein and Keohane, 1993, pp. 12–13). Things are done because 'that is how we do things here' or because 'that's the normal way of doing it'. An idea that is embedded in institutions can be disconnected from the original cause why it was adopted. Worldviews are not necessarily linked to powerful interests. Ideas that were promoted within institutions as a response to powerful interests are often still embedded after the material interests have vanished or changed (Goldstein and Keohane, 1993, p. 21). However, it is rarely seen that worldviews oppose strong economic interests or, more broadly, interests which the government needs to accommodate to ensure re-election (Hall, 1989, p. 12). More likely, worldviews shape the evaluation by policy-makers when faced with equally rational solutions. In these situations, policy-makers are likely to prefer the policy which resonates with the worldviews they hold.

With ideas being internalised, there is a certain proximity between this strand of ideational approaches and historical institutionalist explanations. When ideas are internalised, they are taken for granted and often reproduced in institutions through effects of socialisation (Beyers, 2005; Hooghe, 2005; Checkel, 2005; Allen, 1989). Thus, once internalised, institutions are likely to follow a particular path. This matches the notion of path dependency which plays a prominent role in historical institutionalist thinking (Pierson, 1996; Pierson, 2000). While making explicit the path dependency of internalised ideas helps our understanding of the ideational dynamics, this thesis maintains an ideational framework (instead of a historical institutionalist one) as the path dependent mechanism is ideational, after all – internalised ordoliberal ideas cause a certain path dependency.

The literature specifies several general scope conditions for ideational approaches. Following these scope conditions, it can be predicted under which conditions ideas exert an influence on policies. Arguably, the most prominent scope condition for ideational approaches is uncertainty (Goldstein and Keohane, 1993, p. 13; Puetter, 2012, p. 165). If negotiations are surrounded by uncertainty, actors face difficulties to calculate the costs and benefits of their actions. While they can make reasoned guesses which action would maximise gains most effectively, they are eventually left in the dark about the likely outcome of their actions. To make sense of these situations despite the lack of information, actors are likely to resort to ideas. Ideas can be the devices which fill the gaps in the knowledge of actors; they can either provide knowledge about the likely causal links (through causal ideas) or specify what is desirable to attain (normative ideas) (Goldstein and Keohane, 1993, pp. 9–10).

A second scope condition for ideas is the existence of a crisis situation (Goldstein and Keohane, 1993, p. 13). Crises create an openness for new policies. They induce policy-makers to consult ideas for informational benefits (Goldstein and Keohane, 1993, p. 13). The urgency of the situation forces policy-makers to act. At the same time, crises are often characterised by informational constraints. Therefore, in a crisis situation, actors are inclined to resort to ideas to find guidance on courses of actions. Crises are often preceded by policy-failures. These policy failures create the demand for new policies. As a result, actors will be more open to critically evaluate and adjust their policies. In this process, ideas are likely to influence if not guide their considerations (Hall 1993, 280).

Actors are furthermore likely to resort to ideas in cognitively complex negotiations (Niemann, 2006, p. 473). If solutions cannot be taken 'off the shelf' (Blyth, 2002, p. 36), but need to be developed, ideas can facilitate the work on a solution as they provide input on these cognitively complex issues. Actors are likely to consider the causal and normative claims that specify how to approach such a topic (Niemann, 2006; Goldstein and Keohane, 1993, pp. 9–10).[18] The empirical part of the dissertation will test the validity of these scope conditions.

The literature does not cover in great depth the qualities of ideas which make them influential in politics[19] (Mehta, 2011, p. 26). Hall's framework for the impact of ideas on economic policies predicts that ideas influence policies if they have policy, administrative

[18] Further scope conditions that were met are intense and sustained contact among policy-makers (Beyers, 2005, p. 911; Checkel, 2005b, pp. 10–11; Lewis, 2005, pp. 945–948; Puetter, 2012, p. 165) and a negotiation setting insulated from the public (Lewis, 2005, pp. 945–948; Checkel, 2005b, p. 813; Niemann, 2006, p. 473).

[19] Some studies carve out the conditions for an idea to matter. According to Kingdon, an idea is adopted if the three different 'streams' policies, politics and problems favour its adoption (Kingdon, 1984). Katzenstein and his contributors emphasise national traditions and identities as filters of ideas (Katzenstein, 1996), Rich finds expertise important (Rich, 2004), and according to Cox, the time dimension determines the success of an idea (Cox, 2004). However, Hirschman argues that the diffusion of ideas varies significantly on a case-by-case basis and that attempts to generalise have widely failed (Hirschman, 1989, p. 351). This view is shared by Schmidt, who draws an equally devastative conclusion on the predictability of the success of ideas (Schmidt, 2008, p. 308).

and political viability (Hall, 1989a, p. 371). The policy viability describes the capacity of an idea to identify and define a problem and provide a solution. Such an idea 'enable[s] national leaders to chart a course through turbulent economic times, and ideas about what is efficient, expedient, and just (…) motivate the movement from one line of policy to another' (Hall, 1989a, p. 361). Defining the problem is critical for the selection of policy solutions. Diagnoses of the problem specify the requirements that a policy has to satisfy to solve a problem effectively. It narrows down the number of suitable policy options (Mehta, 2011, pp. 32–33). Once a problem is diagnosed, ideas as policy solutions provide actors with a policy choice (Mehta, 2011, pp. 28–32).[20]

The administrative viability of an idea is determined by whether or not it resonates with internalised beliefs and administrative cultures[21] (Hall, 1989a, p. 371; Goldstein and Keohane, 1993, p. 20). Administrations regulate to what extent policy-makers are exposed to ideas (Hall, 1989b, pp. 11–12). If ideas are internalised (Checkel, 2005b, pp. 812–813), their policy claims are adopted semi-automatically. They are deemed appropriate in a specific institutional environment due to their fit to pre-existing beliefs (March and Olsen, 1998, pp. 951–952).[22] For an idea to have an impact, it needs to convince bureaucracies.

[20] Several studies have demonstrated the importance of policy viability for ideas to have an impact. Parsons analyses the French government's preferences towards European integration and concludes that ideas explain their preferences better than interests do (Parsons, 2002). Kienzle argues that the causal and normative claims of ideas influenced the policies in the EU's Common Foreign and Security Policy in situations of deep uncertainty (Kienzle, 2013). In EMU, McNamara explains the creation of the euro as the result of ideational convergence among the eurozone member states based on the German stability culture. Hence the policy viability of this set of ideas contributed significantly to the creation of EMU (McNamara, 1998). Quaglia strengthens the case for ideas and their impact on policies by arguing that Italy's preference towards joining EMU was strongly underpinned by causal and normative beliefs promoting Europe as a viable solution to domestic problems (Quaglia, 2004).

[21] Administrations may even form an epistemic community that shares a particular set of normative and causal beliefs to advance a particular policy (Haas, 1992, p. 3). Epistemic communities are defined as a 'network of professionals with recognized expertise and competence in a particular domain and an authoritative claim to policy-relevant knowledge within that domain or issue area' (Haas, 1992, p. 3).

[22] There is a vast literature that focuses on the administrative viability of ideas. In Haas' edited volume in the journal International Organization, several authors apply the concept of epistemic communities to a wide range of case studies from trade via nuclear arms control to climate change negotiations (Haas, 1992). Drezner analyses the impact of embedded ideas on US foreign policy (Drezner, 2000). Chwieroth analyses the role of institutional culture for policies of the International Monetary Fund (Chwieroth, 2010). In the field of EU politics, Howorth finds that epistemic communities have a much higher explanatory value than interest-based accounts in analysis of the European Security and Defence Policy (Howorth, 2004). In the area of EMU, Heipertz and Verdun assess epistemic communities as crucial for the outcome of negotiations on the Stability and Growth Pact (Heipertz and Verdun, 2010). De Ville and Berckvens argue that German economists form an epistemic community being an outlier compared to economists in other eurozone member states (De Ville and Berckvens, 2015).

The political viability of an idea encompasses whether an idea is suitable to help governments for re-election (Hall, 1989b, p. 12). Governments need to secure political support for their policies; this requirement influences which ideas they consider suitable to help them in this endeavour[23] (Hall, 1989b, pp. 12–13; Hall, 1986, p. 275). This limits the choice of ideas to those that appear rational for the government to pursue. This condition is compatible with the causal mechanism of ideas as worldviews. They do not prompt governments to act against their interest, but guide them to maximise efficiency. These insights allow us to derive a hypothesis on the impact of ideas:

Hypothesis 2:

> *In situations with several equally powerful material interests, the preferences of governments are determined by the worldviews held by policy-makers.*

The following chapter discusses in greater depth which specific ideas meet the established criteria and are likely to be internalised worldviews. For an initial overview, the sets of ideas considered as worldviews with a potential impact on policies are ordoliberalism for the Northern coalition and post-Keynesianism for the Southern coalition. Ordoliberalism relates to a set of ideas which builds on a long history in Germany. It centres on the core claim to realign control and liability. While ordoliberalism is largely confined to Germany, it shares many of its core claims with neoliberal beliefs (see section 3.2). Therefore, very similar neoliberal ideas could potentially explain the preferences of the other countries in the Northern coalition. The worldview potentially held by officials in the Southern European coalition is post-Keynesianism. It has influenced policies of monetary integration at several instances over the course of history. It suggests first and foremost a far-reaching liability-sharing as a means to increase the resilience of European states against financial markets.

[23] Multiple studies in the field emphasise the importance of the political viability of an idea. For instance, Béland argues that ideas only diffuse in the international arena and affect policies if they are promoted by powerful states (Béland, 2009, pp. 707–708). Gamble analyses the rise of Thatcherism and argues that the ideational content of Thatcherism was strategically chosen in order to secure the return to power for the Conservative Party in Britain (Gamble, 1994, p. 4). Schimmelfennig explains the EU's 2004 enlargement with a 'rhetorical entrapment' based on a public commitment to democracy and human rights as the EU's founding principles that led to unanimous agreement on the Eastern enlargement (Schimmelfennig, 2001). Jabko argues that the European Commission and other powerful actors played 'the market' as constraint on fiscal spending in order to reassure member states to process to a single currency (Jabko, 2006).

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Besides interests and ideas, the theoretical framework will include the neo-functionalist approach. As the banking union was created in the midst of a fundamental crisis, neo-functional approaches would be one of the more obvious approaches to be used for an explanation and a strong contender to an interest-based or ideational framework. Considering the circumstances of the banking union, neo-functionalism can help our understanding of the banking union by making sense of the material crisis pressures that accompanied its creation. For neo-functionalists, integration is driven by (mainly) functional spill-overs. Governments can only achieve an original objective by taking further integration steps (Haas, 1958, p. 297). As a result of the interdependence of policy and issue areas, integration in one area leads to integration in another area (Lindberg and Scheingold, 1970, p. 117). With the apparent incompleteness of the currency union, which consists of a centralized monetary policy, but decentralised fiscal, financial and economic policies, the environment seems to be 'a fertile breeding ground for neo-functionalist spillover pressures' (Niemann and Ioannou, 2015, p. 197). Neo-functionalists would stress that the crisis pressures revealed the institutional weaknesses of the currency union. As a result, they would predict a spill-over from a common monetary policy to a common fiscal, economic and/or financial policy. In this regard, the creation of the banking union would be the result of the crisis pressures originating from EMU's incomplete institutional design. If these pressures drive the preferences of governments, we would expect the German government to advocate more integration in EMU to respond to the crisis pressures. As a result of these pressures, a fully-fledged EMU would at some point come about (Niemann and Ioannou, 2015). The empirical analysis will test if neo-functionalism can provide an explanation of the creation of banking union as an important milestone on the way to a fully-fledged EMU.

Hypothesis 3:

> *Under severe crisis pressures, governments will have a strong preference for a fully-fledged banking union. In the absence of crisis pressures, government will block any steps towards a fully-fledged banking union.*

2.3. The Interstate Negotiations

Liberal Intergovernmentalism: Material Bargaining Power

Liberal intergovernmentalism incorporates an intergovernmental bargaining theory for the analysis of interstate negotiations. It predicts the outcome of negotiations to 'reflect the relative power of states – more precisely, patterns of asymmetrical interdependence' (Moravcsik, 1999a, p. 3; see also Keohane and Nye, 1989). The higher the value a government places on an agreement, the higher its preference intensity and the lower its bargaining power, and vice versa (Moravcsik, 1999a, p. 62; see also Warntjen, 2010, pp. 667–668; Tallberg, 2008, p. 692; Odell, 2010, p. 622; Zartman and Rubin, 2002). The value of unilateral alternatives or alternative coalitions influences the power of a government. The more favourable the best alternative to a negotiated agreement (BATNA), the higher a government's bargaining power (Fisher and Ury, 1983). Opportunities for issue-linkages or longer time horizons are further factors that determine the bargaining power of an actor in negotiations (Moravcsik, 1993, pp. 63–66; Warntjen, 2010, pp. 667–668).

Several factors contribute to an actor's bargaining power. According to Tallberg, the key determinant is 'a state's total amount of resources and capabilities – its territory, population, economic strength, military capabilities, technological development, political stability and administrative capacity' (Tallberg, 2008, pp. 688–689; see also Bailer, 2010, p. 746). While these factors give a rough idea of a country's bargaining power, its issue-specific resources provide for a more sensible assessment in light of the case under consideration (Moravcsik, 1999a, p. 8; Tallberg, 2008, p. 692; Habeeb, 2002, p. 83). In the issue area of economic and monetary policies, we would expect the financial resources to be an important determinant of bargaining power. A country with considerable financial resources is likely to be powerful in determining the conditions of agreements that entail some form of financial assistance. The availability of financial resources is contingent on the size of the economy, economic growth and fiscal surpluses. The trust markets put in a state as evidenced by a high credit rating and low interest rates for sovereign bonds signals the financial solidity of a country to its peers at the negotiation table. Countries that perform strongly on these indicators are more credible in signalling that they have better alternatives to a negotiated agreement (Bulmer, 2014, pp. 1252–1253; see also Schimmelfennig, 2015, pp. 184–185; Beach, 2013).[24]

Liberal intergovernmentalism suggests that the most powerful member states will get the upper hand in negotiations. The most powerful member state in the banking union negotiations was Germany. As the following chapter will discuss in significantly more depth, the German government was superior in both the aggregate and issue-specific power in the negotiations. It has the biggest GDP and population in the eurozone. Its sound fiscal position provides it with vast fiscal space for assistance measures. Exceptionally low sovereign bond interest rates and triple A credit ratings signal trust from financial markets. The power-based liberal intergovernmentalist hypothesis is as follows:

Hypothesis 4:

> *The outcome of the negotiations corresponds to the preferences of the government with the highest material bargaining power.*

Rhetorical Action

Liberal intergovernmentalism predicts that the outcome of negotiations corresponds to the preferences of the most powerful member state. It is disconfirmed if weak member states punch significantly above their weight and force their more powerful counterparts to make painful concessions. An explanation for how an outcome with significant concessions could come about is rhetorical action. Arguments are commonly considered a 'weapon of the weak' (Krebs and Jackson, 2007, p. 38; see also Blyth, 2002, p. 39). As a long track-record proves the impact of arguments in EU negotiations (Risse, 2000; Risse and Kleine, 2010; Schimmelfennig, 2001; Lewis, 2005), the theoretical framework includes an approach which accounts for the possible effect of rhetorical action.

A prominent approach to make sense of the impact of ideas and arguments in negotiations is persuasion. When actors 'argue' (Risse, 2000) or engage in a 'genuine

[24] Furthermore, examples for institutional power resources are voting rights (Bailer, 2010, p. 746; Tallberg, 2008, p. 694), the agenda-setting capacity (Bailer, 2010, p. 746), the monopoly to propose amendments (Warntjen, 2010, p. 668) and domestic constraints such as restrictive mandates of domestic institutions (Warntjen, 2010, p. 668).

debate' (Niemann, 2006), they try to do the 'right thing' (Risse, 2000, p. 9), are open to be persuaded by the better argument and seek to agree on a reasoned consensus. However, actors do not always know or even agree what the 'right thing' actually is. They question the validity claims of statements, assessments of situations and relevant rules and norms. As a result, they engage in a truth-seeking discourse with the objective of reaching a common interpretation of the situation among the actors and of achieving a reasoned consensus on their understanding of the situation and what the 'right thing' is. Actors are goal-oriented, however, the goal is not maximising utility, but reaching a reasoned consensus (Risse and Kleine, 2010, p. 711; Risse, 2000). The 'better argument' is more important than material bargaining power which recedes in the background (Risse, 2000, p. 9).

A second strand of the literature on arguments and rhetoric has focused on the use of manipulative rhetoric. Actors do not seek a reasoned consensus, but to maximise gains through rhetoric. In manipulative rhetoric, governments attempt to silence their opponents and deprive them of the means to contest a particular preference. Powerful causal ideas can become strategically used 'weapons' (Blyth, 2002, p. 39) to win the causal argument. Actors back up their own preferences and attempt to undermine the validity of their opponent's rhetorical justifications. The use of arguments is effective when actors have 'talked [their opponents] into a corner, compelled to endorse a stance they would otherwise reject' (Krebs and Jackson, 2007, p. 36). Their rhetoric is only successful if it is plausible in the judgment of a particular audience and its social context (Laffey and Weldes, 1997; Dryzek, 2010, p. 322). The history of a situation or past experiences influence the judgment of the negotiators. Rhetoric takes place within an environment which negotiators rarely are free to choose. In an environment like the EU, tabling an unrealistic and/or unsuitable solution and attempting to force other parties to debate its merits would be viewed as a hostile action and likely fall through with the audience (Lewis, 2009, pp. 174–176; Schimmelfennig, 2003, p. 220). This partly crosses roads with some rationalists who have put emphasis on 'audience costs' (Fearon, 1994). Yet, in these interstate negotiations, which take close behind closed doors, the audience is not composed of the broad public, but of the negotiators and their administrative and political support structures 'at home'. It is mainly heads of state or governments, ministers, sherpas and high-level negotiators involved in the negotiations who assess arguments and attempt to deploy counter-arguments.

Once governments have put forward arguments and justified their preferences with a certain set of ideas, they are identified with these ideas and expected by their counterparts to be consistent (Schimmelfennig, 2000, p. 119). Alternatives to consistency are costly and thus no viable option. Undoing previous agreements or revoking previous positions will do harm to the standing and reputation of actors (Schimmelfennig, 2001, p. 65). Non-compliance leads to punishment by the audience. Recrafting the terms of the debate is resource and time-consuming and not always possible (Krebs and Jackson, 2007, p. 45). As rational actors, governments aim to avoiding these costs. They acknowledge the need to be consistent, even though their previously used arguments may have manoeuvred them into a weak position.

In previous analyses of the rhetorical power of ideas, actors were constrained by the broader public's perception of what is legitimate. Contestation of problems and solutions then takes place through processes of silencing, shaming or stigmatizing (Adler-Nissen, 2014, p. 152; Krebs and Jackson, 2007, pp. 43–45; Schimmelfennig, 2003, p. 219). However, the banking union negotiations were highly technical elite negotiations that took place behind closed doors among politicians and civil servants. In these environments, the audience consists of the other people in the room. Naturally, there is a domestic side to the negotiations in terms of each party being constrained by what can be sold domestically, but in the actual negotiations, the constraining factor is policy credibility amongst insiders. This is termed 'technical feasibility', defined as a situation where 'policy makers believe that a proposal will work if enacted' (Kingdon, 1984, pp. 131–132).

It follows that the effectiveness of rhetoric depends on two distinct steps. First, actors gain a distinct advantage if they manage to shift the terrain where the causal argument takes place. The frames of reference in negotiations make some arguments appear stronger than others. Actors engage in framing contests to bring negotiations onto such a favourable terrain (Krebs and Jackson, 2007, p. 38). Changing the frame of reference of a debate into a favourable direction will reflect positively on the rhetorical strength of the own arguments and weaken the opponent's argument. Typical determinants of the terrain are previous agreements or a collectively accepted problem definition (problem frame), given that almost all negotiations process through a problem and solution stage (Krebs and Jackson, 2007, pp. 43–46). Establishing a particular definition of the problem (the problem frame) is likely to influence the evaluation of possible solutions (solution frame) – as different problems require different solutions (Krebs and Jackson, 2007). If actors agree on a shared goal, the new frame of reference shifts the negotiations onto a different terrain: arguments are measured as to whether they are consistent with this goal. Rhetoric in negotiations serves to expose these inconsistencies and weaknesses (Krebs and Jackson, 2007, p. 45). Besides setting the terms, the second step in the causal mechanism is the causal argument. For rhetoric to be effective, governments need to win the causal argument (Krebs and Jackson, 2007, pp. 43–44). They need to be able to provide solutions which the audience considers superior. Common strategies are selecting or highlighting facts that serve one's interests and downplaying others which do not (Riker, 1996). If actors can draw on commonplaces that are already present in the rhetorical field, they can strengthen their arguments as they close off routes of rebuttal (Krebs and Jackson, 2007, p. 46). Proposed solutions can only be powerful if they are credible: they need 'cognitive validity' (Carstensen and Schmidt, 2016, p. 324). Both steps are inter-related: establishing a favourable frame of reference (step 1) helps winning the causal argument; merely establishing the frame as such is not sufficient. It cannot be excluded that the other side comes up with unexpectedly strong arguments or managed to shift the debate onto a terrain more favourable to them. For rhetoric to be effective, also the causal argument (step 2) needs to be won. Yet, the outcome of the causal argument again is influenced by the frame of reference. While in theory it is possible to win the argument without having established favourable frames of reference before, this is unlikely to happen in practice. In this instance, both steps are interlinked. Establishing a favourable frame (step 1) facilitates winning the argument (step 2). It is the combination of both steps which makes rhetoric efficient. A reinforcing factor to win the causal argument is the need for consistency. Actors cannot contradict themselves easily without incurring costs. Once actors have accepted a specific frame, they cannot undo it without incurring high costs.

Since the audience acts as a referee whether a certain discourse is plausible or 'right', this account of rhetoric shares common ground with rationalist as well as 'thin' constructivist approaches. In contrast to deliberative Habermasian accounts in which rhetoric (or rather deliberation) is judged by reason and serves the goal of persuasion (Habermas, 1996; Risse, 2000; Finnemore and Sikkink, 2001), this framework considers rhetoric powerful even when it is not truth-seeking and truth-generating. As it is 'the rational choice to behave appropriately' (Schimmelfennig, 2000, p. 116), the social environment (and manipulations of it) impact on the cost-benefit calculation of actors. In line with rationalist approaches, actors use rhetoric strategically. They invoke discourses in the audience that are conducive to their preference, and downplay competing discourses (Dryzek, 2010, p. 320). Skilful rhetorical action frames negotiations and constrains actors. It influences the course of the negotiations.

The just outlined theoretical framework establishes a testable hypothesis for rhetorical action. While the empirical chapters analyse the rhetoric in the negotiations in greater detail, at this stage it can be noted that 'breaking the vicious circle between banks and sovereigns' was a shared goal of all actors. It constituted the problem frame and set the terms of reference for discussions on the solution frame. It is prominently placed in various Conclusions of the European Council and the Euro Summit during the SSM and SRM negotiations (Euro Summit, 2012; European Council, 2012a; European Council, 2012b; European Council, 2013). This is strong evidence that all actors involved universally accepted it as a problem frame. However, while everyone agreed on the problem and shared the goal to solve it, the question of *how* to solve it and to break the circle remained wide open. If rhetorical action was effective, we would expect those actors to punch above their weight which were able to win this causal argument on its solution. In this sense, the shared goal defines the frame of reference (the terrain), and the argumentative strength of each actor determines whether they could use rhetorical action to gain an advantage in the negotiations, i.e. to gain concessions.

Hypothesis 5:

The outcome of the negotiations corresponds to the preferences of those governments which can justify their demands with reference to a commonly accepted problem frame.

In sum, the research design and the theoretical framework suggest a competitive testing of liberal intergovernmentalism and rhetorical action. The liberal intergovernmentalist hypothesis expects the German government to shape the agreement as it has the highest material bargaining power at its disposal. The rhetorical action hypothesis is more open (and further narrowed down in the following chapter), in that it expects that actor to gain concessions who can win the causal argument on how to break the vicious circle between banks and sovereigns.

2.4. Conclusion

A case as complex as the banking union poses serious challenges to theoretical approaches to the grand bargains of European integration. This chapter sought to guide the reader through a range of different approaches that can enhance our understanding of the EU banking union negotiations. Liberal intergovernmentalism is the backbone of the theoretical framework. As the 'baseline theory' to explain the grand bargains of European integration, it is a helpful starting point for the analysis. The main explanatory factors in liberal intergovernmentalism are material interests and material bargaining power. It follows a rationalist logic of action. However, the circumstances of the banking union negotiations trigger several scope conditions and make it likely that ideas did play a role in the negotiations. To test these predictions, the framework thus included ideational approaches as well. Another analytical distinction is the separation between the domestic level, on the one hand, and the interstate level, on the other. The benefits of reducing complexity in terms of higher analytical clarity outweigh the downsides of simplifying the interlinkages between both levels.

Liberal intergovernmentalism predicts preferences of governments that reflect powerful domestic material interests. It distinguishes between interest groups and macro-economic preferences. Interest groups are likely to mobilise for or against the banking union as the project affects their businesses to a fundamental extent; macro-economic preferences matter as the banking union influences how the broader macro-economy will fare and bears consequences for fiscal policy and trade. Liberal intergovernmentalism suggests that the most powerful domestic interest group or macro-economic preference shapes the government's policy on an issue of the banking union negotiations.

Potentially, situations arise where it is difficult to identify with certainty who is the most powerful material interest. Given that different courses of action can no longer be distinguished by the expected utility (in terms of increasing chances of re-election), more than one course of action can be a rational choice for the government. This framework controls for these Folk theorem situations by extending the framework with the aforementioned ideational variable. If governments have more than one rational option, it was predicted that ideas as worldviews are likely to tip the scale in the direction of the interest which resonates most clearly with the identified worldview. The preference of a government is likely to reflect this interest, as filtered through the cognitive bias that results from worldviews held by policy-makers, it appears to be the preferable option. Neo-functionalism could provide an alternative explanation. Under severe crisis pressures, we would expect government to be in favour of a fully-fledged EMU; in the absence of these pressures, they will not take further integrative measures.

Liberal intergovernmentalism assumes that preferences are stable once formed. In the next step, governments negotiate on the interstate level. The intergovernmental bargaining theory predicts an outcome that corresponds to the preferences of the government with the highest material bargaining power. Bargaining power is determined by patterns of asymmetrical interdependence; the government with the best alternative to a negotiated agreement is likely to be powerful in the negotiations. Therefore, the German government is expected to shape the outcome of the negotiations. This hypothesis is tested competitively against an ideational approach based on the notion of rhetorical action (Schimmelfennig, 2000; 2001; Krebs and Jackson, 2007). This approach theorises the impact of rhetoric, which was proven to be an inextricable part of almost all negotiations. It suggests a two-step analysis of rhetorical processes. First, actors determine the frame of references for the negotiations. They try to shape references in a favourable direction to their own preferences. It is an attempt to shift negotiations onto a favourable terrain. This first step of determining the frames of reference is followed by the causal argument in a second step. Actors exchange arguments about the preferable course of action and attempt to use references to rhetorical commonplaces and previous agreements to gain an advantage with the audience. For reasons of consistency, actors are subject to the judgment of the audience. Materially powerful actors can be forced to concessions if, in the eyes of the audience, they fail to back up their preferences rhetorically.

Following this discussion of the theoretical approaches, the next chapter will complete the theoretical framework by operationalising the hypotheses. This prepares the groundwork for testing them empirically in the second part of the thesis.

Chapter 3: Interests and Ideas in the EU Banking Union Negotiations

3.1. Introduction

Economic interests and macro-economic preferences are diverse, and so are the ideas actors hold on the policies within the Economic and Monetary Union. This chapter completes the analytical framework by introducing the reader in more detail to the sets of interests and ideas that are considered relevant in light of the hypotheses. Narrowing down the broad range of interests and ideas to the most relevant ones is a crucial step in the analysis as it allows us to establish very concrete observable implications. Analysing the influence of interest groups on national preferences will only be possible after having examined the structure of the domestic banking systems. Macro-economic preferences can only be established after an analysis of the trade and fiscal implications of the negotiations. A statement on the influence of ideas on domestic preferences requires an assessment of the policy implications of the relevant ideas. For every hypothesis, this chapter develops a set of observable implications to confirm or disconfirm the theoretical predictions in the empirical part of the thesis.

Following the order of the analytical framework, the first section in this chapter analyses the interests and ideas that are potentially important for the formation of domestic preferences. On the interest side, it analyses the domestic banking industries and macro-economic preferences. With regard to the ideational hypothesis, this chapter establishes ordoliberalism and post-Keynesianism as the most relevant beliefs that could potentially become a worldview. The literature assigns them an important role in previous bargains (e.g. Dyson and Featherstone, 1999). It is plausible that they had an impact at this critical moment of eurozone negotiations as well. The framework also tests for neo-functional explanations which are an obvious contender of interest-based or ideational approaches. The analysis is structured along the preferences of the Northern and of the Southern coalition.

The second part of the chapter assesses the relevant factors that determine the outcome of the interstate negotiations. The theoretical framework suggested that material bargaining power drives the outcome. This chapter analyses the distribution of the material bargaining power among the actors. Based on a number of considerations, it arrives at the conclusion that the German government had the highest bargaining power. The second hypothesis suggested that rhetorical action influences the outcome of the negotiations. The respective section in this chapter analyses the prevalent problem and solution frames in the negotiations. A thorough analysis of ideational processes in the course of 2011 to 2013 suggests that the terrain of the negotiations shifted in spring 2012. The commitment to break the vicious circle between banks and sovereigns constituted the novel problem frame in the negotiations.

In sum, this chapter identifies the main interests and ideas relevant to the analysis of the banking union. It illuminates the main concepts and prepares the ground for the empirical analysis in the following three chapters. Following after the theory chapter, it aspires to serve as a bridge that links the theoretical framework with the empirical analysis of the banking union, which follows in the next chapter.

3.2. Domestic Preferences in the Northern Coalition

Material Interests in the Northern Coalition

Beginning with the Northern coalition, this section will discuss the domestic interest groups and the macro-economic preferences as relevant variables for the formation of preferences of the German government. While the public and private banks were the main commercial interests, the fiscal position and trade patterns serve to determine the macro-economic preferences.

Commercial Interests

Within the German banking sector, two groups have traditionally been particularly important: the public banks and the private banks (Financial Times, 2012b). The seven *Landesbanken* (regional banks) and more than 400 *Sparkassen* (savings banks) constitute the public banking sector in Germany. While strictly speaking not in public ownership, the roughly 1,200 cooperative banks are usually considered part of the 'public' banks. They are not profit-seeking per se and thus share the main characteristic of the public banks.
The *Sparkassen* are formally very small banks, but since they are strongly interconnected one can reasonably count them as one single entity. This makes them a powerful financial

group with a market share of 30% of the German banking business. Their assets exceed those of Deutsche Bank (Howarth and Quaglia, 2014, pp. 130–131; Hardie and Howarth, 2013, p. 108; Seikel, 2014, p. 176). Their large presence across the country in less-populated areas provides for a strong market share in retail banking (Seikel, 2014, p. 176). They provide 51% of the funding to non-financial companies, which is of vital importance to the German economy (Howarth and Quaglia, 2014, p. 131). Economic lending is predominantly bank-based and the savings banks provide much of the 'patient capital' that is needed for innovative and research-intensive SMEs (Hardie and Howarth, 2013, pp. 103–108). The public banks were created in post-war Germany to ensure a sufficient supply of loans to the economy. Several forms of state guarantees were introduced: the *Gewährträgerhaftung* was a state liability for all debts the public banks owed to other parties; the *Anstaltslast* was a public guarantee for the existence of public banks (Seikel, 2014, p. 176). As a result of these government guarantees, they obtained very favourable funding conditions, making life a lot harder for the private banks (Seikel, 2014, p. 176; IMF, 2013b). The public banks can traditionally build on close political ties to policy-makers. Local politicians are usually board members of the *Sparkassen* and regional politicians sit on the board of the *Landesbanken* (Véron, 2011b, p. 4). Studies show that the lending of savings banks is synchronised with the electoral cycle. It expands prior to local elections and contracts afterwards. This impacts on efficiency: the closer to an election date loans are granted, the more of them are eventually non-performing (Englmaier and Stowasser, 2014; Gropp and Saadi, 2015). The expertise of board members is low, a reason for Hau and Thum to conclude that 'financial market and banking experience [of board members] is an exception to the rule' (Hau and Thum, 2008, p. 27). While the efficiency of the banks is low, the politicised nature of their lending provides for a certain backing from local and regional politicians for their otherwise economically questionable activities.

Based on their position papers, it is possible to establish the observable implications for the influence of the public banks on German preferences. Evidence supporting the hypothesis would be a stance of the government against direct bank recapitalisations, which the public banks opposed as a joint liability for bank debt in Southern Europe. Likewise, the government would oppose the creation of a joint banking supervisor in the eurozone. The public banks opposed it as they sought to prevent any European influence that could interfere into their close ties with national politicians. After a joint supervisor had already been decided, the savings banks turned against an all-encompassing scope of supervision. They advocated instead a limited scope which would leave them outside of European supervision. Once a supervisor became unavoidable, for efficiency reasons they preferred the ECB as banking supervisor over other EU authorities (such as the Commission) and wanted a resolution process without veto rights for national governments. They dismissed bail-in rules as an unnecessary burden on banks. They also opposed a mutualised resolution fund, assessed as a vehicle for subsidising Southern European banks (BVR/VÖB/DSGV, 2012; BVR/VÖB/DSGV, 2013).

Table 10: Private material interests, public banks: Observable implications for domestic preferences, German government

	Private material interest: public banks
Joint supervision	Against
Direct bank recapitalisations	Against
ECB as supervisor	In favour
All-encompassing scope of SSM	Against
Strong bail-in rules	Against
Mutualised Single Resolution Fund	Against
Veto rights in SRM decision-making	Against

Yet, the public banks have never been the only interest on the German banking market. Their powerful and politically influential competitors are the private banks. Their influence is primarily based on their size and function on the German market. They include global and European champions such as Deutsche Bank and Commerzbank (Howarth and Quaglia, 2014, p. 131) which exercise significant influence on the government (e.g. Quaglia, 2008). Only these big transnational banks can mobilise sufficient funding to finance the large-scale projects abroad for German exporters (Behr and Schmidt, 2015, pp. 7–9; Howarth and Quaglia, 2016b, p. 98; IMF, 2016, p. 29). Hence, they offer important services to the German export industry, which the public banks cannot deliver. The biggest five banks held 22% of the financial assets in the German banking market in 2008 (Hardie and Howarth, 2013, p. 107). Systemic considerations assign them an important role. Both Deutsche Bank and Commerzbank are considered systemically important too-big-to-fail-institutions. While their influence stems from size in the first place, their ties to the government should not be underestimated either. The former Deutsche Bank CEO Ackermann was known to be a top advisor to Merkel during the financial crisis (FAZ, 2011; Süddeutsche Zeitung, 2010; also Der Spiegel, 2009). Since 2008, the German state owned a minority share of Commerzbank. The government rescue was politically contentious and put pressure on the government to not incur financial losses with its investment. This provided for proximity of the government's and the bank's interest (FAZ, 2009).

The private banks embraced the banking union as a means to bring about a level-playing field and strip off privileges from the public banks. The following observable implications for the influence of the private banks on German preferences can be derived. The private banks wanted the government to endorse joint supervision and direct bank recapitalisations as a means to Europeanise the German banking market. The ECB was favoured as supervisor, providing for the necessary reputation that it takes to establish a European system. To emphasise, the private banks wanted all banks in the euro area to be covered by the new mechanism, regardless of their size. Bail-in rules would be strong and automatic (and again apply to all banks); the resolution fund would be mutualised; and Europeanised and individual member states would have no say in bank resolutions.

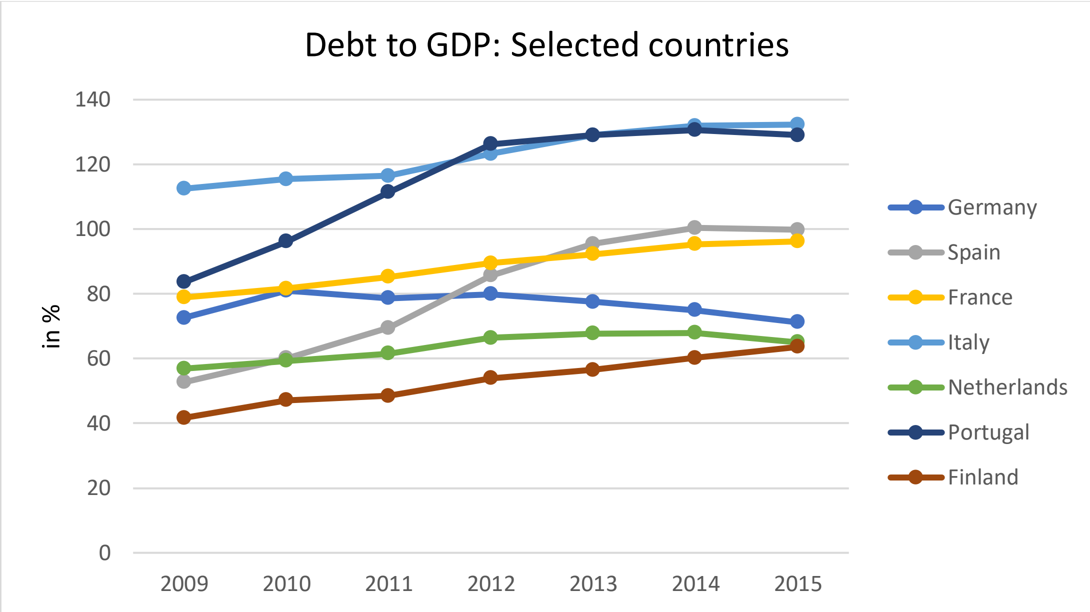
Table 11: Private material interests, private banks: Observable implications for domestic preferences, German government

	Private material interest: private banks
Joint supervision	In favour
Direct bank recapitalisations	In favour
ECB as supervisor	In favour
All-encompassing scope of SSM	In favour
Strong bail-in rules	In favour
Mutualised Single Resolution Fund	In favour
Veto rights in SRM decision-making	Against

Macro-Economic Preferences

For all issues with at least some implications for fiscal policy, liberal intergovernmentalism considers the 'macro-economic preferences of the ruling governmental coalition' (Moravcsik, 1999a, p. 3) another source of material interests. The two most plausible drivers of the macro-economic preferences within liberal intergovernmentalism are the fiscal position of governments and the trade patterns of countries (see section 2.2). Schimmelfennig emphasises the role of the fiscal position to determine the preferences of governments (Schimmelfennig, 2015, p. 181). Figure 1 shows that in all fiscal matters, the member states in the Northern coalition were in a more favourable position than their counterparts in the Southern European coalition. To highlight, the trend shows a favourable development in the North and a negative one in the South.

Figure 1: Debt to GDP



Taking these numbers as a starting point, a full-fledged banking union can plausibly be seen as a risk to the favourable fiscal position of the governments in the Northern coalition. A Europeanisation of supervisory and resolution powers would constitute a wide-ranging upgrade of competences, potentially paving the way to a so-called transfer union in Europe (Howarth and Quaglia, 2013, p. 109), in which Northern European countries supply permanent transfers to Southern Europe. These transfers would not necessarily be fiscal transfers (e.g. by means of a fiscal backstop to the resolution mechanism), but could also be transmitted via the private channel: a joint eurozone resolution fund would result in having healthy banks (from economically stable countries) pay for their weak counterparts (which would mostly be situated in economically weak countries). 282 German economists pointed out in a joint statement that 'if the economically strong countries agree to a shared liability for bank debts in principle, they will time and again be pressured to increase their liabilities' (FAZ, 2012). Providing assistance to the periphery was feared to 'pull hitherto sound economies into the abyss' (Sinn, 2012a). In this transfer union scenario, the core concern was moral hazard: if European funds could be used to cover up the consequences of risky behaviour, the fear was that national supervisors would loosen their control over domestic banks to promote growth – but destabilising the system in the medium to long-term (Howarth and Quaglia, 2014, p. 129). Even worse, failing banks would have been rewarded for their failure. Hans-Werner Sinn, a vocal representative of the German economic mainstream, explained the rationale as follows:

> 'Spanish banks speculated on a continuing increase in real-estate prices […]. To compensate for the damage that their reckless behavior caused, they received €303 billion in extra credit through Target, the European Central Bank's interbank payment settlement system, and can now expect a further €100 billion in help from the European Financial Stability Facility. Much of this money will never return.' (Sinn, 2012a)

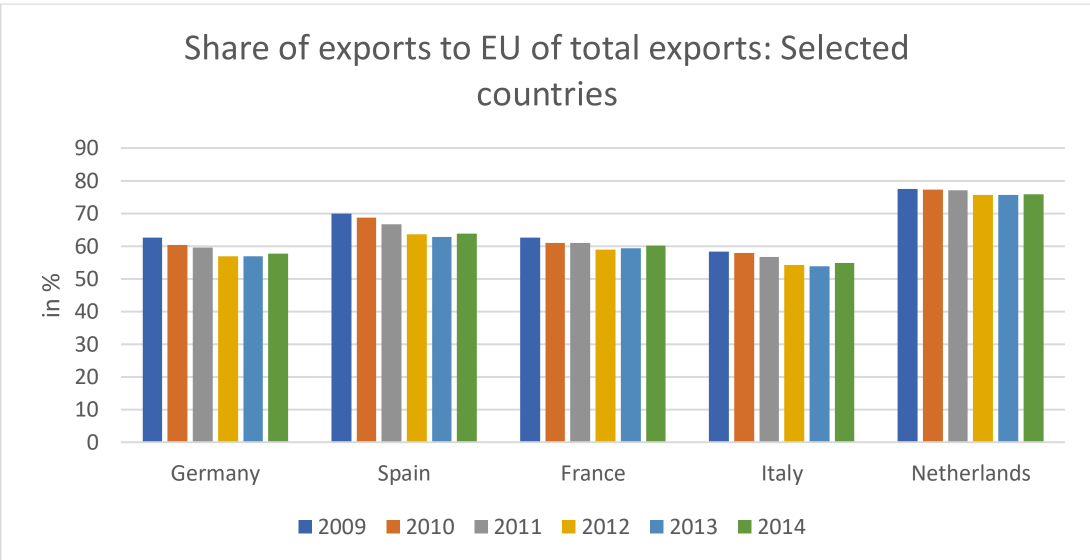
This perspective suggests that the banking union needs to be designed with an absolute minimum of mutualisation and primarily act as a constraint on national governments. This leads to the following observable implications of the fiscal position. We would expect the government to be in favour of joint supervision as a means to constrain national governments, increase the quality of supervision and thus limit the risk of bank failures, which, in turn, would make another ESM bail-out more likely. The fiscal position strongly suggests that the government opposes direct bank recapitalisations as a means to protect its fiscal position. The same logic applies to the prospect of a mutualised resolution fund, for which we would expect strong opposition from a policy based on the fiscal position. Likewise, if the fiscal position influences the government, it would be strongly in favour of automatic bail-in rules to shield the sovereign from bank failures and shift resolution costs to the private sector. It would oppose granting bank supervisory powers to the ECB; a conflict of interest could arise, potentially jeopardising price stability and causing fiscal costs. Lastly, the government would strive for veto rights over bank resolutions as other authorities – such as the Commission or the ECB – would unlikely see it as a priority to protect the German fiscal position.

Table 12: Macro-economic preferences, fiscal position: Observable implications for domestic preferences, German government

	Macro-economic preferences: Fiscal position
Joint supervision	In favour
Direct bank recapitalisations	Against
ECB as supervisor	Against
All-encompassing scope of SSM	Against
Strong bail-in rules	In favour
Mutualised Single Resolution Fund	Against
Veto rights in SRM decision-making	In favour

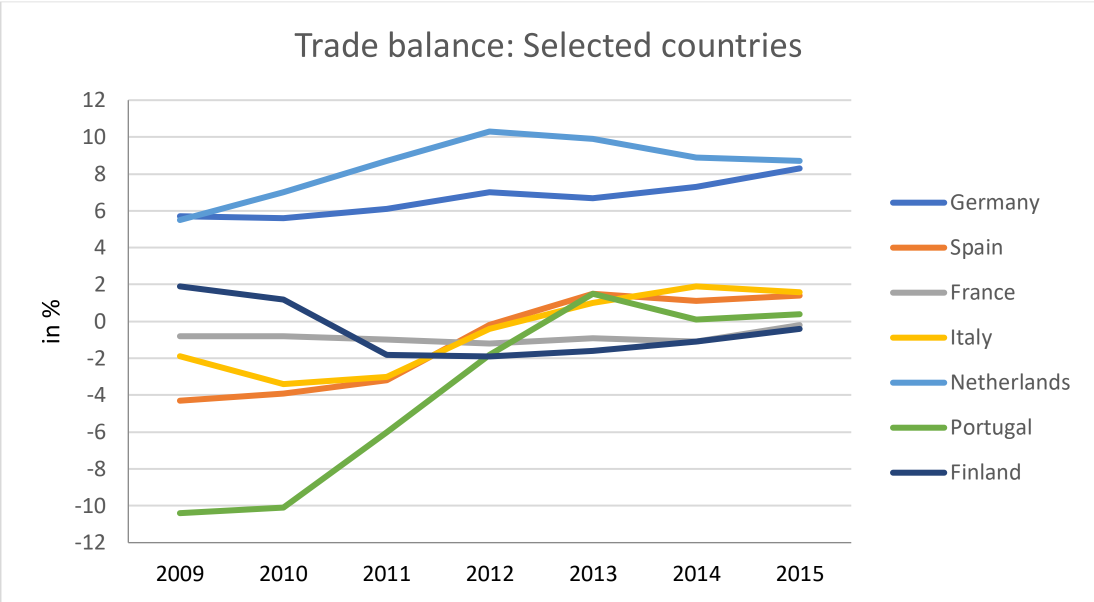
The theory chapter established that trade patterns can form another macro-economic preference. The economic model of Germany (and other Northern European countries, such as the Netherlands) is strongly export-based. They have a powerful export industry, which requires access to foreign markets. Their economies are integrated into European and international trade flows. Especially European markets are important, as the numbers below demonstrate (see Figure 2). Since 2009, around 60% of German exports went to EU member states. The Netherlands stand out in this regard as roughly three-quarters of its exports went to other EU member states since 2009.

Figure 2: Exports to EU of total exports



While all EU economies are highly interdependent, trade patterns diverge between North and South. Economies of countries in the Northern coalition stand out as their trade balance is characterised by a large surplus. The German surplus reached an excessive 8% of GDP in 2015. Notably, Finland is an exception in the Northern coalition as its economy was by and large balanced. Southern economies are less imbalanced than Northern. Many of them have balanced trade accounts or are mildly in surplus or deficit.

Figure 3: Trade balance



These patterns show that Northern economies benefit strongly from the single currency and the fixed exchange rates that go along with it (Bonatti and Fracasso, 2013; Johnston *et al.*, 2013; Hassel, 2011). With regard to German preferences, the analysis of the trade patterns shows that the eurozone is of fundamental interest to Germany. Trade patterns create a strong incentive for stabilising EMU to ensure its smooth functioning and existence[25]. We would expect the government to take decisive action to sustain the eurozone (Howarth and Quaglia, 2014, p. 127; Schimmelfennig, 2015, pp. 181–182).

Yet, experts from different theoretical angles largely agree that the currency union suffers from design flaws and is unsustainable in its current form (e.g. Glöckler *et al.*, 2017; Belke, 2013, pp. 56–57; De Grauwe, 2013a). In the absence of economic policy coordination

[25] UBS estimated the costs of euro break-up with a GDP loss of 20-25% in the first year (Deo *et al.*, 2011). The German Finance Ministry expected a loss of 10% of GDP (Der Spiegel, 2012b).

and some kind of a fiscal or banking union with risk-sharing between North and South, renowned experts considered the demise of the currency union only a question of time (Schmidt, 2010, p. 210; Pisani-Ferry, 2012, pp. 9–13; De Grauwe, 2011a; De Grauwe, 2013a). In order to fix EMU, experts argued that either a fiscal union, a banking union or a revised ECB mandate would be needed to put EMU on a stable footing (Glöckler *et al.*, 2017). In light of the other options, the banking union was both a targeted and a comparably cheap fix, because it entailed only limited fiscal liabilities (Belke, 2013, pp. 56–57). While some feared that the pooled resources could be used to bail-out banks in the periphery with money from the German taxpayer (open letter, cit. in FAZ, 2012), other economists brought into consideration that '[m]any of these investors might actually be German, given that the country is running such a large current account surplus' (Gros, 2013b, p. 2). Therefore, 'the long-run benefits [of the banking union] might be higher for Germany than for countries with weak public finances' (Gros, 2013b, p. 2). The trade patterns and export surplus reinforced the incentives for the banking union.

If interdependence and trade patterns are the decisive influence on the German government's preferences, we would expect it to be a staunch advocate of a full-fledged banking union as a comparably cheap and effective fix to the design flaws of the currency union, ensuring its existence beyond the crisis. The following observable implications can be derived: the government would advocate the creation of a joint supervisor and direct bank recapitalisations as the core components of a functional banking union. It would instate the ECB as supervisor to draw from its reputation and credibility. The scope of the mechanism would encompass all banks. The resolution fund would be mutualised to ensure its effectiveness. To ensure a speedy decision-making, governments would not be able to issue vetoes to bank resolution decisions. Bail-in rules would entail discretion to mitigate negative consequences on financial stability.

Table 13: Macro-economic preferences, trade patterns: Observable implications for domestic preferences, German government

	Macro-economic preferences: trade patterns
Joint supervision	In favour
Direct bank recapitalisations	In favour
ECB as supervisor	In favour
All-encompassing scope of SSM	In favour
Strong bail-in rules	Against
Mutualised Single Resolution Fund	In favour
Veto rights in SRM decision-making	Against

This section has pointed to the sources of material interests. It suggested that the relevant domestic interests are those of the private banks and the public banks. Macro-economic preferences can be derived from the fiscal position and trade patterns.

Worldviews in the Northern Coalition: Ordoliberalism

Ordoliberalism can plausibly be included in the analysis as a potential worldview held by officials in Germany because of its track-record as being held by officials in Germany (e.g. Dyson and Featherstone, 1999) as well as in influencing German preferences. Given the heavy weight of the German government in the Northern coalition, the influence of ideas in the German case is relevant for the policy of the entire coalition. According to Bonatti and Fracasso, the German government 'has adhered tightly to many features of (…) the economic theory of ordoliberalism' (Bonatti and Fracasso, 2013, p. 1028). Olender concurs that ordoliberalism 'informed [the government's] preference formation and its strategic response (…) to address the crisis' (Olender, 2012, p. 8). Nedergaard and Snaith describe ordoliberalism as 'dominat[ing] the German politico-economic landscape' (Nedergaard and Snaith, 2015, p. 1100). It is a frequent element in the discourse of key decision-makers (Van Esch, 2014, p. 294; see also Olender, 2012, p. 5) and its influence on policies is evidenced by measures such as the fiscal compact (Berghahn and Young, 2013, pp. 774–775; Olender, 2012, pp. 8–9). Early ideas of ordoliberalism, also known as Freiburg School of economics, *Ordnungspolitik* (literally translated as 'politics of order') or *Stabilitätskultur* (stability culture) were developed in the interwar period. The term ordoliberalism emerged in the 1950s, when the concept diffused in academic circles and among policy-makers (Siems and Schnyder, 2014, p. 379). It remains a powerful economic theory in Germany and contributes to the reputation of the country as 'outlier' (De Ville and Berckvens, 2015, p. 8) in terms of economic thought, characterised by the almost complete absence of Keynesian economic thought[26] (Hall, 1989c). The German knowledge regime is distinct and has contributed to the preservation of ordoliberal thought (De Ville and Berckvens, 2015). The finance and economics ministries both have a permanent board of academic advisors which regularly provide expertise (Bundeswirtschaftsministerium, 2016; Bundesfinanzministerium, 2016). The well-known *Sachverständigenrat* advises the government publicly and 'made a significant contribution to the dominance of monetarist thought in Germany' (De Ville and Berckvens, 2015, p. 36). It presents its findings in the public, which forces the government to respond and triggers public discussion of economic policies. Further regular public statements from economists have increased their weight in the public debate (e.g. FAZ, 2012; Sinn, 2012b).

After many decades of ordoliberal thought, there is some ambivalence about what 'ordoliberalism' actually entails (Jacoby, 2014a; Ptak, 2004).[27] Sally (1996) distinguishes two different forms of ordoliberalism. On the one hand, there are the legal and economic approaches, linked to the works of Walter Eucken (1951) and Franz Böhm (1933). The second variety is the sociological interpretation of based on Alfred Müller-Armack (1947), Wilhelm Röpke (1937) and Alexander Rüstow (1945). Jacoby criticised ordoliberalism as under-determinant for policy choices as ordoliberals 'are on all sides of every important debate over the Euro' (Jacoby, 2014a, p. 72). He considers three of these sides particularly important (Jacoby, 2014b): first, 'pop' ordoliberalism, a pragmatic variety of the theory which seeks a rule-guided framework but recognises the constraints of real world politics. Second, 'jihadi' ordoliberalism, a much less pragmatic strand which insists on taking rules by the letter, in particular, the abolished no bail-out clause from the Maastricht Treaty. Much of the domestic opposition to the government falls in the category of jihadi ordoliberals. The third and marginalised strand is dubbed 'genesis' ordoliberalism (Jacoby, 2014b). It refers to the Catholic Rhineland capitalism, propagated as the 'good' capitalism and delineated from the Anglo-Saxon 'predatory capitalism', usually encompassing former

[26] The internationalisation of the German economics discipline since the 1990s has challenged the academic predominance of ordoliberalism. Survey data suggests that research *on* ordoliberalism is increasingly marginalised (Süddeutsche Zeitung, 2015; see also FAZ, 2008) but *attitudes* of German economists remain strongly ordoliberal and differ significantly from those of economists in both Southern and Northern Europe (De Ville and Berckvens, 2015).

[27] The variety of ordoliberal thought partially explains why some ordoliberals have turned against government policies in the euro crisis which others classify as ordoliberal (e.g. Jacoby, 2014a).

leading politicians such as Norbert Blüm or Heiner Geißler (Jacoby, 2014b; see also Jacoby, 2014a).

Further grouping can structure the analysis and bring together several of these strands. Jacoby's pop and jihadi ordoliberalism are varieties of what Sally calls legal and economic approaches; Sally's sociological approach matches Jacoby's genesis ordoliberalism. Although this does not insinuate that ordoliberal is an overly coherent paradigm, it can indeed be boiled down to a few core claims. These can then be hypothesised and empirically tested. This analysis understands ordoliberalism along the lines of Sally's political and legal approaches coalescing with Jacoby's pop ordoliberalism since it is the most mainstream version of ordoliberalism.

Despite much variety, the following core aspects of ordoliberalism are fairly uncontested. The first cornerstone of ordoliberalism is the *Haftungsprinzip* (Eucken, 1951, pp. 279–285). According to this 'principle of liability', whoever decides to take a risk deserves to reap the benefits of his or her actions, but also needs to be liable for any losses that may be incurred. This principle is described as 'sacrosanct' (Nedergaard and Snaith, 2015, p. 1101) for ordoliberals. Violations of the principle of liability are assumed to trigger irresponsible behaviour and moral hazard (Siems and Schnyder, 2014, p. 386; see also FAZ, 2012; Sinn, 2009). Translated to financial regulation, the principle means that 'banks must be allowed to fail' (FAZ, 2012), as 282 German economists put it in a public statement. In principle, the same was to be ensured for sovereigns and led ordoliberals to advocate a sovereign default mechanism for the eurozone (e.g. Fuest *et al.*, 2015). With regard to economic and fiscal policies, the principle of liability suggests that national governments were responsible to restore competitiveness and fiscal prudence. A stable currency 'begins at home' (Dyson and Featherstone, 1999, p. 275) as sharing liabilities across the euro area would potentially create conditions for moral hazard.

Ordoliberal frameworks consider markets as a corrector to domestic policies of governments. If governments risk fiscal, financial or economic stability with unsustainable policies, ordoliberals assumes that markets will signal through rising interest rates for sovereign bonds that corrective action is needed. Therefore, in the context of EMU, market forces should not be restrained, but used to stabilise the economy in a market-conforming framework (Siems and Schnyder, 2014, pp. 380–382).

A strong state and state interventions is among 'the core claims of ordoliberalism' (Siems and Schnyder, 2014, p. 380). However, in contrast to socialists these interventions are meant to be not market-constraining, but market-conforming (Müller-Armack, 1947, p. 90; see also Bibow, 2009, p. 168). In ordoliberal thought, a strong state acts as the 'guardian of the competitive order' (Eucken, 1951, p. 327) by merely setting and maintaining the framework for efficient markets[28]; it does not pursue economic activity itself (Röpke, 1950, p. 181; Eucken, 1951, p. 255; see also Bibow, 2009, p. 168). Part and parcel of the emphasis on a stability-enhancing framework is an independent central bank (Eucken, 1951, pp. 288–289; see also Howarth and Rommerskirchen, 2013, p. 753). Ordoliberals staunchly fought against any measures that could restrict the independence of the central bank (Berghahn and Young, 2013, p. 776). In this incentive-driven framework, a red line for ordoliberals is the fear of a so-called transfer union. The above-cited 282 German economists warned that 'the socialisation of debt is no sustainable solution to the current problems' (FAZ, 2012). A mutualisation of resources would only be possible in a 'political union', i.e. if governments give up sovereignty to an extent that makes moral hazard impossible (Howarth and Quaglia, 2013, p. 111). This would imply that liability and control are aligned. Bail-outs, which ordoliberals assessed very critically, are only feasible if they come with extensive conditionality in order to prevent moral hazard (Sachverständigenrat, 2011, p. 144; see also Olender, 2012, p. 9; Siems and Schnyder, 2014, pp. 385–388).

The fact that ordoliberalism is a genuine 'German' belief leads to the question to what extent it is able to explain preferences in the entire Northern coalition and not only for Germany. Ordoliberalism has historically developed in close ideational proximity to neoliberal beliefs. It was closely related to the new liberalism emerging in the 1930s. Both new liberalisms exchanged their ideas intensively on several seminars and conferences following Lippmann's book 'The Good Society' (1937) (Siems and Schnyder, 2014, p. 379). The new liberalisms sought to renew liberalism by introducing market mechanisms and the competition principle to liberal thought, as well as the proposition that markets require state intervention to function (Lippmann, 1937). The Chicago School of neoliberal thought increasingly moved away from the second statement, whereas

[28] More specifically, an action is market-conforming if it does not restrict the three most fundamental market forces: the tendency to reduce costs, to reduce profits in the long run and to increase profits in the short run (Siems and Schnyder, 2014, p. 380; see also Eucken, 1951, p. 255).

ordoliberals stood firm to both principles (Mirowski and Plehwe, 2009). Nowadays, the core difference between the 'ordo' and the 'neo' strands of liberal thought lies in their conception of the state. Neoliberals see the role of the state limited in creating markets. In the following, market forces will lead to self-regulation with only minimal state intervention required. For ordoliberals, the state does not only need to create markets, but also maintain them. There is a continued rationale for state interventions. Despite this difference, both approaches share most aspects of the contemporary liberal economic thought: a market-driven framework for economic activity, a focus on supply side measures, no demand management, balanced budgets, low inflation policies, and an independent central bank (Berghahn and Young, 2013; Mirowski and Plehwe, 2009; Ptak, 2004; Sally, 1996; Siems and Schnyder, 2014). Considering this large set of shared beliefs, it is plausible to assume that despite the particular focus on ordoliberalism in Germany, similar sets of ideas could potentially account for preferences of other governments in the Northern coalition.

While this dissertation already explains German, French, Italian and Spanish preferences in great depth, it will not go into much detail with regard to Dutch and Finnish preferences. The power and size in the Northern coalition puts the German governments centre stage. The distribution of power was significantly more asymmetrical in the Northern than in the Southern coalition. There is less need for a detailed analysis of the preferences of the German allies as the German government's weight exceeded by far that of its fellow coalition members. Weighing the space and resources required for a detailed analysis of Finnish and Dutch preferences against the marginal benefits for explaining the outcome of the negotiations, their preferences will not be analysed in the same depth as those of the other countries in focus. Nevertheless, considering the importance of neoliberal thought, this paragraph sought to show that the chosen ideational framework is not necessarily country-specific, but can in principle be extended to the other Northern countries.

Following this clarification of ordoliberal thought and its relation to neo-liberalism, several observable implications can be derived. If these sets of ideas influence a government, it would be against direct bank recapitalisations (unless a full political union comes about) to avoid a shared liability for bank debt without shared political control. It would be in favour of joint supervision to constrain national governments – yet, this transfer of sovereignty would notably not be sufficient to justify direct bank recapitalisations since – beyond supervision – national governments still had sufficient channels of influence on their banks, such as, among others, mortgage policies and capital controls. Against this backdrop, joint supervision alone would not justify introducing a European liability for bank debt. The same logic would not permit a mutualised bank resolution fund to ensure that there is no sharing of liability without a full sharing of control. For the same reason, Germany would aim to obtain a veto right for the use of the bank resolution fund to be able to effectively avoid moral hazard. It would also prefer a bank supervisor other than the ECB. If the ECB were to become a supervisor, the stability culture would be at risk as the monetary policy could suffer from conflicts of interests between monetary policy and banking supervision. Given the enormous difficulty for the new supervisor to ensure effective control over 7,000 banks in the euro area, ordoliberals would advocate a limited, but effective scope of the supervisory mechanism. It would cover predominantly the institutions with systemic stability considerations. Considering that bail-in rules were the pet project of ordoliberals and a cornerstone of their efforts to realign control and liability in the financial sector, we would expect a government preference in favour of strong and automatic bail-ins to do justice to the principle of liability.

Table 14: Ideas, ordoliberalism: Observable implications for domestic preferences, German government

	Ideas: ordoliberalism
Joint supervision	In favour
Direct bank recapitalisations	Against
ECB as supervisor	Against
All-encompassing scope of SSM	Against
Strong bail-in rules	In favour
Mutualised Single Resolution Fund	Against
Veto rights in SRM decision-making	In favour

Historically, there was a subtle tension between ordoliberal ideas and a normative commitment to European integration in Germany (Bulmer, 2014, p. 1246). A normative consensus on European integration as a goal in its own right traditionally helped to overcome barriers to cooperation arising from a dogmatic view based on ordoliberal policy principles (Bulmer, 2014, p. 1245; Olender, 2012, p. 2). The 'European vocation' (Bulmer and Paterson, 2013, p. 1394) paired with a 'federalist consensus' (Risse *et al.*, 1999, p. 165) and a commitment to Franco-German reconciliation (Katzenstein, 1997, p. 26; Paterson, 2011a, p. 58) made the country the 'posterboy' (Paterson, 2011a, p. 58) of European integration. Yet, the recent literature states a 'normalisation' (Paterson, 2011b; Bulmer and Paterson, 2010; Hyde-Price and Jeffery, 2001; Kundnani, 2012) of German attitudes towards Europe. Core events of the euro crisis were characterised by 'a decided tilt in influence away from those advocating political integration as a goal in its own right towards a coalition of those focused on economic and financial objectives' (Bulmer and Paterson, 2013, p. 1398). Considering the shrinking role and impact of this normative commitment for German policies, this thesis will not test their impact systematically. Interview evidence supported this assessment of its minor impact. For instance, while the Foreign Ministry in Germany is usually considered an advocate of pro-European policies, a senior official in the Finance Ministry (which was domestically in the lead for negotiating the banking union) ridiculed their position by saying that 'in the Foreign Ministry, they always want world peace, but this doesn't help us with Greece' (GFM3, 2015).

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Neo-functionalist explanations predict a spill-over effect from the common monetary policy to the fiscal, economic and/or financial sector. The crisis pressures would lead governments to agree on further integration in the financial dimension to ease these material pressures. Based on this logic, one would expect a fully-fledged banking union to come about. However, it is to be noted that the material pressures lost in importance after the ECB publicly assumed the function of a lender of last resort on 26 July 2012 (Draghi, 2012). With crisis pressures as the main driver of further integration, their absence results in no momentum for integration. As a result, neo-functionalists would expect the negotiations to run out of steam and fail, eventually. Therefore, the observable implications of neo-functionalism need to take into account two different dynamics. We would expect that driven by crisis pressures, governments agree on the creation of a joint banking supervisor and a mechanism of direct bank recapitalisations. We would, however, expect no significant integration after the end of the acute phase of the crisis. Therefore, the scope of the new mechanism would be limited and the governments would not allow bank supervisory powers to go to an independent and powerful institution such as the ECB. In the absence of crisis pressures, they would not agree neither agree to automatic bail-in rules, nor a mutualised fund, nor would they give up veto powers over bank resolutions. As all euro area governments were exposed to the crisis pressures, we would expect them to respond to them in the same way. No separate observable implications based on neo-functionalism are derived for the Northern or Southern coalition.

Table 15: Neo-functionalism: Observable implications for domestic preferences, all euro area governments

	Neo-functionalism: crisis pressures
Joint supervision	In favour
Direct bank recapitalisations	In favour
ECB as supervisor	Against
All-encompassing scope of SSM	Against
Strong bail-in rules	Against
Mutualised Single Resolution Fund	Against
Veto rights in SRM decision-making	In favour

This section has introduced the interests and ideas relevant to the preference formation of the German government. It covered material interests and ordoliberalism, the main explanatory factors in the chosen analytical framework. It included neo-functionalism as an alternative approach. The following section turns to the sources of preferences in the Southern European coalition.

3.3. Domestic Preferences in the Southern Coalition

This section analyses the preference formation in the Southern European coalition. While the first part devotes attention to the material interests in the Southern coalition, the second part examines post-Keynesian sets of ideas. It establishes observable implications for each of the hypotheses in the respective section. The analysis is limited to the big three member states in the Southern coalition, namely France, Italy and Spain.

Material Interests in the Southern Coalition

Commercial Interests

While the banking sectors in France, Italy and Spain vary in their structure, they all became increasingly vulnerable to market pressure in the course of the financial crisis. The French banking sector was one of the largest and one of the most concentrated in Europe. In

2007, its size amounted to 334.8% of GDP. It was marginally smaller than the banking system in the UK (399.7%), but much larger than the German financial sector (195.5%) (Howarth, 2013, p. 130). In the same year, the five biggest banks hold 51.8% of the total assets, a number significantly greater than the 22% in Germany. The aggregated assets of the top three banks represented 250% in France, 189% in Spain and 121% in Italy (which is close to the German number of 118%) (Véron, 2011b, p. 4). French governments have consistently pursued the creation of national champions. Traditionally a 'financial network economy' (Morin, 2000, p. 37), the political power of the banks has over decades benefited from revolving doors between the Treasury and the banks (Howarth, 2013, p. 142; Véron, 2011b, p. 4). Various forms of protectionism have shielded French banks against foreign competition and takeovers (Howarth, 2013, pp. 138–142). Similar to the French banking sector, Italian banks are highly internationalised. Concentration, however, has remained fairly low. In 2007, the five biggest banks held 33% of the assets in 2007 (Pagoulatos and Quaglia, 2013, p. 182). Many banks in Italy have focused on the local and the regional level (Pagoulatos and Quaglia, 2013, p. 182); the banking system is 'less market based, regionalized rather than globalized, relatively 'traditional', retail oriented, low leveraged [and] able to rely on wide domestic deposits' (Pagoulatos and Quaglia, 2013, p. 197). Thus, Italian banks typically are small, but highly internationalised (Howarth and Quaglia, 2016c). As in France, the national supervisor tended to block foreign takeovers (Véron, 2011b, p. 4).

The degree of concentration in the Spanish banking system is located in-between the French and the Italian sectors: on the one hand, it is characterised by both highly competitive transnational banks (such as Santander and BBVA). They remained unscathed in the financial crisis, are strongly diversified and belong to the worldwide leading banks (Royo, 2013, p. 160). On the other hand, a significant part consisted of small and regionally-oriented institutions, the so-called *cajas*. These almost tore the country into insolvency (Royo, 2013, pp. 157–158). However, many of them were wiped out in the crisis and forced to merge to Bankía in 2010. This restructuring consolidated the sector and made it less diverse. The banking system is characterised by 'extensive interventionism, state control over the banking system, and underdeveloped capital markets' (Perez and Westrup, 2010). The most obvious case of state intervention was the detrimental role of the national supervisor Bank of Spain in the Spanish crisis. While Spanish supervisors enjoyed an excellent reputation on the technical level, political interference from the national government prevented them from addressing the speculative bubble in the property market (Royo, 2013, pp. 163–164).

Even though the structure of the banking systems varied markedly, a common concern of the banks in the countries of the Southern coalition was worsening financing conditions as a result of the financial fragmentation of the internal market. Its effect was particularly severe for Italian and Spanish banks (Howarth and Quaglia, 2013, pp. 104–106; Herring, 2013). Initially, Italian banks were less crisis-prone than many of their competitors. They were well-capitalised and much less exposed to the sub-prime crisis in the US that incited the worldwide financial crisis (Pagoulatos and Quaglia, 2013, p. 192). Yet, after years of crisis, since 2011, non-performing loans in Italy began to put a strain on bank balances in an increasing magnitude (Pagoulatos and Quaglia, 2013, p. 195). The large home bias of Italian investors spread the crisis throughout the entire banking system. It led to a reinforcement of the systemic character of the crisis. Eventually, this development turned to a fundamental threat to the stability of the banks. A similar development occurred in Spain. The burst of the property bubble affected mainly the small *cajas* (Royo, 2013, p. 157). They were vulnerable because of high lending volumes to the construction sector. Yet, the systemic crisis created spill-over effects to the bigger banks. The ECB reacted with the Long-Term Refinancing Operations (LTROs). The provision of additional liquidity calmed markets, but as many banks used it to buy government debt[29], it also increased their vulnerability to shocks transmitted from the sovereign (Royo, 2013, p. 167). Eventually, estimates of the recapitalisations needed for the banking sector reached 100 to 250 billion Euro (Royo, 2013, p. 167).

Solving the crisis became a question of survival, especially for Italian and Spanish banks (Hennessy, 2014, p. 161; Hardie and Howarth, 2013, pp. 104–106; Gros and Schoenmaker, 2014, pp. 533–534; Pagoulatos and Quaglia, 2013, p. 193). French banks were less affected, but by no means immune (Donnelly, 2014, pp. 990–991). A particular burden on France was the partial contagion from the sovereign to the private sector in the period between summer 2011 and January 2012 (Financial Times, 2011a; Financial Times, 2011b). When the French sovereign lost its triple A rating in 2011, the funding conditions of banks worsened considerably (given that the credit rating of a bank's home

[29] The ratio of sovereign bonds that were domestically held reached 30% in mid-2012 while those held by foreign investors declined from 56% in 2011 to less than 39% in mid-2012 (Royo, 2013, p. 167).

state is usually a glass ceiling for its own credit rating). This situation was reportedly perceived as a 'near-death experience' (GFM9, 2015) by some in the French financial community and beyond (Donnelly, 2014, p. 991; Financial Times, 2011c; Financial Times, 2011d). The banking crisis did not become systemic in France (Howarth, 2013, p. 131), but signs of contagion increased the pressure to 'do something' and led to a more favourable stance of French banks towards the banking union (Donnelly, 2014, pp. 990–991).

Across all three countries, the position papers of the banking associations reflect their welcoming stance towards EU interventions as a means to solve the problems in the sector (FBF, 2012a; FBF, 2012b; FBF, 2013; FBF, 2014; ABI, 2012a; ABI, 2012b; AEB, 2011; AEB, 2014a; BBVA, 2013). They were aligned and pushing strongly towards a full-fledged EU banking union. Based on their position papers, the following observable implications for their influence on the preferences of their respective governments can be derived. Banks in all three countries sought a mechanism for direct bank recapitalisations as they expected to be the main beneficiaries. Moreover, they were in favour of a mutualised resolution fund, notably with no veto rights for governments in bank resolution decisions. The banking associations were favourably inclined towards the allocation of supervisory tasks at the ECB to draw from its reputation. Likewise, there was agreement that all banks should be subject to the new mechanism to ensure that it could be effective across the entire sector. Bail-in rules were rejected as a threat to financial stability, most clearly by Italian banks which considered them 'unpractical, unnecessary and counterproductive' (ABI, 2012c, p. 8). In principle, all banking associations were favourable towards the creation of a joint supervisory authority as a means to bring about a European supervisor. There was, however, a somewhat more hesitant stance from the French banks, which did not necessarily want to depart from the close relationship to their own supervisor and refrained from taking a clear position.

Table 16: Private material interests, banking sector: Observable implications for domestic preferences, Southern European governments

	Private material interest: banking sector
Joint supervision	In favour *(French banks: hesitant)*
Direct bank recapitalisations	In favour
ECB as supervisor	In favour
All-encompassing scope of SSM	In favour
Strong bail-in rules	Against
Mutualised Single Resolution Fund	In favour
Veto rights in SRM decision-making	Against

Macro-Economic Preferences

The concerns of the banks with worsening funding conditions and a systemic crisis in the banking sector were partly overlapping with macro-economic considerations. Italy and Spain had their back to the wall in the spring and summer of 2012 and this was partly the case because of the fragility of the banking sector. The escalation of the crisis in the financial sector increased the pressure on sovereigns. The risk of default was looming on the horizon. Given the size of the two countries, a break-up of the eurozone did not appear unthinkable. It comes as no surprise that both the French president François Hollande and the Italian prime minister Mario Monti pledged in a joint statement to 'do everything (…) that the eurozone is defended, preserved and consolidated' (Le Monde, 2012a). From the perspective of trade patterns, the risk of a euro break-up suggests strong support for the banking union as a vehicle to draw from the resources from economically stable member states. The banking union would be a means to stabilise the eurozone and maintain smooth and unconstrained trade flows with their main trading partners. As Figure 2 showed, the South is dependent on intra-EU trade at similarly high levels as the North. Avoiding a disruptive shock to the single market becomes imperative from this perspective to avoid the unpredictable fallout from the break-up of the single currency (Deo *et al.*, 2011). This results in a preference in favour of fixing the institutional flaws of the single currency with a strong emphasis on the introduction of financial transfers. Even though the reintroduction of national currencies would have provided the opportunity to increase competitiveness through currency devaluations, the disruptive consequences of a break-up did not render it a rational choice (Eichengreen, 2010; McKinsey, 2012). As a result, the trade patterns suggest a policy of fixing EMU.

No large differences emerge between predictions based on trade or fiscal positions in the Southern coalition. Public debt levels in Southern Europe were rather high (see Figure 1). Their debt levels were consistently higher than those of the Northern countries. France is partially an exception to this rule. However, its debt level developed considerably worse than Northern European countries. It converged with other Southern European countries over the course of the crisis. Indeed, its dire economic situation, high public sector deficits, and low competitiveness figures (World Economic Forum, 2011, p. 15) justify putting France on par with other Southern European countries. This set a strong incentive towards risk-sharing and mutualisation. A macro-economic preference based on the fiscal position would thus suggest advocating a more genuine currency union with a symmetric burden-sharing and reinsurance of EMU members to increase the resilience of the currency union. This corresponds with a preference based on trade patterns. For analytical clarity, their similarity provides for merging them to a single hypothesis based macro-economic preferences.

The observable implication of an impact of the macro-economic preference would be government policy in favour of a full-fledged banking union. Specifically, this would include a joint supervisor, a mechanism for direct bank recapitalisations and a mutualised resolution fund as the main pillars. Furthermore, the ECB would become the supervisor to strengthen the mechanism; all banks would be included in the scope of the mechanism; veto rights in the SRM decision-making would be stripped off from national governments, and discretion built in bail-in rules would minimise the adverse impact of the new regime on financial stability.

Table 17: Macro-economic preferences, fiscal position and trade patterns: Observable implications for domestic preferences, Southern European governments

	Macro-economic preferences: fiscal position and trade patterns
Joint supervision	In favour
Direct bank recapitalisations	In favour
ECB as supervisor	In favour
All-encompassing scope of SSM	In favour
Strong bail-in rules	Against
Mutualised Single Resolution Fund	In favour
Veto rights in SRM decision-making	Against

Worldviews in the Southern Coalition: Post-Keynesianism

With regard to the ideational hypothesis, the literature on EMU suggests that the worldviews held by policy-makers could in the Southern coalition most plausibly be post-Keynesian ideas. Seminal studies show their influence on EMU negotiations in the past (Dyson and Featherstone, 1999). More recent research demonstrated their relevance in the euro area crisis management (Schmidt, 2013; Lequesne, 2013). This section introduces the main tenets of post-Keynesianism and their implications for the negotiations on the banking union.

In the history of Economic and Monetary Union, post-Keynesian beliefs have become the main contender to ordoliberal ideas. They build on John Maynard Keynes' set of economic ideas (Hall, 1989c) and are Keynesian in that they relate to the General Theory of Employment, Interest and Money (Keynes, 1936), but 'post'-Keynesian in that these ideas underwent several transformations in the decades following the publication of Keynes' seminal study. The stratification of Keynesian thought resulted in a somewhat incoherent paradigm that others simply call 'non-neo-liberal' beliefs (Schmidt, 2013, p. 456). Post-Keynesianism is linked to and inspired other sets of ideas, such as the French umbrella concept *intégration solidaire* (Lequesne, 2013, p. 47), which the then-French finance minister Pierre Moscovici understood as 'the promotion of mechanisms for risk-sharing among Member States, and greater integration of European economies' (Moscovici, 2012). Mechanisms for mutualisation or risk-sharing in the fiscal as well as financial dimension were means to achieve this goal (De Grauwe, 2013a; Lequesne, 2013, p. 47; Schild, 2013).

Several aspects of post-Keynesianism are diametrically opposed to ordoliberalism. Post-Keynesians consider markets inherently unstable (Keynes, 1936, pp. 23–24). Incomplete information and herding behaviour undermine their effectiveness as correctors to government actions. Post-Keynesians criticise that the rise of interest-rates is 'too slow and too weak' when a debt crisis builds up, and 'too much and too late' after the outbreak of a crisis. A very sudden and destructive overreaction of markets leaves little time for corrective governmental action. In this perception, markets do not help to prevent crises as an early warning system, but make them much worse through speculation (Bofinger, 2013, p. 165; see also Banca d'Italia, 2012; European Central Bank, 2014). This post-

Keynesian critique of market behaviour justifies corrective government action, such as counter-cyclical fiscal policies. Governments are supposed to promote economic growth and employment as their main priorities (Keynes, 1936, pp. 25–29). In contrast to ordoliberal self-restraint, fiscal policy is an instrument that exists for a reason and needs to be used to stabilise demand. Notably, government action along these lines is predominantly market-correcting, not market-conforming. As price stability is only a second-tier goal, post-Keynesians see no strict need for central bank independence (Bibow, 2013, p. 611). The central bank is another economic policy instrument which can be used to support the government's economic policies. Keynes considered a 'managed currency' (Keynes, 1924, p. 170) inevitable.

These more abstract principles were closely tied to the 'problem-solving' (Belke, 2013, p. 57) approach advocated by many post-Keynesians in the euro crisis. Instead of reliance on market balancing in the long-term, problem-solving referred to a short-term oriented and state-interventionist course of action. It sought the development of instruments to counter market-pressure with 'substance' (Lequesne, 2013, p. 47). A currency area without transfer mechanisms is seen as unstable and unworkable in the long term (Schmidt, 2010, p. 210; Pisani-Ferry, 2012, pp. 9–13). To develop the necessary instruments for market-correcting policies, post-Keynesians consistently advocated risk-sharing and mutualisation. Measures such as the joint issuance of debt ('eurobonds'), a shared budget for the eurozone, or a common unemployment insurance or other automatic stabilisers would institutionalise risk-sharing and reduce the vulnerability of EMU (Belke, 2013, pp. 53–55; De Grauwe, 2013a, pp. 9–11). The ECB in the role as lender-of-last-resort would drive down interest-rates in the periphery (De Grauwe, 2013a, pp. 9–11). A longer period with high inflation would facilitate the process of regaining competitiveness (Bonatti and Fracasso, 2013, p. 1024). In stark contrast to the pro-cyclical policies that were adopted since 2010, anti-cyclical fiscal policies could provide support to economically weaker countries, (Frankel *et al.*, 2011; Wren-Lewis, 2016). These logics of the paradigm coalesced in a preference for some form of risk-sharing, an institutional innovation seen as necessary to sustain the common currency (Belke, 2013, p. 60).

Post-Keynesians did not neglect the role of domestic policy failures in the build-up of the crisis, but weighed other factors more heavily. They mainly focused on the systemic and institutional flaws of the euro area. It deprived countries of adjustment mechanisms such as national monetary policy or exchange rate fluctuations, but did not replace it with a sufficient level of interstate risk-sharing. In this fragile environment, persistent trade surpluses of Northern European economies caused imbalances in the capital account, deteriorated the competitiveness in the periphery and fed in financial bubbles (Krugman, 2009; Pettis, 2013, pp. 13–14). As 'for every foolish debtor there must be a foolish creditor' (De Grauwe, 2013a, p. 7), post-Keynesians blame Northern European banks (and their supervisors) as at least partly responsible for inflating Southern economies: 'Northern Europe behaved like the automobile salesman who sells cars to his customers by providing them with cheap credit' (De Grauwe, 2013a, p. 7). The financial crisis was the external shock that eventually led to the outbreak of the crisis (Belke, 2013, p. 54). For post-Keynesians it was because of institutional flaws such as the lack of automatic stabilisers and the ECB's limited mandate that EMU was vulnerable to external shocks in the first place (Belke, 2013; De Grauwe, 2013a). Against this background, the crisis was seen as inevitable because of EMU's institutional flaws. Domestic policy failures were only the tip of the iceberg (De Grauwe, 2013a).

There are several intersections between post-Keynesian (economic) ideas and long-held normative beliefs in countries of the Southern coalition. The distrust against market mechanisms resonated with French ideas of *étaisme* which suggest that the state controls markets, and not vice versa (Dyson and Featherstone, 1999, pp. 92–94). The state expresses the people's will (*volonté politique*) and is the home of the nation's values and democratic legitimacy (Risse *et al.*, 1999, p. 173; Dyson and Featherstone, 1999, pp. 64–67). In this conception, European integration is the instrument to expand the power of the nation state to the outside world (Risse *et al.*, 1999, pp. 170–171). The Council is supposed to become a *gouvernement économique* that puts the state in the position to counter market forces (Dyson and Featherstone, 1999, pp. 63, 92–95). These ideas are not part of post-Keynesianism as such, but they resonate with it in respect of market-correcting interventions. These calls fell on fertile (normative) grounds (Lequesne, 2013, p. 46). French ideas about the need to counter market-action with government action were in principle compatible with normative ideas in Italy and Spain. The *vincolo esterno*[30] in Italy (Quaglia, 2004, p. 1103; Dyson and Featherstone, 1999, pp. 452–459; 1996) or the *atraso*[31]

[30] The *vincolo esterno* usually refers to an external constraint which provides stability to the otherwise fragile political system and political institutions in Italy.
[31] The *atraso* is associated to the Franco dictatorship and usually refers to a feeling of backwardedness in the political and economic development, especially in comparison to other Western European countries.

in Spain (Jauregui, 2003, p. 292; Menéndez-Alarcón, 2004, p. 58; Barbé, 1999, pp. 169–170; Granell, 2000, p. 69) shared the emphasis on a functioning and effective framework. Yet, there is one important difference. According to the *vincolo esterno* and the *atraso*, state action is supposed to be 'European' and not national. As a normative reference point, it serves to overcome the failures of domestic institutions. However, this difference should not be overstated. It is centred on the question whether European competences are a means (France) or an end in itself (Italy, Spain), but eventually both suggest more European competences.

Following these explanations, the following observable implications of post-Keynesian ideas in the banking union negotiations can be established. Evidence for their impact would be a preference of Southern European governments for a full-fledged banking union with a significant extent of risk-sharing. It would entail a joint supervisor, a mechanism for direct bank recapitalisations and a mutualised resolution fund as the core components. To make the banking union stronger, the ECB would be assigned the role of supervisor and all banks would be covered by the mechanism. There would be a level of discretion in applying bail-in rules to be able to react to markets and maintain some room for manoeuvre. Given the positive stance towards government interventions, one would not expect an objection to national vetoes for the resolution decision-making (based on e.g. Lequesne, 2013; De Grauwe, 2013a; Quaglia, 2004; Areilza and Torreblanca, 2012; Díez Medrano and Gutiérrez, 2001; Dyson and Featherstone, 1996; Risse *et al.*, 1999).

Table 18: Ideas, post-Keynesianism: Observable implications for domestic preferences, Southern European governments

	Ideas: post-Keynesianism
Joint supervision	In favour
Direct bank recapitalisations	In favour
ECB as supervisor	In favour
All-encompassing scope of SSM	In favour
Strong bail-in rules	Against
Mutualised Single Resolution Fund	In favour
Veto rights in SRM decision-making	In favour

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A neo-functionalist explanation for Southern preferences would not expect the policy stance of Southern governments to differ significantly from their Northern counterparts. Since both were affected by crisis pressures, they would react in the same way (see section 3.2 for a longer discussion).

Table 19: Neo-functionalism: Observable implications for domestic preferences, all euro area governments

	Neo-functionalism: crisis pressures
Joint supervision	In favour
Direct bank recapitalisations	In favour
ECB as supervisor	Against
All-encompassing scope of SSM	Against
Strong bail-in rules	Against
Mutualised Single Resolution Fund	Against
Veto rights in SRM decision-making	In favour

3.4. Interstate Negotiations: The Weight of Material Bargaining Power

This section centres on the operationalisation of the hypotheses for the interstate negotiations. It is divided into two parts. The first one operationalises the hypothesis derived from liberal intergovernmentalism and thus puts a focus on the role material bargaining power can play in interstate negotiations. The second section is devoted to rhetorical action and introduces the most relevant problem and solution frames in the negotiations. Regarding the first hypothesis, liberal intergovernmentalism predicts an outcome of the interstate negotiations which reflects the preferences of the most powerful member states. It distinguishes between the aggregate and the issue-specific resources of material bargaining power. Based on these power resources, the German government and its allies from the Northern coalition can reasonably be considered the more powerful actors in the negotiations. This reasoning finds common ground with other research on German bargaining power (Paterson, 2011a; Bulmer, 2014; Schoeller, 2017; Beach, 2013). In terms of aggregate state power, the German government has vast financial resources at its disposal (Bulmer, 2014; Howarth and Quaglia, 2013). It was the largest member state in the euro area with a share of GDP of 27.6% (Eurostat, 2012). Since the beginning of the sovereign debt crisis, Germany expanded its proportion of the eurozone GDP from 26.6% in 2009 to 27.8% in 2013. Markets perceived the German government as an anchor of confidence in the eurozone's stability, putting it centre-stage in all crisis negotiations. This position is evidenced by the issue-specific indicators. The German sovereign was the only one among the large eurozone countries with an AAA credit rating and a stable outlook. France lost its triple A at the end of 2011; Italian and Spanish bonds had become even riskier investments in the course of the crisis.

Table 20: Credit ratings, Q3 2011/Q1 2012

	Germany	France	Italy	Spain
Fitch	AAA (stable)	AAA (negative)	A- (negative)	BBB (negative)
Moody's	Aaa (stable)	Aa1 (negative)	A3 (negative)	Baa3 (negative)
Standard & Poor's	AAA (stable)	AA+ (negative)	BBB+ (negative)	BBB+ (negative)

Sources: based on Trading Economics (2017a; 2017b; 2017c; 2017d).

The German government was able to sell sovereign bonds with a ten-year maturity for the lowest interest-rate in the euro area. It fell to 1.83% in the first quarter of 2012, whereas France (3.05%), Italy (5.71%) and Spain (5.23%) had to pay a significantly higher rate to sell debt (eurozone average: 4.39%). It is worth noting that the interest-rates of the four states started at a similar level, when the sovereign debt crisis began in the 4th quarter of 2009 (Germany: 3.19%; France: 3.53%; Italy: 4.06%; Spain: 3.79%)(all numbers based on Eurostat, 2013). The figures suggest that the German government enjoyed market confidence, which it could use to its advantage in the negotiations with economically weaker countries.

Table 21: Development of interest-rates, sovereign bonds with 10-year maturity

	Germany	France	Italy	Spain
Q4 2009	3.19%	3.53%	4.06%	3.79%
Q1 2012	1.83%	3.05%	5.71%	5.23%

Sources: based on Eurostat (Eurostat, 2013).

As a result of the sound economic situation, the preference intensity of the German government in the banking union negotiations was low in comparison to other member states. As Howarth and Quaglia point out, the country was able to bail-out or resolve its banks autonomously and without European assistance. Non-agreement on the banking union was in several aspects a feasible alternative (Howarth and Quaglia, 2014, pp. 130–131). Conversely, the preference intensity of the counter-coalition was high due to the on-going – and worsening – crisis. The eurozone was caught in a bad equilibrium which put especially Southern European governments at the losing end (Belke, 2013; De Grauwe, 2011a).

The composition of coalitions is another factor that can modify the distribution of bargaining power in negotiations. The evidence suggests that other member states could not form a powerful coalition that undermined the German government's superior material bargaining power. On the contrary, the German government received strong support from the Dutch and Finnish governments. The coalition was kept together by two factors: aligned interests and a set of shared ideas. With regard to the former, the economic factors behind the material interests of the governments in the Northern coalition were broadly similar. Their economies performed strongly, resulting in a trade and fiscal surplus (see Figure 1 and Figure 3). From a material perspective, they faced the same challenge: how many adjustments costs could they shift to the South, and how much risk-sharing did they have to concede to stabilise EMU? Second, all of these three countries shared broadly the same set of ideas. While ordoliberalism is commonly seen as a belief which is specific to Germany, the larger class of related neoliberal ideas have diffused across countries. While the literature does not agree on whether ordoliberalism is a variety of neoliberalism or a theory on its own, it is undisputed that both sets of ideas share many core claims (see section 3.2). This is important as ideas can be 'coalition magnets' (Béland and Cox, 2016), understood as 'the capacity of an idea to appeal to a diversity of individuals and groups, and to be used strategically by policy entrepreneurs (…) to frame interests, mobilize supporters and build coalitions' (Béland and Cox, 2016, p. 429). Against the background of the history of the currency union as driven by a neoliberal consensus (McNamara, 1998), the evidence gathered in interviews shows that the coalition of Northern European countries was held together by a set of common beliefs. For instance, a Dutch official advising the Prime Minister stated that 'the huge concern with moral hazard has underpinned not only German, but also Dutch EMU policy making' (NMGA2, 2016). By contrast, a finance minister from a Southern European country, notably from a different coalition, complained that 'they always talk about moral hazard. It's totally overplayed!' (FM1, 2016). This evidence supports the view that beliefs were a magnet for coalitions – with a positive and a negative pole.

Finland and the Netherlands were small countries, but financially powerful. The closest German ally was the Finnish government, but it was no central actor in the negotiations, as its banking sector had no significant size. The Dutch government had much more weight, as it is home to one of the biggest financial sectors in the eurozone. It played an important role in the negotiations. The Dutch government was strongly focused on building an alliance with their German counterpart to closely coordinate policies and strategies. A Dutch negotiator reported that they 'were always very keen on keeping Germany on the right track' (NMGA1, 2016) to shoot down excessive risk-sharing. They only diverged occasionally in the later stages of the negotiations when an agreement had to be found. Neither of the two wanted to give a free lunch for Southern banks and governments; however, the Dutch were more compromising. After all, they 'want[ed] a complete banking union. With risk-mitigation, to be very clear. But also with EDIS and a fiscal backstop. We wanted a full-fledged banking union' (NCB2, 2016). For instance, the Dutch government aligned with the German government on rebuking the Southern idea of an immediate mutualisation of a resolution fund, but changed sides when, regardless of the question of timing, the German government continued its principled opposition to a joint fund. Despite these nuances, the overall cohesiveness of the Northern coalition was high and negotiators reported several tricky issues where they stood in for each other. Occasionally, this coalition was joined by Austria. A member of the Council reported that 'there was a clear triple A alliance. In all negotiations affecting the Eurogroup and affecting ECOFIN. That's what I'm very, very clear on' (CEU1, 2015). The German government enjoyed 'a kind of veto power' (Howarth and Quaglia, 2014, p. 128) in the negotiations. By contrast,

> 'Italy and France and Spain do not have an alliance as tight as you can find between Finland, Germany and to a large extent the Netherlands. Today, I do not see a real counterweight to Germany in all these negotiations.' (CEU1, 2015)

The Southern coalition was less coherent than its Northern counterpart. It was composed of a higher number of member states and their interests were more diverse. A member of cabinet of the president of the European Council remembered that the Southern coalition 'did not really exist very much. The French knew of course that there were limits to what they could do with Italy and Spain. They certainly did not want to be pitted against Germany' (CPEC1, 2015). An Italian negotiator expressed his frustration:

> 'Paradoxically, you have Southern countries which have a more Nordic position than Germany because they went through an ESM programme. We have a relationship with France and sometimes we have an agreement. But at the end, France leaves us, unless we're with Germany.' (IOPM1, 2015)

A Spanish negotiator recalled the coalition dynamics in EMU from the Spanish perspective:

> 'France had quite some points in common with us, but they are not a reliable partner. We can't trust them. We know that in the end they will abandon us and do something with the Germans. Italy is even less reliable and they change their position all the time. And Germany has always been our favourite partner because they are both reliable and strong. And if Germany supports your position, you know you're safe. And therefore everyone wants to be with Germany.' (ST7, 2015)

These insights lend support to the superiority of the German government in terms of material bargaining power. It can thus be established that if material bargaining power explains the outcome of the negotiations, we would expect the banking union to reflect the preferences of the German government. The German government would be able to prevent the creation of a mechanism for direct bank recapitalisations and a mutualised resolution fund. Bail-in rules in the euro area would be strong and triggered automatically. The government would impose a joint banking supervisor on its counterparts, but entrust an institution other than the ECB with supervisory tasks. The mechanism's scope would be limited and focus on the systemically important banks only. Member states would obtain veto rights for bank resolution decision-making to ensure that there is no misuse of EU resolution funds (Agence Europe, 2014a; Agence Europe, 2013a; Agence Europe, 2013b; Agence Europe, 2013c; Agence Europe, 2013d; Agence Europe, 2013e; Agence Europe, 2013f; Agence Europe, 2013g; Howarth and Quaglia, 2014, pp. 129–134; Howarth and Quaglia, 2013, p. 112; Financial Times, 2012c; Financial Times, 2013a; Financial Times, 2013b; Schäuble, 2014a; Schäuble, 2013; Finance Ministries, 2012).

Table 22: Material bargaining power: Observable implications for the interstate negotiations

	Material bargaining power
Joint supervision	Part of the agreement
Direct bank recapitalisations	Not part of the agreement
ECB as supervisor	Not part of the agreement
All-encompassing scope of SSM	Not part of the agreement
Strong bail-in rules	Part of the agreement
Mutualised Single Resolution Fund	Not part of the agreement
Veto rights in SRM decision-making	Part of the agreement

3.5. Interstate Negotiations: Ideas and Frames for Rhetorical Action

Rhetorical action as the chosen rival approach to material bargaining power puts emphasis on the rhetorical processes in negotiations. Rhetoric shifts the negotiations in a direction that cannot be explained with material bargaining power only. Despite an unfavourable distribution of bargaining power, rhetorical action can enable actors to punch above their weight and gain concessions. This section operationalises the hypotheses derived from rhetorical action. While only the empirical part can establish whether rhetorical action took place, let alone succeeded, this section prepares the groundwork for the analysis. It identifies the relevant ideas and frames for rhetorical action. These serve as potential avenues for rhetorical action as they determine the terrain where negotiations take place and set the terms of references for rhetoric. This section seeks to show that the 'vicious circle between banks and sovereigns' became the prevalent and collectively agreed *problem* frame in spring 2012. It then introduces the two most relevant *solution frames*: the Southern coalition advocated risk-sharing, the Northern coalition a frame of structural reforms and risk-reduction. To test empirically whether rhetorical action based on these solution frames influenced the negotiations, the section will establish observable implications for each of the two frames.

The Problem Frame

Throughout the crisis, experts, institutions and governments offered a number of competing diagnoses for the causes of the euro crisis. For much of the crisis, the so-called ‘fiscal recklessness hypothesis’ (Johnston *et al.*, 2013, p. 6) was predominant, even to a degree at which it had ‘almost become conventional wisdom’ (Johnston *et al.*, 2013, p. 6). While emphasising the role of fiscal deficits and debt, an overall low competitiveness in the euro periphery was identified as a second important cause of the crisis (Armingeon and Baccaro, 2012, pp. 255–259; Hancké, 2012, p. 20). However, in spring 2012 a different diagnosis became ever more important among academics and political actors: the vicious circle between banks and sovereigns (Véron, 2011a). It did not suggest a low competitiveness and fiscal profligacy as root causes, but a latent banking crisis characterised by interactions between weak sovereigns and failing banks. Several member states had incurred high public debt as a result of bailing out their banks. This increase in the level of sovereign debt led to a lower value of sovereign bonds, which many banks held on their balance sheets as securities. This devaluation of their assets put the banks under pressure, again. However, another bank bailout would have deteriorated public finances further, and triggered another round of the vicious circle. In September 2011, many observers understood that

> ‘the current phase, which is often described as a sovereign debt crisis, is really a sequence of interactions between sovereign problems and banking problems. (…) [T]he situation is best described as a twin sovereign and banking crises that mutually feed each other. The result of this interaction is a gradual contagion to more countries and more asset classes.’ (Véron, 2011b, p. 2)

The novel idea of the vicious circle began to diffuse into the political arena between mid-2011 and mid-2012 at a time when the crisis in Spain escalated and opened a window of opportunity. It originated from academic circles and think tanks. Policy-makers pointed to research from Paul de Grauwe (LSE) and Nicolas Véron (Bruegel) as the source of their knowledge about the idea. One official in the Spanish Treasury remembered that ‘it was Bruegel [i.e. Véron] that started to come up with this idea that something had to be done with the banking sector’ (ST1, 2015). An advisor to the Dutch prime minister ’was convinced of the logic behind the vicious circle. I read Paul De Grauwe and I thought that made sense’ (NMGA2, 2016). A senior official in the European Commission explained that ‘there is this famous article by Paul de Grauwe on the interaction between the banks and the sovereign. I used De Grauwe’s article very intensively also to convince people here internally’ (COM7, 2015).

In a second step, international institutions acted as 'policy entrepreneurs' (see section 2.2), understood as 'advocates for proposals or for the prominence of an idea' (Kingdon, 1984, p. 122). They dragged the idea from the narrow confines of academic circles to the political realm. As early as in August 2011, the managing director of the International Monetary Fund (IMF) Christine Lagarde requested an 'urgent recapitalization' of banks to ensure they are 'strong enough to withstand the risks of sovereigns' (Lagarde, 2011):

> 'One option would be to mobilize EFSF or other European-wide funding to recapitalize banks directly, which would avoid placing even greater burdens on vulnerable sovereigns.' (Lagarde, 2011)

In a widely-noticed speech in Berlin in January 2012, Lagarde angered her German hosts as she used the vicious circle to make the case for more risk-sharing in the eurozone: 'To break the feedback loop between sovereigns and banks, we need more risk-sharing across borders in the banking system' (Lagarde, 2012). The ECB shared the IMF's assessment and channelled the idea into the European policy process (De Rynck, 2016, pp. 129–131). The ECB vice-president Vítor Constâncio laid out that it was a

> 'major lesson of the present crisis [that] some of the major imbalances that are besetting the euro area stemmed from uncontrolled behaviour of some banking sectors that eventually contaminated the sovereign.' (Constâncio, 2011)

His fellow member of the ECB Executive Board José Manuel González-Páramo seconded him. He warned of bank bail-outs 'triggering a self-defeating vicious circle' (González-Páramo, 2011). He sought a 'stronger regulatory and governance framework, so as to prevent negative feedback loops between banks and sovereigns' (González-Páramo, 2011). The ECB identified the problem and started to suggest initial forms of the banking union as the solution:

> 'For the euro area I will say clearly: we need for cross-border banking institutions a European Resolution Authority, including or combined with a Resolution Fund, as well as a European Supervisor.' (Constâncio, 2011)

The European Commission added her voice to that of the IMF and the ECB. It came late with its high-level support for the vicious circle, which led one of the Commission's top officials to scoff at Barroso that he 'came very, very late to this process, probably after it was on the front page of the Financial Times' (COM7, 2015). Yet, as late as June 2012 also Barroso publicly declared that 'a vicious circle has become established' and that 'we can break this negative cycle now if we are bold enough to establish a strong and integrated financial framework' (Barroso, 2012). Eventually, the IMF, the ECB and eventually the European Commission formed an advocacy coalition (Sabatier, 1988;

Sabatier and Jenkins-Smith, 1994). Their ideas were deeply rooted in the economics mainstream which considered institutions of risk-sharing – as they exist in the USA – part and parcel of a currency union (IMF, 2013a; Asdrubali *et al.*, 1996). They arrived at a shared understanding of the problem frame in the euro area, ranking systemic factors higher than country-level variables such as competitiveness and national fiscal policies.

The vicious circle entered policy debates at a time when a window of opportunity was opening up. At the European Council in May 2012, president Van Rompuy had secured a mandate to draft the so-called Four Presidents' Report in collaboration with the presidents of the ECB, the Commission and the Eurogroup. This report was supposed to lay out proposals for institutional reforms of the euro area. It provided the opportunity to float the vicious circle diagnosis at the highest level of the member states (van Rompuy, 2012a). While drafting the report, Van Rompuy's cabinet drew heavily from the resources and expertise of the ECB. Consequently, they appropriated the ECB's analysis centred on the vicious circle. Getting the Southern European governments on board did not require persuasion. It was an exercise of preaching to the choir (CPEC1, 2015; CPEC2, 2015), given that breaking the vicious circle seemed favourable to more risk-sharing. Treasury officials from France and Spain confirmed:

> 'We saw the contagion episodes. We saw the importance of the link between banks and sovereigns. We saw also the discrepancy between the playing field of the banks and the capacities of the states which were behind.' (FT1, 2015)

> 'The vicious circle was the most important development. Everyone was aware of it and everyone wanted to tackle it.' (SOPM1, 2015)

The breakthrough for the vicious circle as a collectively accepted problem frame came with its recognition in the Northern coalition. The German Economic Experts Council, a privileged epistemic community (Haas, 1992) and positioned in-between academia and policy-makers, recognised in October 2011 that the 'monetary union is now trapped in a vicious circle of an interlocking sovereign debt crisis and a banking crisis' (Sachverständigenrat, 2011, p. 1). Policy-makers in the German and Dutch Finance Ministries perceived the vicious circle as a 'fact' (GFM3, 2015) and 'a fair description of what was happening' (NT1, 2016). For instance, one official in the German finance ministry admitted: 'There is an underlying rationale that makes sense. It's not total rubbish, you can't dismiss it completely' (GFM5, 2015). By June 2012, the highest level of the German government accepted the problem frame. Merkel declared in the German Parliament in June 2012 that

> 'the situation in Spain shows us how important it is to shift our focus on the banking sector and decrease the risk of contagion between banks and public finances' (Merkel, 2012a).

With all sides having agreed to the problem frame, it became collectively recognised at the G-20 summit in Los Cabos, Mexico, on 18 and 19 June 2012. The meeting was attended by the four eurozone heavyweights Germany, France, Italy and Spain and the summit statement says:

> 'Euro Area members of the G20 will take all necessary policy measures to safeguard the integrity and stability of the area, improve the functioning of financial markets and *break the feedback loop between sovereigns and banks*.' (G-20, 2012, p. 1)[32]

The evidence presented above is intriguing with regard to the causal mechanism at play. The recognition of the problem frame among Northern European governments was one of the rare instances in the banking union negotiations with some degree of persuasion taking place. The above quoted interviews with policy-makers from Germany and the Netherlands suggest that academic research persuaded them of the existence of a vicious circle in the euro area. As a result, the governments in the Northern coalition accepted the interaction between sovereigns and banks as a fact. These spill-over effects between both sectors could no longer be ignored and they agreed that something had to be done about the vicious circle. However, two limitations apply: the evidence shows that at this stage the German government was only persuaded of the problem; it did not yet converge on a shared resolution frame. The section on German solution frames below will analyse in greater detail the limits of persuasion in the banking union negotiations. Second, the history of early ideas of the banking union shows that a persuasive idea by itself is not sufficient, but requires material pressures as a catalyst. In the absence of material pressures, there is only so much persuasion can do. More specifically, experts from the IMF and Véron drew attention to the risks of transnational banks in a national supervisory and resolution framework as early as in 2007. With the financial crisis still out of sight, the IMF experts predicted that transnational banks 'can be "too large to fail" and also "too large to save", because they are too big relative to the home country's resources' (IMF, 2007, p. 9). They suggested a significantly enhanced cooperation of national authorities, uniform regulation, a bank insolvency regime and a single deposit insurance

[32] Emphasis added by the author.

scheme (IMF, 2007, pp. 14–15; see also Véron, 2007, pp. 4–6). The IMF president Dominique Strauss-Kahn called for a 'European Resolution Authority' including 'an integrated system of crisis prevention, crisis management, crisis resolution, and depositor protection' for 'at least the major cross-border banking groups, as well as all banks running large-scale cross-border operations' (Strauss-Kahn, 2010; see also Véron, 2008; Posen and Véron, 2009), but was ignored. The early period of the crisis brought incremental change, but fell short of decisive change (e.g. Larosière, 2009). For instance, the Commission president Barroso disregarded the idea of a joint supervisor, as quoted above: 'we are trying to avoid a heavy-handed, top-down approach where it isn't necessary. This network [of supervisors] represents a realistic approach' (Barroso, 2009). Yet, incremental solutions continued to fail (Wiggins *et al.*, 2015; Posen and Véron, 2009, pp. 5–6) and the missing condition for more far-reaching policy solutions to be discussed was the vicious circle in conjunction with material pressures. In line with neo-functional logics, material pressures created a pressure to act and the vicious circle guided policy-makers of the centrality of the banking dimension. Véron and the IMF proposed a European financial regulation and supervision as early as 2007 (IMF, 2007; Véron, 2007), but it was not until the vicious circle became the 'core problem' (Véron, 2011a) that these ideas were seriously considered. To be noted, these findings stand in some tension to the literature on persuasion. Habermasian accounts of persuasion assume that persuasion takes place in ideal-speech situations with no constraints preventing actors from changing their mind (Habermas, 1984; Risse, 2000). In the banking union negotiations, however, the actors were highly constrained by material pressures which put the existence of the currency area at risk. The evidence suggests that these constraints did not prevent persuasion, but fostered it as the problem pressure forced all actors to increase the efficiency of their crisis management.

This collective recognition of the problem frame at the G-20 in Los Cabos subsequently determined the terrain where the negotiations were to take place. However, disagreements persisted with regard to the solution of the vicious circle. A Dutch negotiator got to the point with his distinction between the problem frame and the solutions to it: 'It was not so much the vicious circle that we were afraid of, but direct bank recapitalisations' (NT2, 2016). Both the Northern and the Southern coalition advocated rival solution frames to the vicious circle, ranging from structural reforms to risk-sharing and mutualisation between members of the currency union. The following section introduces the two sides' competing solution frames.

The Solution Frames

One solution frame to the vicious circle consisted of an increased level of risk-sharing in the euro area. Many experts converged on the view that direct bank recapitalisations were an effective means to break the circle. Considering 'the core problem of the sovereign-banking nexus', Véron suggested that '[e]urozone-wide financial mechanisms should at least partly replace national backstops' (Véron, 2011a). Among these mechanisms, the possibility of direct bank recapitalisations was 'eminently important' (De Grauwe, 2012; see also McArdle, 2014; Verhelst, 2013a, pp. 26–27; Merler, 2014). Direct bank recapitalisations mean that member states inject joint funds into failing or failed banks without channelling them through the home state of a bank. This mechanism increases the risks for the providers of the funds, but effectively breaks the link between banks and sovereigns: bank failures do no longer tear down the home sovereign of the bank (as the costs of bank failures are shared among all member states, the home member states is only marginally affected by the costs). Based on these considerations, the IMF's Managing Director Christine Lagarde argued that 'a pan-euro area facility that has the capacity to take direct stakes in banks will help break this link' (Lagarde, 2012).

The coalition of Southern European member states readily backed the risk-sharing solution frame as a response to the vicious circle. They had long-held preferences in favour of more risk-sharing, as a means to reduce the vulnerability of countries in a currency area. Similar to the USA, where economically strong states explicitly or implicitly absorb shocks in the periphery, a sharing of resources in the euro area would increase its resilience against shocks. In line with this thinking, the French president Hollande aimed to employ the bailout funds as vehicles for mutualisation and risk-sharing in EMU: 'it would be good if the EFSF could play a bigger role than today for the banks which need it. And a possibility would be using its funds without channelling it through the government' (Hollande, 2012a). The Commissioner Olli Rehn gave an exemplary account of the solution frame based on risk-sharing:

> 'Allowing the ESM to directly recapitalise banks, once the conditions are met, is a cornerstone of our efforts to break the vicious circle between banks and sovereigns. Once in place, this will be a powerful tool to ease pressure on sovereigns in the euro area.' (cit. in EurActiv, 2012a)

The preference for direct bank recapitalisations was embedded in a broader vision based on far-reaching mutualisation in various sectors of the euro area. Hollande did not conceal his intentions to bring about more mutualisation in the fiscal dimension either: 'Budgetary union means that we have a European Treasury, which can issue bonds and mutualise debt' (Hollande, 2012b). His Spanish counterpart Mariano Rajoy shared these plans and declared himself 'a supporter of progressing towards a monetary union, towards a fiscal union, towards an economic union, and steps in-between could be eurobonds or a more active central bank' (Rajoy, 2012a).

Further support for the risk-sharing solution frame was derived from the alleged misfit between calls for structural reforms and austerity, on the one hand, and the new problem frame of the vicious circle, on the other. Proponents of the risk-sharing solution frame argued that for countries caught in a vicious circle, neither an ESM programme increasing their debt-to-GDP ratio nor structural reforms or fiscal consolidation can credibly solve this problem. In the words of the then-French economy minister Michel Sapin: 'France needs to avoid the vicious circle (…). No one can escape the vicious circle with austerity' (Sapin, 2012). Risk-sharing had been a French preference before the emergence of the vicious circle, making it a politically expedient solution frame (Moscovici, 2012; see also Lequesne, 2013, p. 47). A senior official advising the French prime minister reported that Hollande concluded at the beginning of his term that 'austerity has failed' (FOPM1, 2016). The Italian and Spanish governments followed their French counterpart with similar decisiveness (Rajoy, 2012b; Rajoy, 2012c; Emmanouilidis, 2012, p. 2; Ludlow, 2012a, p. 7; Financial Times, 2012d; Financial Times, 2012e; Bloomberg, 2012).

If rhetoric matters and the risk-sharing resolution frame wins the causal argument, we would expect a full-fledged banking union with significant risk-sharing to come about. It would strongly build on shared resources. In detail, there would be an agreement on direct bank recapitalisations and a fully mutualised fund, encompassing all banks in the euro area. The ECB would be the joint supervisor to ensure the credibility of the new scheme, and no national veto rights could constrain the effectiveness of resolution decision-making. This would make bail-ins redundant.

Table 23: Rhetorical action: Observable implications for the interstate negotiations, risk-sharing solution frame

	Rhetorical action: risk-sharing
Joint supervision	Part of the agreement
Direct bank recapitalisations	Part of the agreement
ECB as supervisor	Part of the agreement
All-encompassing scope of SSM	Part of the agreement
Strong bail-in rules	Not part of the agreement
Mutualised Single Resolution Fund	Part of the agreement
Veto rights in SRM decision-making	Not part of the agreement

At first sight, it may seem puzzling why countries in the North accepted a problem frame that was seemingly supported primarily by Southern European governments. However, not only did the Southern governments perceive their solution frame to be suitable to the new problem frame – so did the German government with its own solution frame. Thus, both the North and the South welcomed the new problem frame, but continued to diverge on the solution and saw the new frame as an opportunity to draw support for their own frame.

From the German perspective, the vicious circle was merely a symptom of other problems. This line of thinking suggested that stable and healthy sovereigns were less prone to be pushed into a vicious circle between banks and sovereigns – as a more resilient sovereign would be able to absorb shocks from the banking sector without collapsing (GFM4, 2015). To increase their resilience, countries needed to undergo structural reforms and put their own house in order. In this reasoning, structural reforms were a suitable response to the problem frame of the vicious circle. In line with this reasoning, the German Economic Experts Council suggested far-reaching domestic reforms, conditionality for financial assistance, and the involvement of the private sector in shouldering the costs of the insolvency of individual countries (Sachverständigenrat, 2011, p. 7). One German official from the Finance Ministry remembered their assessment of the problem and the solutions suggested:

> 'Breaking the vicious circle was a cognitive focusing of the assessment where the crisis comes from, what its nature is and how to get over it. The idea by many was "let's do the banking union and everything will be fine". It was like a holy grail that came around the corner. This went so far that even we said: 'in principal yes, but...'. We didn't question the vicious circle as such, but we pointed to the problems causing it. I wanted an all-encompassing solution to

the causes of the crisis, but with the vicious circle these were only partially addressed.' (GFM5, 2015)

His perception was strongly supported by one of his colleagues:

> 'Of course, these problems became a lot more acute in countries in which there was an interaction between banks and fiscal problems. But there were causes for the vicious loop: too much public debt, which weakened the sovereign's ability to absorb private debt and a badly regulated banking sector led to banking risks. And we had these discussions a lot earlier than the acute period in spring 2012. This situation merely created a new dynamic, but it was not the trigger for the problem.' (GFM3, 2015)

A Spanish negotiator recalled how his German counterparts made sense of the vicious circle: 'They think if you had your finances in order, then you wouldn't be under suspicion that you aren't able to back your banking sectors' (ST4, 2015). A colleague seconded:

> 'The Germans were very consistent. They always said: 'the root cause is a fiscal cause and you need to put your house in order.' At the peak of the crisis, fiscal discipline did not become less important, but they agreed to first tackle urgent things. It's a shift of emphasis, but not a change of the main ideas.' (ST5, 2016)

As discussed above, the German government was persuaded to accept the vicious circle as the predominant problem frame. However, it was not persuaded to change its preferences; instead, the result of the persuasion that took place is better described as a reprioritisation. The government continued to hold the view that fiscal deficits and low competitiveness were the root causes of the crisis. If governments had kept their sovereigns in order, the interaction between sovereigns and banks could not have taken place as the former would have been more resilient. The German government was persuaded of the vicious circle, but maintained that only structural reforms would solve its root causes. It accepted though that, besides these principled considerations, the vicious circle between banks and sovereign was an urgent problem that needed to be tackled without any further delay.

The German government advocated constraints on national governments in line with its analysis of the crisis as the result of domestic policy failures. According to Schäuble, '[t]he EU institutions, the EU commission included, should get more instruments to exercise control. Otherwise it would be impossible for a currency union to work' (cit. in EU Observer, 2012a). A case in point were the experiences in Spain, where government interventions jeopardised the efforts of the banking supervisor to prevent a bubble in the real estate sector from building up (see section 3.3). Merkel referred to it as an example of the detrimental impact of political interventions from national governments: 'this example shows us that we need an independent supervisor, for instance in the banking sector' (Merkel, 2012b). An increase of the standards in banking supervision was also recognised as a benefit to Germany in the sense that it lowers the risk of banking crises in other member states, as one official in the Finance Ministry explained: 'We had a bad quality of banking supervision in many member states. Now, we've had a chance to achieve a better supervision, which is also beneficial for Germany in terms of a higher financial stability' (GFM9, 2015).

In addition to structural reforms and more constraints on national governments, the third component of the German solution frame was the intention to shift the costs of bank failures to the private sector. As Merkel emphasised, 'we are guided by the conviction that the financial sector should shoulder an appropriate share of the costs to resolve the financial crisis' (Merkel, 2012a). Schäuble clarified that '[w]e need to break the vicious circle between sovereigns and banks in order to avoid that at the end it's the taxpayer who suffers' (Schäuble, 2014b). The main instrument for this purpose was imposing bail-ins, i.e. forcing investors to bear parts of the losses of bank failures to make them liable for their investments. If the private sector bears the losses of bank failures, they do no longer spill over to the sovereign; this is meant to effectively prevent the emergence of a vicious circle at no costs for the taxpayer. It builds on previous attempts of private sector involvement (PSI) in the restructuring of sovereign debt. Shifting costs of bank failures to private agents was a long-term goal of the German government and the new problem frame provided a new opportunity to gain political support for it.

If rhetoric matters in the negotiations and the German solution frame won the causal argument over risk-sharing, we would expect a very different kind of the banking union to come about. It would neither entail a possibility for direct bank recapitalisations nor a joint resolution fund, but strong and automatic bail-in rules. The agreement would furthermore shift supervision away from national governments and to a single European supervisor, but this supervisor would be an institution different to the ECB to avoid constraints on the independence of the latter. Also, national vetoes (and especially for Germany) in the resolution decision-making would be a further safeguard against the misuse of funds.

Table 24: Rhetorical action: Observable implications for the interstate negotiations, structural reform/risk-reduction solution frame

	Rhetorical action: structural reforms/bail-in
Joint supervision	Part of the agreement
Direct bank recapitalisations	Not part of the agreement
ECB as supervisor	Not part of the agreement
All-encompassing scope of SSM	Part of the agreement
Strong bail-in rules	Part of the agreement
Mutualised Single Resolution Fund	Not part of the agreement
Veto rights in SRM decision-making	Part of the agreement

The analysis produced two findings. First, the vicious circle between banks and sovereigns became the predominant problem frame in spring 2012. All governments and institutions recognised it and suggested breaking it. However, the second result is a persisting disagreement with regard to solutions to the identified problem. Two rival frames were advanced for breaking the vicious circle. While Northern governments suggested structural reforms, more European control and involving the private sector, the South preferred risk-sharing and mutualisation across borders to increase the resilience of sovereigns.

3.6. Conclusion

A variety of factors can determine the preferences of governments and whether they are able to successfully impose their preferences on their counterparts in negotiations. This chapter sought to focus the analysis on those factors which the theory chapter predicted to be important. Liberal intergovernmentalism suggests that material interests and material bargaining power explain the outcome of the formation of preferences and of interstate negotiations. This chapter introduced the reader to the relevant interests and the distribution of bargaining power in the banking union negotiations. The two ideational approaches predict that ideas and rhetorical action influence the preferences and the negotiations.

The chapter identified several sources of material interests in Germany. The public and the private banks account for a roughly equal market share. They are similarly powerful, as both play important roles in the economy. The former turned against the banking union, whereas the latter was very favourably inclined towards the project. The macro-economic preferences were based on a strong fiscal position and internationalised (and Europeanised) trade patterns. The fiscal position suggested a limited banking union without joint resources as fiscal considerations would dominate. Trade patterns, however, would result in a priority on fixing EMU, which would inevitably include greater risk-sharing.

On the ideational side, the chapter presented the long history of ordoliberal ideas and their influence on German policies. These ideas broadly align with Germany's fiscal position. In the Southern coalition, the banking sectors were ailing under the crisis. A full-fledged banking union was a means for reducing financial fragmentation and helping the banks to get back on their feet. Likewise, the macro-economic preferences suggest a policy along the same lines as a means to increase the resilience of EMU through more risk-sharing and mutualisation. Post-Keynesian ideas resonate with risk-sharing and mutualisation, given their strong emphasis on market-corrective policies.

If the neo-functional approach provides an alternative explanation, we would expect that governments are strongly in favour of a fully-fledged banking union during times of crisis, but would renege from their commitments once crisis pressures faded away. Concretely, they would have been in favour of a joint supervisor and direct bank recapitalisations at the Euro Summit, but opposed further integration steps in the SSM and SRM negotiations as the crisis pressures had already been markedly reduced, if not disappeared.

The remainder of the chapter dealt with the interstate negotiations. The distribution of material bargaining power favours the German government. For liberal intergovernmentalism to be confirmed with regard to the outcome of interstate negotiations, it would have to be the German government that imposes its preferences on its counterparts from the Southern coalition. A competing hypothesis predicted the outcome to be the result of rhetorical action. This chapter showed that all actors agreed on the vicious circle between banks and sovereigns as the problem frame in the negotiations, but two rival solution frames opened different avenues for rhetorical action. The Southern coalition preferred solving the vicious circle through significant mutualisation and risk-sharing. The solution frame preferred by the Northern coalition suggested a policy of structural reforms to make sovereigns more resilient and avoid that they are pushed into the vicious circle.

Having established observable implications for each of the hypotheses, this chapter completed the theoretical framework. The following steps in the analysis serve the empirical testing of the hypotheses. This will be structured in three chapters. The first empirical case is the Euro Summit in June 2012, which led to a breakthrough for the banking union. It is followed by one chapter on the Single Supervisory Mechanism, and one on the Single Resolution Mechanism.

Chapter 4: The Euro Summit in June 2012

4.1. Introduction

> 'Dear fellow citizens, the decisions which chancellor Merkel was forced to make at the Euro Summit are wrong. We, the economists from the German-speaking countries, are deeply concerned with the latest step towards a banking union, which will result in a collective liability for the bank debt in the eurosystem. (…) Politicians might hope that they can limit the liabilities and the misuse [of joint funds] with a joint banking supervisor. Yet, it is unlikely that this attempt will be successful, as the debtors are in a structural majority in the eurozone. If the economically strong countries agree to the principle of a shared liability for bank debts, they will time and again be pressured to increase their liabilities (…). Please speak to the member of parliament in your constituency. Our representatives should be made aware of the dangers for our economy.'
>
> (Statement by 282 German economists, 5 July 2012, cit. in FAZ, 2012)

The Euro Summit of 28 and 29 June 2012 marks a watershed moment for the eurozone. After a turbulent and partly chaotic summit, the heads of state or government agreed on the creation of a mechanism for direct bank recapitalisations in connection with the creation of a joint banking supervisor. The alarming statement of 282 German economists quoted above exemplifies the dismay of the German public about the summit outcome (Der Spiegel, 2012a; Reuters, 2012a). Business interest groups (BDI, 2012) rejected the outcome in similar tone. Conversely, the leaders in the South rejoiced. Monti lauded his own negotiation tactics as 'objectively very useful' (cit. in Council of the European Union, 2012). Commentators perceived him as 'a clear victor, having broken chancellor Angela Merkel's resistance just as Italian striker Mario Balotelli cracked the German defence on the pitch in Warsaw earlier this evening' (Der Spiegel, 2012a) after the Italian football team's victory over the German side in the semi-finals of the European football championship in the same night.

Two issues were particularly contentious at this stage of the negotiations: first, the creation of a mechanism for direct bank recapitalisations. It was central to the negotiations, but negotiators held widely different preferences about the desirability of such a mechanism. The second contentious issue was the establishment of a single European banking supervisor. Given the large-scale sovereignty transfer it would entail, the stakes were high and the preferences around the negotiation table very different. How can we explain the unexpected outcome of these two issues which led to the perception of Southern leaders having carried the day?

The analysis suggests that German preferences were formed against the background of considerable fragmentation of domestic interests, not least because of the high degree of uncertainty at this critical moment for the future of the euro area. As uncertainty obscured the evaluation of the costs and benefits of the available policies, both shifting adjustment costs, as well as decisive steps towards a genuine EMU, would have been rational to pursue. Hence, material interests do not result in a single rational course of action. The evidence suggests that internalised ordoliberal ideas held as worldviews tipped the balance in favour of preferences based on the fiscal position. Policy-makers evaluated the situation from the point of view of ordoliberal ideas and these resonated much stronger with fiscal considerations than alternative preferences, including the acceptance of additional liabilities. The preferences of the Southern coalition were motivated by the prevalent material interest to introduce measures of risk-sharing across borders to sustain the currency area, a preference backed up by both private interests and macro-economic considerations. Overall, fragmentation was low, which means the scope condition for ideas was not triggered, and material interests do account for the preference formation in the Southern coalition.

In the interstate negotiations, the two coalitions held diametrically opposed preferences. The outcome suggests that the Southern European coalition punched above its weight in the negotiations. The analysis shows that the effective use of rhetorical action was critical for this outcome to materialise. The shared goal of breaking the vicious circle between banks and sovereigns constrained the German government. It had accepted the vicious circle as problem frame, but its proposed solutions did not convince its counterparts. German ideas of structural reforms were judged as an unsuitable solution frame to this particular problem. On this new terrain, the German government was set to lose the causal argument. Experts, international institutions as well as Southern European governments made a powerful case for risk-sharing as an effective solution to the problem. Framing their own preferences in favour of risk-sharing as a contribution to the shared goal of breaking the vicious circle, the Southern coalition was able to extract concessions from the German government, in spite of its lower material bargaining power.

This chapter serves two purposes. First, it provides an explanation for the outcome of presumably one of the most important summits in the history of the European Council. As Glöckler *et al.* stated, 'few analyses so far have attempted to shed light on the swift creation [of the banking union]' (Glöckler *et al.*, 2017, p. 1138). Second, in addition to the value of fostering our understanding of the concrete outcome, it serves as a test to the theoretical framework introduced earlier. The results of the empirical analysis help the assessment of the theoretical propositions. Furthermore, the analysis provides further evidence of the influence of ideas on EU negotiations, both at the level of domestic preferences and interstate negotiations.

The next section briefly restates the observable implications of each hypothesis for the two contentious issues of the negotiations. This is followed by an introduction to the signature events in June 2012, followed by an analysis of the decisive steps and considerations leading to the grand bargain at the Euro Summit in June 2012.

4.2. Observable Implications

This section recalls the observable implications for each of the established hypotheses, beginning with the hypothesis on the domestic preferences of the German government. The private banks were outward-looking and interested in a level-playing field. This included both advocacy for a joint supervisor and direct bank recapitalisations as a means to put an end to the ongoing banking crisis (BDB, 2012). To be able to confirm their influence on the government, we would expect the latter to advocate joint supervision but reject direct recapitalisations. The public banks, however, were inward-looking and rejected European interference of any kind. They turned against joint supervision and direct recapitalisations (BVR/VÖB/DSGV, 2012). We would expect the government to reflect these preferences if the public banks were central to their preference formation. If the German government's primary macro-economic preference is sustaining the eurozone to maintain its trade patterns, we would expect it to be in favour of both supervision and direct bank recapitalisations. Both are fixes to the currency union's institutional flaws with a favourable cost-benefit balance when compared to other fixes such as eurobonds (Glöckler *et al.*, 2017, p. 1142). If, by contrast, the fiscal position determines the German government's position and it seeks to limit adjustment costs and be wary of the risks of a transfer union, we would expect it to oppose direct bank recapitalisations. It would, however, support joint supervision as a means for stripping powers off from national governments, which are all-too-often capturing their national bank supervisors (Howarth and Quaglia, 2013, p. 109). Ordoliberal ideas put the fear of moral hazard centre stage. Their impact on the government would result in resistance against direct bank recapitalisations which weaken the alignment between control and liability. At the same time, ordoliberals would be in favour of joint supervision as a means for constraining national governments. From a neo-functionalist perspective, we would expect the government to in favour of both joint supervision as well as direct bank recapitalisations as the currency union was exposed to strong material pressures in June 2012.

Table 25: Euro Summit: Domestic preference formation, German government

	Private material interest: public banks	**Private material interest: private banks**	**Macro-economic preferences: fiscal position**	**Macro-economic preferences: trade patterns**	**Ideas: ordoliberalism**	**Neo-functionalism: crisis pressures**
Joint supervision	Against	In favour	In favour	In favour	In favour	In favour
Direct bank recapitalisations	Against	In favour *(weakly)*	Against	In favour	Against	In favour

Moving on to the observable implications for the governments in the Southern coalition, the macro-economic preference arising from their fiscal position as well as trade patterns suggests the creation of mechanisms of risk-sharing and mutualisation in the euro area. They would have served the goal to put EMU on a stable footing, while shifting some of the crisis costs to the Northern part of the continent (Schimmelfennig, 2015, p. 183). If macro-economic preferences drove the government's considerations, we would expect to see it supporting both joint supervision and direct recapitalisations. Similarly, the banks were strongly affected by the fragmentation of the financial markets. Most of them (especially in Italy and Spain) advocated direct bank recapitalisations and were willing to accept a joint supervisor (even though banks in France were less enthusiastic) (FBF, 2012b; ABI, 2012a; BBVA, 2013). The influence of post-Keynesianism would translate into support for the package of direct recapitalisations and joint supervision as a means to further the risk-sharing elements in the European construction. However, the support for supervision would be linked to an agreement on direct recapitalisations; an isolated agreement on supervision would contradict the primacy of risk-sharing, as will be shown in more detail in section 4.4. Same as above, neo-functionalism would predict a preference for joint supervision and direct bank recapitalisations.

Table 26: Euro Summit: Domestic preference formation, Southern coalition

	Macro-economic preferences: fiscal position and trade patterns	**Private material interest: banking sector**	**Ideas: post-Keynesianism**	**Neo-functionalism: crisis pressures**
Joint supervision	In favour	In favour *(France: hesitant)*	In favour *(if agreement on DBR)*	In favour
Direct bank recapitalisations	In favour	In favour	In favour	In favour

Moving on to the interstate negotiations, the power-based hypothesis predicts that the result of the Euro Summit corresponds to the preferences of the German government as the most powerful member state. For this prediction to be confirmed, we would expect an agreement on joint supervision, but no direct bank recapitalisations. By contrast, the ideational hypothesis suggests that rhetoric influences the negotiations. If the advocates of the risk-sharing solution frame could successfully corner their counterparts with their arguments, we would expect an agreement on direct bank recapitalisations and joint supervision. If, however, the structural reform solution frame gained the upper hand in the rhetorical battle, there would be no such direct recapitalisations, but joint supervision.

Table 27: Euro Summit: Interstate negotiations

	Power: material bargaining power	**Rhetorical action: risk-sharing**	**Rhetorical action: structural reforms/ risk-reduction**
Joint supervision	Part of the agreement	Part of the agreement	Part of the agreement[33]

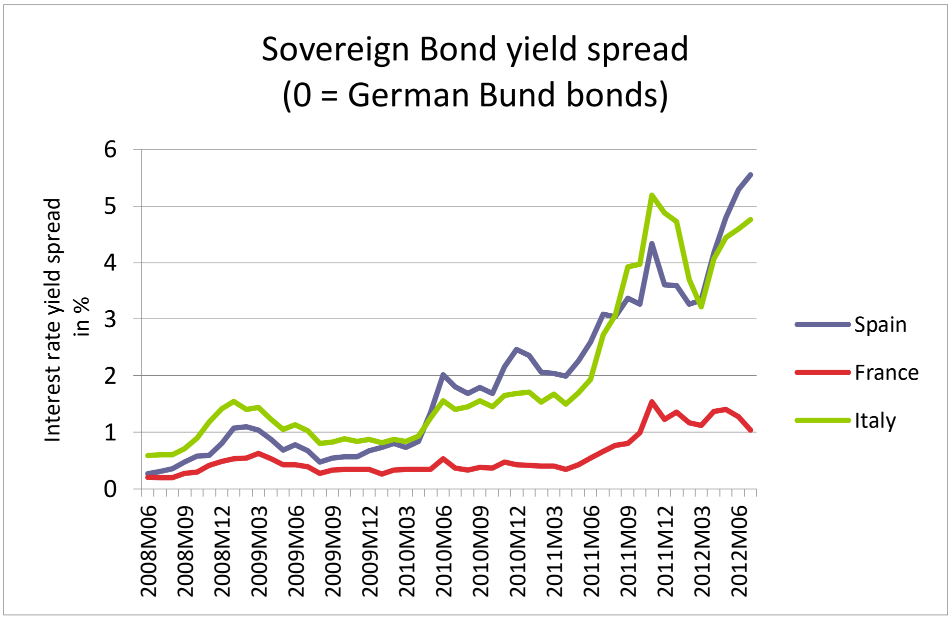
[33] See footnote 15; strictly speaking, joint supervision is overdetermined as all three approaches suggest that it will come about. In this case, the method of congruence does not provide for a confirmation or disconfirmation of the hypotheses (unless all three can be disconfirmed at the same time). Yet, process

Direct bank recapitalisations	Not part of the agreement	Part of the agreement	Not part of the agreement

4.3. The Eurozone in Spring 2012: Nearing the End-Game

The situation in the eurozone in June 2012 was characterised by panic at the financial markets and a fragile overall environment. Muddling through had become the *modus operandi* of the crisis management, but it failed to extinguish the fires that had already been ignited since 2008. Greece, Ireland and Portugal had received a loan from the European Stability Mechanism but the programmes did not calm down markets. Investors raised the pressure on the Italian and Spanish sovereigns. First signs indicated that France was the next one in line (see Figure 4). Contagion was no longer an abstract fear, but impossible to ignore and taken as a fact in June 2012.

Figure 4: Sovereign bond interest-rate spread



Source: Eurostat; own graph.

The tense situation resulted in an increasing awareness among policy-makers that they were close to the edge of the abyss. They were forced to 'fight the endgame of the crisis'

tracing can still discriminate between them and confirm one hypothesis while disconfirming the other two hypotheses.

(ST1, 2015). This caused a sense of panic on the corridors of finance ministries and EU institutions. According to a French negotiator, '[t]he market situation was appalling. We were freaked out to see that the contagion was going to Spain' (FT1, 2015). This collective feeling was reinforced by the belief that, according to a close advisor of the then-French finance minister, '[e]verything we did before didn't work' (FOPM1, 2016). The anxieties were particularly strong in Spain. The government had its back to the wall and was at risk of losing access to financial markets at affordable rates. The crisis threatened the future of the government. One senior official in the Treasury remembered that 'we were pissing against the wind. Something had to happen' (ST5, 2016). The uncomfortable situation was by no means confined to the crisis countries. It was equally shared by, for instance, the German government. A senior official in the German Finance Ministry admitted that '[t]he situation had become very severe. We thought through all possible scenarios, including the end of the currency (...). Spring 2012 was characterised by the search for a master plan. That was the case for Germany as well as for Europe' (GFM8, 2016). EMU had approached its make-it-or-break-it moment in the early summer of 2012. One sherpa of a member of the European Council remembered that '[p]eople felt it might turn into a question of survival. And that's the reason why a number of unorthodox things started happening' (CPEC1, 2015).

This environment in spring 2012 suggests that the scope conditions for a potential influence of ideas were met. The framework suggested that ideas influence policies when there is uncertainty, a crisis situation with a strong sense of urgency, as well as cognitively complex negotiations. The evidence above shows that the negotiators faced a fundamental crisis of the single currency which required urgent action. At the same, there were no solution that could be taken 'off the shelf'. This created uncertainty about the measures that were needed to satisfy markets and their long-term impact on the institutional framework of the currency union. Against this background, the scope conditions suggest that an ideational approach can potentially offer fruitful insights into the analysis.

4.4. The Preferences of Member States: How to Sustain a Common Currency?

The material pressures at the summit are analytically important as the urgency of the situation is likely to increase the openness to compromise on all sides. However, these pressures do not reveal much about the likely terms of the agreement. The next sections will illuminate our understanding of the process in more detail. An analysis of domestic preferences is the first step to make sense of the outcome.

The Northern Coalition: Shifting Adjustment Costs

The emerging evidence for the vicious circle between banks and sovereigns had changed the problem frame, but the German government remained stubbornly opposed to risk-sharing. It continued to perceive the euro crisis as the result of domestic policy failures. The main adjustment following the vicious circle consisted of no longer locating these failures exclusively in the sphere of fiscal and economic policy, but broadening the perspective to the banking dimension. A leading official in the Commission remembered 'that Germany has never completely parted from the fiscal narrative, but at least at that point, it was less as prevalent' (COM7, 2015). Despite this change of emphasis, the German government remained consistent with the solution frame of structural reforms. Only a stable sovereign was thought to be sufficiently resilient in a banking crisis. At the early stages of the negotiations, the Chancellery rejected the very term 'banking union' to avoid giving the slightest impression of a planned sharing of liabilities, for instance through a joint bank resolution fund or a mechanism for direct bank recapitalisations. These preferences of the German government were shared by its strongest allies. The Finnish government was closely aligned and while the Dutch government was in principle open to the banking union (the latter had floated a proposal for a joint resolution fund as early as 2008 (Gammelin and Löw, 2014)), they rallied behind the German government at this critical and decisive moment (Ludlow, 2012a). The Finnish and Dutch governments feared to become the paymaster in this urgent situation and relied on Germany to have the necessary political weight to prevent having to pay for the periphery (NMGA2, 2016; NCB2, 2016). According to one member of the European Council, their differences were only subtle – a greater openness on the Dutch side for some risk-sharing in the longer term – and did not prevent them from siding with the German government in June 2012 (MEC1, 2016).

The urgency of the situation did cause a reversal of the German stance on the creation of a European banking supervisor. The German government had opposed it for decades (Véron, 2008, pp. 1–2; Grossman and Leblond, 2011), but reversed its policy when the proposal for direct bank recapitalisations entered the negotiations. In light of these new developments, the creation of a joint supervisor was not exclusively about losing control over the domestic banking industry, but provided the advantage of being a credible safeguard against moral hazard. The crisis had shown that national supervisors were all too often under the influence of national governments. This created adverse incentives as governments' alternative goals, such as promoting economic growth, jeopardised an effective banking supervision. In addition to a higher quality of supervision, another strong motive for German negotiators was to achieve a reduction of loopholes for international banks to circumvent national rules. A senior official in the German Finance Ministry reported that '[w]e realised that we had a problem with banking supervision. Almost all our banks were involved in the Irish crisis. There was even some form of "supervisor hopping"' (GFM7, 2016; see also Scharpf, 2011, p. 25). From this perspective, a joint supervisor was a means for reducing the risk that national governments give too much leeway to their national banking sector and to increase the quality of supervision overall. As Merkel put it:

> 'We need a credible European banking supervision, which is impartial and does not get diverted by national interests. At least those banks with a systemic relevance should be subject to a strengthened joint supervision.' (Merkel, 2012a)

As the above analysis showed, crisis pressures played an important role for German preferences. It limited the policy options available and constrained the government's room for maneuvre. The apparent role for these pressures leads to the question whether a neo-functionalist explanation accounts for German preferences. However, the neo-functionalist hypothesis can be confirmed only to some extent. On the one hand, the evidence above shows that material pressures forced the German government to act. It could not ignore the crisis pressures as non-action could have resulted in the break-up of the currency, an outcome the German government was adamant to avoid. On the other hand, while these pressures explain that governments will act and do *something* to avoid break-up, they do not explain why the German government was in favour of joint supervision, but not direct bank recapitalisations. Following the neo-functional logic, we would expect the German government to advocate direct recapitalisations. They would have addressed the functional weaknesses of the existing institutional framework and been a decisive step towards a more complete currency union. Against this background, it remains a puzzle for neo-functionalism why the German government continued to oppose important steps in the direction of a fully-fledged currency union, despite the crisis pressures. In sum, neo-functionalism explains *why* the German government decided to act, but not *how* it acted and, more specifically, why it continued to resist crucial integration steps despite strong material pressures.

Having clarified the government's preferences permits us to evaluate the hypotheses on the domestic preference formation. The government's favourable stance towards joint supervision matches both the preference of the private banks (BDB, 2013b) and the macro-economic preference to limit transfers, but runs counter to the position of the public banks (BVR/VÖB/DSGV, 2012) and the macro-economic preference of fixing EMU as suggested by trade patterns. In the second contentious issue of direct recapitalisations, private banks and the macro-economic preference of sustaining EMU is insufficient, as they suggested a favourable position of the government (BDB, 2013b). The public banks opposed it (BVR/VÖB/DSGV, 2012). Based on these matches and mismatches, we can rule out that the government followed one of the banking groups, as the government acted inconsistent with their positions. Even though the government professed its willingness to 'defend the stability of the euro area', as the German finance minister Wolfgang Schäuble put it (Schäuble, 2010a), there is no strong evidence either that this intention manifested itself in voluntarily shouldering additional burdens. This, however, was expected by the hypothesis of macro-economic preferences based on trade patterns. It can be refuted as the government did not take a favourable stance towards direct bank recapitalisations. There is a match on both issues, however, between the government and the macro-economic preferences as derived from the fiscal position. Following the method of congruence, these matches provide strong support for the corresponding hypothesis.

However, given the many competing and fragmented interests, it is not yet established sufficiently robustly why the government prioritised the fiscal position over competing interests. For instance, it would have been equally plausible to use the window of opportunity to agree to a lasting fix of the currency area. The framework of this study suggested that in cases with a high fragmentation of interests, governments resort to ideas to evaluate and make a decision between the many competing interests. This hypothesis would be confirmed if these ideas and preferences were congruent. Furthermore, process-tracing would reveal the causal mechanism. If it was indeed internalised ordoliberal ideas that tipped the balance in favour of the fiscal position, interviewees in the Finance Ministry would frame ordoliberal ideas as a point of reference that is taken for granted, manifesting their internalisation. They would, however, not be presented as trumping or overriding the fiscal position, but naturally feeding into it – and explain why the fiscal position was preferred over equally rational competing interests.

The evidence supports this perspective. The government's choices match the policy implications of the ordoliberal ideas of *Ordnungspolitik*. It had a favourable stance towards joint supervision as a means for constraining national governments and rule out future domestic policy failures. Likewise, the preferences matched ordoliberal ideas with regard to direct recapitalisations, which it rejected on the grounds of causing moral hazard and violating the 'principle of liability' (Eucken, 1951, pp. 279–285). Interview data from the Finance Ministry point to strong identification with ordoliberal ideas as an internalised institutional culture. According to one official, 'some follow a purer doctrine than others, but it's a joint doctrine' (GFM5, 2015). One of his senior colleagues seconded:

> 'We firmly believe in *Ordnungspolitik*. We begin thinking about it when we shave us in the morning. And when we leave our offices late in the evening, we still think about *Ordnungspolitik*. It is the soul of this house.' (GFM8, 2016)

One official emphasised the internalised nature of ordoliberal beliefs in the Ministry:

> 'There is no question we've got an ordoliberal culture in this house. Only a few here have actually read Eucken or Müller-Armack and many don't know much about the broader theory of ordoliberalism. But we certainly all agree on *Ordnungspolitik*.' (GFM7, 2016)

These findings are consistent with the literature that has identified ordoliberalism as a 'basic value' (Nedergaard and Snaith, 2015, pp. 1106–1107) in German ministries (see also Segers and Van Esch, 2007, p. 1092; Bulmer, 2014, p. 1257; Kaltenthaler, 2002, p. 72; Nedergaard and Snaith, 2015, p. 1097). While the interviewees provide strong evidence for the internalisation of ordoliberal ideas, Merkel's discourse shows close proximity to ordoliberal arguments of realigning control and liability and fiscal considerations about protecting the taxpayer. The day before the Euro Summit, Merkel warned against financial transfers as 'eyewash and fake solutions' (Merkel, 2012a). She championed this policy with her assertion that there would be no eurobonds 'as long as I live' (cit. in Der Spiegel, 2012c). At the same time, Merkel's justification for her preferences leans very explicitly towards the ordoliberal theme of realigning control and liability.

> 'There should never be a misfit between control and liability. Control and liability needs to go hand in hand. Joint liability requires sufficient control in the first place.' (Merkel, 2012a)

Likewise, she disagreed with the Four President's Report published just before the summit on similar grounds:

> 'I decisively disagree with the report in that it mostly speaks of mutualisation and only in second place and also very imprecise about more control and enforceable obligations. This leads to a misfit between liability and control in this report.' (Merkel, 2012a; see also Emmanouilidis, 2012, pp. 9–10)

Schäuble explained how realigning control and liability fell together with protecting the taxpayer, when speaking to his colleagues from economically weaker countries: 'You want to shift the risk from your banks to the German taxpayer. Under no circumstances are we going to agree' (Schäuble, 2014c).

Overall, the evidence marshalled suggests an interplay rather than a competitive relationship between ordoliberal ideas and the fiscal position. The German government was faced with a number of competing interests, but since ordoliberal ideas were internalised and resonated best with the reasoning behind the fiscal position, they tipped the balance in favour of the latter.

The Southern Coalition: Sharing Liabilities

Initially, the Southern coalition was as hesitant as the Northern coalition in seeking more integration in the banking dimension. Similarly, their focus was on the fiscal dimension. Eurobonds was the pet project of the Southern leaders (Hollande, 2012c; Rajoy, 2012a; for Monti: Bloomberg, 2012; see also Lequesne, 2013; Belke, 2011). Only when the close link between banks and sovereigns began to take its toll on their countries' economic situation, policy-makers were alerted of the centrality of the banking dimension. This resulted in a preference for direct bank recapitalisations as a means to achieve a similar effect like eurobonds (namely mutualisation), but through the banking dimension (Hollande, 2012c; Financial Times, 2012e). Remarkably, also in their coalition, the vicious circle did not cause a change of the goal (mutualisation), but changed the instrument from the fiscal (eurobonds) to the banking dimension (direct recapitalisations). Hollande came out publicly in favour of a far-reaching banking union for the first time as late as at the press conference after the informal European Council summit in May 2012:

> 'Mr Monti and I upheld this proposal at the informal [European] Council. I myself said I want financial supervision mechanisms, deposit guarantees and crisis resolution to be integrated. So that's a point we'll come back to. The more you coordinate and centralize, the better the response is on supervision, crisis resolution and above all deposit guarantees. Moreover, I was in agreement with Mr Monti on many points this evening.' (Hollande, 2012c).

Notably, Hollande supported a full-fledged banking union – not joint supervision only, as suggested by the German government. The French government was not against the creation of a joint supervisor, but it was not seen as a single measure but part of a broader package. To be acceptable, it needed to go hand in hand with further mutualisation. Whether this was to take place through direct recapitalisations or through a bank resolution fund was a secondary concern. Giving up control was a means to an end, but not an end in itself. As Hollande put it: 'more integration is necessary to have more solidarity. Each integration step needs to be accompanied with a solidarity instrument' (Hollande, 2012d). Therefore, 'the political union comes afterwards. It's the period that follows the budgetary union, the banking union, the social union' (Hollande, cit. in Le Monde, 2012b). He saw the need to 'deepen economic and monetary [now] and, tomorrow, political union' (cit. in Financial Times, 2012e): first comes a sharing of liabilities, control is shared afterwards.

The French government could count on strong support from its Italian and Spanish counterparts. Their countries were in the eye of the storm during the eurozone crisis. This uncomfortable position shaped their preferences throughout the negotiations. Both sought new measures of financial assistance, but slightly diverged regarding the exact priorities. The main preference of the Spanish government was an agreement on direct bank recapitalisations (Rajoy, 2012b; see also Financial Times, 2012d). This instrument was urgently needed after the Spanish government had submitted its request for 100bn Euro[34] of financial assistance from the ESM on 25 June and was now seeking ways to escape the bank-sovereign nexus. Prime minister Rajoy was asking for 'fiscal integration and banking integration, a banking union with eurobonds' (Rajoy, 2012c). A senior official in the Treasury explained the preference's background:

[34] After all, the government needed only 49 bn Euro. However, this was still unknown in June 2012.

> 'It was all about preventing a full [ESM] programme. We knew that otherwise we would be like Ireland. (…) Direct bank recaps were the only solution to break the vicious circle.' (ST5, 2016)

The Monti government's overarching priority was an agreement on decisive support for Italy and Spain at bond markets, a cypher for bond buying by the ECB. In Monti's view, his government was a virtuous one, as it carried out reforms. Yet, financial markets failed to honour the sacrifices that were being made. The Italian proposal for the G-20 summit in Los Cabos proposed interventions by the ECB at bond markets as soon as the sovereign bonds' interest-rates exceeded a level that was deemed 'fair' (which was not specified). The ECB should then purchase bonds in order to mitigate the tail risk and bring down the interest rates to this 'fair' level (Monti, 2012; SEC2, 2016; see also Ludlow, 2012a, p. 7; Financial Times, 2012d). Rajoy claimed that '[t]he only institution which today has the capacity to ensure these conditions of stability and liquidity that we need is the ECB' (cit. in Financial Times, 2012f). These measures were needed to 'put an end to the vicious circle between the vulnerability of the banking sector and the sovereign debt crisis' (Monti, cit. in Bloomberg, 2012). In addition to their respective top priority, both governments were favourably inclined towards a wide range of other measures. Teetering on the brink of collapse, they sought short-term support of any kind, primarily direct bank recapitalisations, a full-fledged banking union including joint funds, a bank license for the ESM and a more active policy by the ECB or the ESM at bond markets (Emmanouilidis, 2012, p. 2; Financial Times, 2012e).

The preference for direct recapitalisations and joint supervision provides support for the hypothesis derived from macro-economic preferences. It is safe to assume that more mutualisation would have been beneficial for the fiscal position of Southern countries and stabilised EMU (which is important from a trade perspective). Break-up costs would have been prohibitively high for the trade and the fiscal position (Schimmelfennig, 2015, pp. 181–183; Howarth and Quaglia, 2014, p. 127; Deo *et al.*, 2011, p. 1). While these considerations fully explain the high priority for direct recapitalisations, the support for joint supervision was fairly weak among Southern governments. They were only willing to sacrifice supervisory powers if – and only if – there would be direct bank recapitalisations in return. Since the fate of the banks was closely linked to the fate of the state, private material interests followed the same line. Italian and Spanish banks were severely affected by the fragmentation of the single market and put at a disadvantage with competitors from economically more stable countries. They wanted relief and strongly supported a full-fledged banking union as a fix to their problems (ABI, 2012a, p. 3; ABI, 2013, pp. 2–3; AEB, 2012, p. 17; AEB, 2011, p. 14; BBVA, 2013). The French case is different to some extent as the country did not stand as close to the abyss as Italy and Spain. However, its situation was not fundamentally different as contagion to France had already been ongoing, merely at a different pace (see Figure 4). The deteriorating fiscal position – and a deficit of more than 6% in 2011 (Eurostat, 2017) – weakened the economic prospects and strongly incentivised risk-sharing in EMU. A stabilisation of the eurozone through mutualisation was a strategy that matched the macro-economic preferences based on both the fiscal position and trade patterns, which were closely aligned in this question. Likewise, French banks stood to gain significantly from a joint European supervisor and a common regime to inject funds into failing banks as both measures would have Europeanised the market. Against the backdrop of a highly-concentrated and internationalised domestic banking market, creating a level-playing field in the euro area would pave the way for French banks to make the next step from national to European champions. To complicate matters, despite these sound political-economic reasons, the French banking sector turned out to remain surprisingly restrained in discussions about the banking union. According to an interviewee in the prime minister's European Affairs Directorate (SGAE), the banks were 'perplexed', 'not sure about it [the banking union]' and 'didn't see why there should be a joint supervisor now' (FOPM1, 2016; see also Epstein and Rhodes, 2014, p. 23; De Rynck, 2016, p. 130; Véron, 2011b, pp. 4–5). They were in favour of joint supervision and direct recapitalisations (FBF, 2012b), but their impact is better captured as reinforcing the government's preference than causing it. Hence, in sum, the macro-economic preferences seem to account best for French preferences. In addition, private interests signalled lukewarm support to the government.

The Southern coalition was united behind its goal of direct bank recapitalisations. It aimed at a further sharing of liabilities, necessarily preceding any further sharing of control. Conversely, the German government sought a sharing of control; a sharing of liability was not desired, and either way conditioned on sharing control. The preference configuration seemed irreconcilable before negotiations took off in June 2012. The next section turns to the interstate negotiations and seeks to explain how an agreement was reached despite the disparate policy preferences. Notably, in contrast to the German government, the preference of the Southern European coalition is in line with neo-functional predictions at this stage. Crisis pressures were high ahead of the Euro Summit in June 2012 and the Southern preference for more risk-sharing matches neo-functional predictions of further integration as a means to address functional weaknesses of the institutional framework.

Table 28: Euro Summit: Preferences of core member states

	Northern coalition	**Southern coalition**
Core preference	Joint banking supervision Strong rejection of mutualisation or sharing of liabilities, such as direct bank recapitalisations	Direct bank recapitalisations Favourable towards full-fledged banking union

4.5. Summit Diplomacy: From Incremental to Radical Policy Change

In the process of negotiating the euro rescue, four meetings and summits were critical to bringing about the agreement on direct bank recapitalisations and joint supervision:

- the G-20 summit in Los Cabos, Mexico, attended by the heads of state or government and finance ministers of Germany, France, Italy, and Spain on 18 and 19 June;
- a meeting between the heads of state or government of the same countries in Rome on 22 June;
- a secretly held meeting of the finance ministers of the four countries at a hotel near the airport in Paris on 26 June;
- the Euro Summit in Brussels on 28 and 29 June.

Preparing the Agreement

The G-20 meeting is important because it locked-in the problem definition of the vicious circle between banks and sovereigns (as described in section 3.5). It marked the first public recognition of the vicious circle as the eurozone's core problem by the heads of state or government of the four key member states in the euro area. Yet, a solution to the problem was not yet on offer. To reconcile the different ideas on the solution of the circle, another three meetings were needed. The next attempt to reach a solution was a meeting in Rome between Merkel, Hollande, Monti and Rajoy. The fact that it took place only three days after the G-20 signals the urgency of the situation. However, the heads could not overcome the divisions. The three Southern European governments demanded direct bank recapitalisations, a more active ECB, or eurobonds. Merkel categorically rejected any of the three (CPEC1, 2015; SEC2, 2016). However, they did seal the growth compact demanded by Hollande. Furthermore, they decided to give a mandate to their finance ministers to continue the search for solutions to the vicious circle at a separate meeting (Ludlow, 2012a, p. 8).

While the growth compact was little more than a symbolic side payment to Hollande for the ratification of the fiscal compact, the subsequent meeting of the finance ministers considerably advanced the negotiations. The negotiations were held secretly at a hotel[35] near the CDG airport in Paris at the invitation of Hollande's sherpa Emmanuel Macron. The four finance ministers were supported by their deputies, Commissioner Rehn and his director-general, as well as van Rompuy's head of cabinet. The main discussions took place between Schäuble and Macron. The former reiterated his government's resistance towards short-term measures that could potentially result in moral hazard. He insisted that direct bank recapitalisations would constitute a mismatch between national control for the banking sector and a European liability for financial losses. Schäuble was adamant that direct recapitalisations would only be possible if a joint banking supervisor was to be established in equal measure.

Some members of the French delegation retrospectively speculated that Schäuble's offer was made in a purely tactical manner and based on the expectation that the French government would surely reject it. A closely involved advisor to the French prime minister supposed that '[t]he joint supervisor was put as a condition we would never accept' (FOPM1, 2016). A member of van Rompuy's cabinet presumed that '[t]hey thought that perhaps this would kill it. They thought it was such a maximalist request that nobody would accept it and then they would get away without the direct recaps' (CPEC2, 2015). Macron mounted the pressure and German members of the delegation perceived him as 'talking about direct bank recaps all the time' (GFM8, 2016). Yet, if Schäuble's tactic aimed to derail the negotiations with a maximalist request, then it was not effective. Macron signalled the French government's willingness to create a joint supervisor, provided that the deal included the mechanism for direct bank recapitalisations so strictly

35 Sheraton Hotel, Satellite Room (GFM8, 2016).

rejected by the German government. Even though there was no formal agreement in the airport hotel, Schäuble's condition was met – and the way seemed cleared for direct bank recapitalisations (Peet and La Guardia, 2014, p. 75; Ludlow, 2012a, p. 9; Financial Times, 2013c; CPEC1, 2015; CPEC2, 2015; GFM8, 2016; SEC2, 2016; MEC1, 2016; CPEC3, 2015). One finance minister reported that 'we were very close to a solution that day' (SEC2, 2016). One sherpa summarised the shift in the German position: 'In Rome they said no and in Paris Schäuble said, "Well, maybe." So they had adjusted their strategy' (SEC1, 2015). However, to the surprise of many, the attempt of backtracking was yet to follow, even though from Merkel and not Schäuble.

Locking-In the Agreement

As stipulated in the invitation to the summit, it was supposed to begin with a meeting of the European Council in the afternoon of 18 June in order to adopt Hollande's growth pact. This was to be followed by a discussion of van Rompuy's report on a genuine EMU (van Rompuy, 2012a; van Rompuy, 2012b). A Euro Summit should follow in the evening of that day, albeit without a pre-defined agenda. Despite the progress made at the airport, there was still a gulf to be bridged between the German and the French government. Their delegations were unable to develop a joint position prior to the meeting. Direct bank recapitalisations were scheduled as a discussion point, but 'many observers expected a stand-off, with an uncertain outcome, between Italy and Spain on one side, and Germany on the other' (Emmanouilidis, 2012, p. 2).

Two developments became apparent when the negotiations at the Euro Summit started. Merkel intended to backtrack from Schäuble's offer at the airport. A member of van Rompuy's cabinet got the impression that 'Merkel tried to resist the whole concept as much as she could, the direct recap and the single supervision. She tried to kill it' (CPEC2, 2015). A leading negotiator in the Council remembered that 'Merkel brought Schäuble into line. She called him off in a way that we had not seen before. (…) Later that year, Schäuble went so far as to pretend he had never been at the airport' (CEU2, 2016). Even more importantly, the second development put the summit at the brink of failure. Rajoy and Monti did not remain silent on the side lines, but raised the pressure on the German government. At a critical moment, they issued their veto against the Growth Compact. It had already been informally agreed at the summit in Rome, but at the Euro Summit, Monti and Rajoy refused to sign it off for as long as the Euro Summit did not deliver on more ambitious measures for the eurozone. Hollande, who had his hands tied because he could not veto his own Growth Compact, refrained from vetoing but expressed his support to Monti and Rajoy[36] (Financial Times, 2012d; Der Spiegel, 2012a; Emmanouilidis, 2012, p. 3; Ludlow, 2012a, p. 8). The veto transformed the negotiation environment. It increased the urgency yet another time. The press was notified of the ongoing clash, which was expected to trigger a market reaction the next morning. After the episode of the veto, all negotiators were aware that 'the system was so much under stress that if there was a failure of that Euro Area Summit, the system would fall apart the day after' (CPEC2, 2015).

To avoid a failure, the head of cabinet of van Rompuy called an emergency meeting of all sherpas. The Euro Summit continued in parallel to discuss the other issues on its agenda. The national representatives in the Euro Working Group[37] (EWG; the deputy finance ministers) supported the sherpas (Financial Times, 2012d). In this combination never seen before, both political firepower and economic expertise were at the table.[38] Van Rompuy's head of cabinet Frans van Daele sustained the dynamic that was created by the veto. He opened the meeting saying that '[w]e are here to agree on direct bank recapitalisations' (CPEC2, 2015). This was highly welcomed by the French, Italian, Spanish and Irish sherpas. Thus, 'when he finally gave the floor to Germany, there was already a momentum in the other direction' (CPEC2, 2015). Yet, the German sherpa Meyer-Landrut continued to drag his feet. He was adamant to stop recapitalisations by maintaining the link to joint supervision. This link was supposed to mitigate the problem of moral hazard (CEU1, 2015; CPEC1, 2015; CPEC2, 2015). Yet, '[i]n the sherpa meeting, the astonishing thing was this "Yes-let's-do-it", which was not anticipated. They thought we were going to put this proposal on the table [i.e. to set it on the agenda of the meeting] and then everybody would say "Oh, no, this is impossible". And the status-quo would remain. But this backfired' (CPEC2, 2015). After six hours of negotiations, the sherpas eventually agreed on a joint statement, but had not clarified the precise relationship between joint

[36] Merkel needed the agreement on the growth compact in order to get the support from the SPD for the domestic ratification of the fiscal compact.
[37] The EWG is the preparatory body of the Eurogroup. It consists of the eurozone deputy finance ministers and is presided by Thomas Wieser.
[38] The EWG president Thomas Wieser had originally convened a separate meeting of the EWG at the same time, but when Merkel and her sherpa Meyer-Landrut learnt about the meeting taking place, they forced van Rompuy to abort their meeting immediately: the crisis had by then become *Chefsache*. Van Rompuy gave in to their demand, but instead of muting the EWG he decided to merge their meeting with that of the European Council sherpas.

supervision and direct recapitalisations. The most important gap was the sequencing, i.e. which of the two elements would be established first. After the ensuing four hours of negotiations among the heads of state or government, the final statement stipulates that the ESM can inject funds directly into banks '[w]hen an effective single supervisory mechanism is established' (Euro Summit, 2012) – an outcome which did not solve the actual problem, as the word 'established' permitted for a broad range of meanings stretching from a mere political agreement on its creation to a supervisor having taken up the actual work and controlling banks. The Southern European governments insisted on a tight timetable for the establishment of the joint supervisor, which they successfully imposed on the German government ('by the end of 2012', Euro Summit, 2012, p. 1).

The exact wording of the agreements reflects the contentious nature of the deliberations. The first sentence of the European Council Conclusions in June 2012 reiterates that *'it is imperative to break the vicious circle between banks and sovereigns'* (Euro Summit, 2012). This is strong evidence for the collective acceptance of the vicious circle problem frame; a development the analysis will return to below. Direct recapitalisations were subject to the SSM starting its operations as banking supervisor: 'When an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could, following a regular decision, have the possibility to recapitalize banks directly' (Euro Summit, 2012, p. 1). The statement maintained the principle of 'appropriate conditionality' (Euro Summit, 2012, p. 1) in exchange for direct recapitalisations, but left considerable wiggle room, as conditionality 'should be institution-specific, sector-specific or economy-wide' (Euro Summit, 2012, p. 1). Institution-specific conditions meant as little as that a bank receiving aid would have to be resolved. Likewise, the 'us[e of] the existing EFSF/ESM instruments in a flexible and efficient manner' (Euro Summit, 2012, p. 2) without further conditionality for those member states following the recommendations in the various economic and fiscal policy frameworks at the European level reinforced the interpretation that aid could be obtained with significantly weakened conditionality, which also ran counter to German preferences.

While a Southern European sherpa boasted that 'our line prevailed at the summit' (SEC2, 2016), negotiators from Northern governments did not hide their discontent. An official in the German Finance Ministry shared his memories of the day after the summit: 'That was not a nice morning at work... everyone was like: "what did they…"' (GFM5, 2015).

An advisor to the Dutch prime minister remembered the decision as 'a tough one to swallow' (NMGA1, 2016). His colleague in the Dutch Treasury was even clearer in his response:

> 'Before the summit, they asked me what line to take at the negotiations (…). I told them that by no means we can agree to direct recapitalisations. And I told them to push for bail-ins. Then, I'm at home and I get this phone call at 6am in the morning after the summit. And they tell me that they just signed an agreement with direct recaps but no bail-ins. And I thought: "What the fuck has happened here? What have you done?"' (NT1, 2016)

4.6. Negotiating the Euro Summit: Preventing the Break-Up

Direct Bank Recapitalisations

The Euro Summit came to an end with a result that the German government had consistently rejected over the course of the crisis. This section seeks to identify the causes for this outcome. It argues that the outcome is explained by a two-step process. First, the acceptance of the problem frame of the vicious circle shifted the negotiations onto a terrain which was distinctly more favourable to Southern arguments of risk-sharing. In the negotiations, they could win the causal argument against the German government, whose proposals seemed ill-suited to solve the urgent problem of the vicious circle at this critical moment. Eventually, the German government had to give in to a mechanism on direct bank recapitalisations.

The Southern coalition geared up their rhetoric, incorporated the new problem frame and linked it to their preferred solution frame. At the centre was the alleged need for a mechanism for direct bank recapitalisations. The Spanish economy minister Luis de Guindos canvassed for the measure: 'I think direct bank recapitalisation is a possibility. It is one of the fundamental elements to break the link between bank risk and sovereign risk' (cit. in Reuters, 2012b). He was supported by the ECB Executive Board member Benoît Cœuré: 'If the ESM could inject capital directly into banks, with strong conditionality and control, this would also help to break the bank-sovereign loop' (cit. in Financial Times, 2012g). Notably, both established an explicit link between the collectively agreed problem frame and their respective solution frame of risk-sharing. A

French Treasury official remembered their stance towards the vicious circle and how they sold it to their peer negotiators from other member states: 'We had an instrument. We thought it was brilliant. And it was kind of an obvious answer to the developments in Spain' (FT1, 2015), i.e. the risk of creating a vicious circle in Spain if the ESM loan was to be channelled through the government. Especially the Spanish case opened a window of opportunity, as one French negotiator reported:

> 'Spain and Ireland were clearly two lessons through which the French arguments about not everything being a question of budget responsibility were strengthened. (…) Both cases provided much more force to our argument.' (FT1, 2015)

The German government responded to these arguments by advancing its solution frame of structural reforms. Sovereigns should put their own house in order instead of hoping for support from taxpayers in other countries. Merkel set the agenda the day before the summit:

> 'Our signpost out of the crisis can only be a rigorous analysis of its causes. These are the lack of competitiveness of some euro countries, fundamental flaws in the construction of the Economic and Monetary Union, and the over-indebtedness of sovereigns. These problems are made at home, and we need to be committed to solving those problems at home.' (Merkel, 2012a)

The Finance Ministry responded with dismay to ideas of risk-sharing, as advanced by some:

> 'The South always focuses on the short-term. And if they say that we have to start risk-sharing today and risk-reduction tomorrow, then we know what they mean. "Tomorrow" means "we're never going to do it". This is not credible. We always oppose their short-termism. Because we're used to ask for the actual causes of the problems.' (GFM8, 2016)

The German government was rhetorically inflexible for two reasons. First, against the background of the vicious circle, German arguments were perceived as targeting the wrong time horizon. Neither an ESM programme with strict conditionality nor bail-ins were perceived as addressing, let alone solving the problem of a vicious circle between banks and sovereigns. The German government also advocated joint banking supervision, but this did not address short-term pressures either because 'ECB supervision is to avoid the next crisis, but does not help in the current one' (ST1, 2015). Since '[t]he June agreement was clearly with a focus on how can we break the loop' (FT5, 2015), the prospect of an agreement on joint supervision without recapitalisations did not satisfy the Southern coalition. They refused any agreement without direct recapitalisations, as one member of the European Council insisted: 'I wanted more ambitious results which do not only matter in the long-term, but also in the short-term' (MEC2, 2015). Yet, one of his 27 peers in the European Council noticed that 'the Germans were silent on the short-term. The private sector involvement had already failed and they had no other solution to break the bank-sovereign nexus' (MEC1, 2016). An advisor to the French prime minister remembered that '[w]e needed to solve the sovereign-bank nexus and we were willing to block everything that was not conducive' (FOPM1, 2016). A Southern European sherpa vigorously described his anger about the German side:

> 'This was not the right time to see who wins and who loses. I always said 'if the euro breaks up, then what's that for a benefit?' This German obsession with moral hazard, it prevented us from doing what we had to do. I always said: 'We can do the finger pointing afterwards – but now let's jump, let's do something, let's make decisions!' (SEC2, 2016)

Given the problem definition, short-term measures were considered a more suitable response. Yet, the short-term was the Achilles heel of the German agenda. Finance minister Schäuble asserted retrospectively that '[w]e followed ordoliberal principles when creating the banking union' (Schäuble, 2014d). Yet, as economist Hans Werner Sinn, who is in principle sympathetic to ordoliberalism, admitted:

> 'Although the ordoliberal recipes serve to protect the jungle from an outbreak of fire, they are less effective in putting out fires that have already been ignited' (Sinn, 2011, p. 267).

In line with Sinn, a senior official in the German Finance Ministry explained that '*Ordnungspolitik* is the reason for our distrust towards quick fixes. Because each quick fix changes the incentive structure and this is why painful reforms are not carried out' (GFM7, 2016). Ordoliberalism's fear of moral hazard tied the German government's hand. It made it inflexible to craft a powerful response. It had little to offer to alleviate short-term pressures, but continued to advance structural reforms. This did not bode well with negotiators from the Southern governments. A Spanish high-level negotiator remembered that the German government 'didn't come up with any new proposals. They just proposed fiscal discipline… and budget cuts… and fiscal discipline… and austerity… but nothing else' (ST5, 2016). A colleague realised that 'the only answer of the Germans to our problems was to tell us that we did terrible mistakes in the past' (ST7, 2015). At the same time, German negotiators were aware of the instrumental use of the vicious circle to further reforms of the eurozone according to Southern European preferences:

> 'The vicious circle was a label used to mutualise whatever you could get hold of. It's been an iconic word – you just mentioned the word and seemingly everyone agreed. But much of that didn't address the real problems.' (GFM7, 2016)

There were an increasing number of indications that the Southern governments were gaining ground with their strategy. The vicious circle blocked German arguments about structural reforms linked to an ESM programme channelled through the state. One (remarkably non-Southern) sherpa of the European Council remembered how these arguments improved the negotiation position of Southern European governments:

> 'The line of reasoning of the Spaniards at that time was you should do recapitalisations directly. If you transit your help or your intervention through the Spanish state, you end up by making two debtors, instead of one. And that was a point, an important point. There was a high degree of resistance again in the Northern part of the European Union, but many people have intellectually found that the Spaniards had a point.' (SEC1, 2015)

The German government lost the causal argument and was eventually forced to concede. The agreement on the problem frame changed the terrain of the negotiations and constrained all governments in that their solution frames had to be suitable to solve the collectively agreed problem. In these argumentative processes, Southern negotiators successfully rebuked German arguments – which the Germans themselves assessed as weak to solve the short-term challenges posed by the vicious circle. They could extract concessions from the German government, despite the latter's higher material bargaining power. The German government did, however, obtain the approval for the creation of a joint supervisor, a project the South viewed rather unfavourably. The next section will turn to this part of the outcome.

Joint Banking Supervision

If, as argued above, Southern arguments were winning the argument over German ideas, why was the South not effective in preventing an agreement on joint banking supervision as well? This section seeks to show that the problem frame, in this case, favoured German preferences, not Southern ones. The risk-sharing solution frame does not provide for credible causal arguments *against* a joint supervisor. While breaking the vicious circle can hardly be achieved with an agreement on supervision *only*, joint supervision as such is not incompatible with the goal of breaking the circle. It is neutral in this regard. Thus, the vicious circle does not lend any support against joint supervision – and, therefore, it did not pose an obstacle for the higher German bargaining power to materialise.

One clarification is in order: In one regard, joint supervision is different from structural reforms and a bail-in policy as the other components of the German solution frame. In contrast to joint supervision, bail-ins trigger financial instability in the short-term and are de facto not applicable in an acute financial crisis. Likewise, structural reforms are not fiscally neutral in the short-term and therefore also bear the risk of reinforcing a vicious circle in the short-term. The latter two proposals are more vulnerable towards rhetorical action than joint supervision, which puts it in a somewhat special position.

The Northern government advanced two types of arguments in the negotiations on the joint supervisor. The first one emphasised the need for joint supervision to counter the incentives for moral hazard that are set by direct recapitalisations. The availability of European funds to cover the costs of bank failures potentially gives rise to adverse incentives if banks remain under national oversight. Thus, an official in the German government explained that 'under no scenario, we would use the money of our taxpayer to pay for banks we do not control. This was a *quid pro quo*: European funds only if we have European oversight' (GFM1, 2015). As a Dutch negotiator put it:

> 'We asked for joint supervision first, we wanted to see whether it works. We were cautious because we wanted a minimal control over banking policies. And the current arrangement still is not ideal as we do not have any control over policies relevant to the banking sector other than supervision, such as estate and mortgage policies. This put a clearly defined limit to our liability. We could not agree to mutualise risks without anyone giving up sovereignty in return.' (NMGA2, 2016)

This line of reasoning was difficult to rebuke. The problem frame of the vicious circle did not provide any cover in this regard. In principle, a joint supervisor is no obstacle to solving the problem. One senior official from the Commission remembered the widespread acceptance of the German request:

> 'Several member states were asking for the direct recapitalisation. Then, apparently, Merkel said: 'look, this is nonsense. You cannot put direct capital in a bank if you don't supervise them'. Some smart guy, it may have been van Rompuy, said okay, then we do the supervision.' (COM7, 2015)

A member of the Italian Treasury found it 'a matter of common sense. If we recapitalise banks from the ESM, we need to let the ESM take control of banks. And instead of the ESM, the ECB was put in charge, after all' (IT2, 2015). The main concern of the South was to have supervision only, but no recapitalisations. As Hollande already stated: 'We can only have new rules if we also make another step towards solidarity' (cit. in Le Monde, 2012b). Yet, while having a joint supervisor as a stand-alone measure would have been a suitable target for rhetorical action (given its limited contribution to solving the vicious circle), it was rhetorically difficult to oppose it once there was an agreement on more solidarity in the form of direct bank recapitalisations.

The second argument used in favour of a European supervisor was the weakness of national supervisors in the lead-up to the financial crisis. According to a German senior official, the weak quality of supervision had increased the vulnerability of individual countries:

> 'We realised quickly that we had a problem with banking supervision. Almost all of our banks were affected by the Irish crisis. There was even some form of 'supervisor hopping' going on in Europe.' (GFM7, 2016)

Likewise, the Spanish case had not only exemplified the vicious circle at work, but also the role of national supervisors in triggering the vicious circle. This was common knowledge among the negotiators. A member of the cabinet of van Rompuy recaptured the supervisory mistakes of national authorities:

> 'Some of the national supervisory systems which we thought had done a decent job finally proved themselves as having been unable to cope with the situation. One particular example, which caught the attention more than any other one, is the case of Spain. For a number of years, people have thought that the Spanish supervision had been excellent and then corpses start falling out of the crypt boards. I think that was a driving element.' (CPEC1, 2015)

A Spanish negotiator admitted that 'the trigger was bad experiences with the Bank of Spain. It was good on a technical level, but did a bad job in supervision because of political interference' (ST5, 2016). This political interference was acknowledged to be a consequence of 'the combined pressure of banks, the public wanting to get loans, for instance in real estate sectors, and governments needing money. And that coalition just had been too strong for individual national supervisors. It was basically hard' (CPEC1, 2015). Allocating supervisory powers at the European level would have effectively solved this problem as a European institution – and the ECB in particular – would be a much more difficult target for political interferences by single member states. Integrated financial markets had led to the rise of transnational banks which were difficult to supervise for national authorities. A representative of the ECB laid out their analysis:

> 'We were in the famous financial trilemma. Financial stability, financial integration and sovereignty are incompatible. As we have financial integration and we want financial stability, something had to give. The member states had to give up national financial policies.' (ECB1, 2015)

A German negotiator emphasised:

> 'We wanted to make sure that such a crisis cannot happen again. Now we have this new banking supervisor which hopefully does a good job. And I do think the risk of another crisis on this scale is indeed lower.' (GFM4, 2015)

Increasing the efficiency of banking supervision was a justification that was difficult to dispute. A former finance minister gave an example for a counter-argument by mentioning that 'in the US, they had high losses as well, even though they had a single supervisor' (FM1, 2016). However, this argument did not gain in importance in the negotiations; considering that the US experience is usually taken as an example for the benefits of further integration in a currency union, using it the other way around would have proven a risky rhetorical strategy. Overall, the problem frame of the vicious circle did not lend sufficient support to arguments against joint supervision either. It proved unsuitable as a rhetorical tool. Consequently, the Southern European responses were weak. They failed to reverse the material bargaining power of the German government.

4.7. Conclusion

Four summits in June 2012 were crucial for reaching an agreement on the creation of a joint supervisor and direct bank recapitalisations: the G-20 meeting in Mexico, the summit of the four Heads in Rome, a secret meeting of the four finance ministers in Paris and the Euro Summit in Brussels. Each of them was important for advancing the negotiations. The G-20 meeting was critical because it locked in the problem definition. For the first time, the big four member states involved collectively agreed on the vicious circle as the core problem. The meetings in Rome and Paris built a bridge in the process: they continued the discussions based on the new problem definition and advanced the work towards a solution, but did not yet reach agreement. They narrowed the debate to direct bank recapitalisations and joint supervision. The Euro Summit was the forum where a deal could be brokered: an agreement on direct bank recapitalisations and the creation of a European banking supervisor.

This process leading to the agreement provides for a test of the theoretical framework. The liberal intergovernmentalist hypothesis predicted that material interests determine domestic preferences. In the case of Germany, material interests were found to be diverse and rendering the liberal intergovernmentalist hypothesis inconclusive. The analysis showed that ordoliberal ideas were referred to as a worldview for the analysis of the case under consideration. They tipped the balance in favour of the macro-economic preference based on the fiscal position, which took priority over competing interests. By contrast, the cases of Italy and Spain confirmed the material interest hypothesis. They were hardest hit by the worsening crisis. This resulted in a strong preference based on both macro-economic interests and the private material interest in support of more risk-sharing and mutualisation. As there was no significant fragmentation of interests, the ideational scope condition was not triggered in the Southern coalition. Notably, in all involved member states, the idea of a vicious circle between banks and sovereigns was important to cause a shift from the fiscal to the banking dimension of the crisis. Yet, in no case did it cause a shift of the goals, but only of the favoured means, by refocusing the attention from the fiscal to the banking dimension. The neo-functional explanation was overall fairly accurate at this stage of the negotiations marked by severe crisis pressures. It correctly predicted Southern preferences as well as the German preference for joint supervision. It cannot, however, explain why the German government was against direct bank recapitalisations, despite strong crisis pressures.

The outcome of the interstate negotiations leads to a mixed assessment of the theoretical propositions. The German government was arguably the most powerful member state with a high material bargaining power and a low preference intensity (Paterson, 2011a; Bulmer, 2014). However, it was forced to accept a mechanism of direct bank recapitalisations it initially opposed. This outcome cannot be explained with a power-based approach. The rhetorical action hypothesis has received more support in regard to this issue. The agreement on the vicious circle as problem frame established a frame of reference, which favoured Southern European arguments of risk-sharing. With the goal of the negotiations being clearly defined – breaking the vicious circle – German arguments in favour of structural reforms were perceived as unsuitable. They were not perceived by the audience as solving the problem under consideration. This provided a coalition of Southern European governments with an opportunity to employ rhetorical action. They suggested a mechanism for direct bank recapitalisations. Relying on experts, international organisations and fellow governments, they framed more risk-sharing as an effective response to the collectively professed problem of the vicious circle. In so doing, they deprived the German government of effective means for rebuttal and extracted a concession on direct bank recapitalisations.

At the same time, the German government was successful in imposing a joint European supervisor on Southern European member states. At first sight, this outcome is surprising, given the effectiveness of rhetorical action in the case above. However, in this case, rhetorical action did not strengthen the negotiation position of the Southern coalition, as they could not craft a powerful response. Since the problem frame of the vicious circle cannot be used to make the case against joint supervision, it was on this issue that the Southern arguments were unsuitable. They gave in to German bargaining power and accepted joint supervision as a supplementary measure to direct bank recapitalisations.

Despite the agreement, many question marks remained after the Euro Summit and fundamental differences could not be reconciled, but were postponed to later stages of the negotiations. For instance, it remained unclear what exactly was needed in terms of supervision before direct recapitalisations could be used. The formulation that joint supervision needed to be 'established' before using the recapitalisation instrument was open to many different meanings. The next chapter analyses how these discussions were eventually solved in the subsequent negotiations on the SSM in the Council.

Chapter 5: The Single Supervisory Mechanism

5.1. Introduction

The negotiations of the banking union entered the next stage when the general agreement on joint supervision and direct bank recapitalisations from the Euro Summit in June 2012 had to be transformed into concrete legislative acts. Reaching agreement on the Single Supervisory Mechanism was the first step. After intense informal negotiations over the summer 2012, the European Commission published a proposal for two regulations and a communication on 12 September 2012. Protracted negotiations resulted in an agreement on the Council's General Approach on 13 December 2012. The Council and the European Parliament sealed a political agreement on 19 March 2013. The formal approval of the final texts of both regulations[39] followed at the Coreper on 18 April 2013 (European Commission, 2016a).

The events at the Euro Summit in June 2012 set the scene for the SSM negotiations in the Council. The summit reached a surprisingly ambitious outcome, but due to the chaotic circumstances, the heads of state or government left the meeting room with different interpretations of the outcome – an important aspect for the analysis, which will receive further attention in the course of this chapter. The Euro Summit's assertion that '[i]t is imperative to break the vicious circle between banks and sovereigns' (Euro Summit, 2012) established the collectively professed goal of creating the SSM. However, Monti's press conference immediately after the summit raised a storm. He violated an unwritten rule among the heads of states or government, which forbids public shaming of the losers at their summits. Monti lauded himself for his negotiation strategy, which caused bad blood on the side of the German government. The press conference reinforced the public perception in Germany of Merkel having lost against Southern governments. This domestic pressure narrowed down the room for manoeuvre of the German government considerably, and not to Monti's advantage, as the following sections on the SSM negotiations will show.

[39] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions; Regulation (EU) No 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) No 1024/2013.

The role of the European Central Bank in the new supervisory framework was the first of the two most contentious issues of the SSM negotiations. The ECB eventually became the host institution of the new mechanism, despite German concerns about a conflict of interest between the new supervisory tasks of the ECB and the conduct of monetary policy. The second contentious issue was the scope of the new European supervisor. The member states controversially discussed which banks the SSM should cover. The German government sought to exclude small banks from the SSM's scope, as they wanted national supervisors to remain in charge of them. Yet, they had to give way to an integrated system favoured by other member states, not least because of concerns with the level-playing field in the internal market.

The research findings of this chapter corroborate the previous findings that ordoliberal ideas influenced the German government in the formation of preferences. The fiscal position and trade patterns suggested diametrically opposed preferences. While the former would have suggested limiting the scope of the mechanism and no supervisory tasks for the ECB, the latter would have been favourable towards both. In this situation, there was scope for ordoliberal ideas to settle the fragmentation between competing interests. Given that the appreciation of sound money and the fear of moral hazard are characteristic for ordoliberal ideas, ordoliberal ideas sided lines with preferences based on the fiscal position. Less complex, Southern European preferences corresponded to macro-economic considerations. In addition, they matched the interests of the private interests. They suggested an all-encompassing scope and a strong role for the ECB to draw from the prestige of the institution and increase the future supervisor's clout at financial markets. Notably, neo-functionalism cannot explain why at this stage the negotiations did not fail, considering that material crisis pressures diminished rapidly.

The analysis of the interstate negotiations underlines the power of rhetoric. The German government as the most powerful member state had to concede on both the role of the ECB as institutional host as well as the scope of the mechanism. From the perspective of material bargaining power, the reasons for these concessions remain unclear, as the German government continued to be the most powerful EMU member state. More plausibly, the lock-in of the vicious circle problem frame, in connection with the prevalence of the risk-sharing solution frame, helped the Southern coalition to extract concessions from the German government. Most negotiators perceived German solutions as idiosyncratic and unsuitable to the agreed problem frame.

The following section will briefly recall the observable implications of each hypothesis. Then, national preferences will be analysed. The last two sections focus on the two contentious issues, i.e. the role of the ECB and the scope of the mechanism. They serve as cases to test the hypotheses on domestic preferences and the interstate negotiations.

5.2. Observable Implications

Determining the precise role of the ECB in the future mechanism was one of the rare instances where the German public and private banks shared the same interests. They both wanted the ECB to become the institutional host of the new supervisory framework (BVR/VÖB/DSGV, 2012, p. 2; BDB, 2012, p. 1). The two banking groups parted ways, however, with regard to the scope of the framework. The *Sparkassen* resisted change and strongly rejected European oversight. They sought a limited scope, excluding small and mid-sized banks (BVR/VÖB/DSGV, 2012, pp. 1–2). The private banks favoured an all-encompassing scope to create a truly level-playing field (BDB, 2012, p. 1; BDB, 2013a, pp. 3–5; Deutsche Bank, 2012). Depending on which group proved more influential, we would expect their interest to inform the government's preference. From a macro-economic point of view, allocating bank supervisory powers at the central bank was a double-edged sword (see section 5.5). Information symmetries increase the efficiency of banking supervision. Yet, it comes at the cost of a potential conflict of interest between monetary policy and banking supervision. Thus, the macro-economic preference for shifting adjustment costs results in a preference against the ECB as bank supervisor to prevent risks to its monetary function.

The observable implications for trade patterns would be a more relaxed attitude towards the abstract risk of inflation, but an emphasis on an effective banking union to fix EMU. Regarding the scope, the fiscal position suggests a macro-economic preference for a limited scope in order to exclude potential liabilities. From the perspective of trade patterns as the underpinning of macro-economic preferences, a broad scope was expected to serve best the goal of stabilising EMU and would thus be expected as government preference. If ordoliberal ideas held as worldviews were potentially able to settle a conflict between other competing interests, the German government would prioritise the independent conduct of monetary policy. Price stability is at the heart of ordoliberalism. The government would, therefore, oppose a supervisory role of the ECB. In the case of the scope, the importance of realigning control and liability to prevent moral hazard suggests a preference for effective supervision. Both the ECB and the German Finance Ministry assessed a broad scope as jeopardising this goal. Therefore, ordoliberal ideas would suggest a narrow scope. Neo-functionalists would at this stage predict that the negotiations collapse. The pressures had already diminished after the ECB's announcement to step in as a lender of last resort, which removed crisis pressures as possible drivers of the integration process.

Table 29: SSM: Domestic preference formation, German government

	Macro-economic preferences: fiscal position	**Macro-economic preferences: trade patterns**	**Private material interest: public banks**	**Private material interest: private banks**	**Ideas: ordoliberalism**	**Neo-functionalism: crisis pressures**
ECB as supervisor	Against	In favour	In favour	In favour	Against	Against
All-encompassing scope of SSM	Against	In favour	Against	In favour	Against	Against

With regard to the Southern coalition, the banks decisively supported the central bank as supervisor. France, Italy and Spain already had this arrangement in place on the national level and their experiences were encouraging (e.g. BFM, 2012; BBVA, 2013, p. 12). Likewise, Southern banks were strongly in favour of an all-encompassing supervisor to increase their credibility at financial markets (FBF, 2012b; see also BBVA, 2013, p. 12). Turning to macro-economic preferences, we would expect a preference in favour of the ECB as supervisor. Its credibility would calm financial markets and provide for more efficient resolutions. For essentially the same reasons, an all-encompassing scope would have been desirable from the perspective of macro-economic preferences of the Southern coalition. If these macro-economic interests influence the governments in this coalition, we would expect them to be in favour of the ECB as joint supervisor and a broad scope of the mechanism. The same neo-functional logic as in the case of the German coalition applies.

Table 30: SSM: Domestic preference formation, Southern coalition

	Macro-economic preferences: fiscal position and trade patterns	Private material interest: banking sector	Ideas: post-Keynesian	Neo-functionalism: crisis pressures
ECB as supervisor	In favour	In favour	In favour	Against
All-encompassing scope of SSM	In favour	In favour	In favour (if better access to liability-sharing)	Against

Lastly, turning to the interstate negotiations, the power-based hypothesis would be confirmed if the outcome corresponds to the German preferences of entrusting an EU institution other than the ECB with supervisory powers, and to a strictly limited scope of the mechanism. If rhetorical action based on the risk-sharing frame could be used to corner opponents, we would expect concessions by the German government. That is, the ECB would be the host of the mechanism in order to draw on its reputation; the scope of the mechanism would be more encompassing than envisaged by the German government. If, by contrast, the structural reform solution frame was effectively advanced, the outcome would leave little room for joint measures that could result in shared liabilities. The ECB would not be entrusted with supervisory powers and many banks would not fall under the joint supervisor.

Table 31: SSM: Interstate negotiations

	Power: material bargaining power	Rhetorical action: risk-sharing	Rhetorical action: structural reforms/ risk-reduction
ECB as supervisor	Not part of the agreement	Part of the agreement	Not part of the agreement
All-encompassing scope of SSM	Not part of the agreement	Part of the agreement	Not part of the agreement

5.3. The Legacy of the Euro Summit

The legacy of the Euro Summit had strong repercussions for the SSM negotiations. Not only were the Euro Summit Conclusions important, but also what Monti made of them in his doorstep interview at around 4 am on his way out of the summit building. Speaking with the press, he did not conceal his satisfaction with the agreement reached at the Euro Summit and lauded his own role in reaching it (Council of the European Union, 2012). He insinuated analogies between the summit outcome and Italy's win over Germany in the semi-final of the football Euro Cup. It was an unusually triumphant statement, described by one sherpa as a 'big mistake' (CPEC1, 2015) and by another one as a 'communications disaster' (SOPM1, 2015). It breached an unwritten rule of behaviour among the heads of state or government, but at least during that night his remarks remained undisputed[40] and particularly the football comparison guided the framing of his remarks in the press. The image of Merkel being the 'big loser' (Reuters, 2012a) gained traction and the next morning the German government was faced with a hostile public opinion in Germany (Ludlow, 2012a).

Merkel's immediate response was an attempt to renegotiate the agreement to save her face and punish Monti, but her initiative failed. Her fellow leaders feared a revision of the outcome could trigger market reactions. The Euro Summit Conclusions remained untouched, but a face-saving concessionary paragraph was introduced in the European Council Conclusions (which in contrast to the Euro Summit Conclusions had not yet been put in the public domain) (Ludlow, 2012a, p. 23; see also CPEC2, 2015; SEC2, 2016; MEC1, 2016; SOPM1, 2015).

The more important medium-term consequences of this episode were a further hardening of the German position (Howarth and Quaglia, 2013, p. 111). The hostile public opinion forced Merkel's hand. The German position became less compromising. The first target of German backtracking was direct bank recapitalisations. The Finance Ministry openly sabotaged the negotiations and aimed to 'make their [i.e. bank recapitalisations] use as difficult and unlikely as possible' (Schäuble, 2014e). They eventually got their way. The use of the mechanism as adopted in June 2014 ended up being highly constrained. It

[40] Among the members of the European Council, also Van Rompuy, Barroso, Juncker and Kenny spoke to the press in some length during that night. They did so in the usual diplomatic way. Merkel and Rajoy gave only very brief statements of a couple of seconds without substance.

excluded the legacy debt, which banks accumulated under the reign of the national supervisor. Having dramatically lost in value for the crisis countries, it did no longer play much of a role for the management of the still ongoing crisis. However, essentially getting rid of direct bank recapitalisations was only possible in exchange for a concession in another area: the German government signalled openness to the creation of a resolution mechanism, effectively a functional substitute to direct recapitalisations. There was 'absolutely no mention of joint resolution at the Euro Summit' (CEU1, 2015), but governments increasingly realised that having European supervision and national resolution would likely be inefficient in a crisis. A member of cabinet of van Rompuy explained their strategy:

> 'We didn't mention the resolution because it was thought that it's too big to put on the table before we have a formal agreement on the supervision. Let's not open another front which may jeopardise the whole thing. But we always knew: Once you have single supervision, you've got to have single resolution. And once you have single resolution, you've got to have deposit insurance. We wanted resolution, we could let go the recapitalisations. The idea was to let the Germans roar, as long as we would get resolution. Let them make noise. That was our position…' (CPEC2, 2015; similar: CPEC3, 2015)

Considering that a mutualised resolution mechanism would render direct recapitalisations obsolete, the South could do with the latter. In addition to the shift in the German position, a second important factor that facilitated the creation of a resolution mechanism was the more permissive market conditions after the ECB president Mario Draghi's 'whatever it takes' speech on 26 July (Draghi, 2012). The easing market pressure limits the explanatory power of approaches that solely focus on crisis pressures as the driver of eurozone integration (Niemann and Ioannou, 2015). More concretely, if the agreement at the Euro Summit was driven by the material crisis pressures *before* Draghi's speech, one would expect that *after* his speech the negotiations on the SSM break down. Following the neo-functional logic, governments would not agree to further integration in the absence of strong material pressures.

An equally important legacy of the Euro Summit was the Conclusions of the heads of state or government in the euro area. Statements of the European Council are recognised as very important signposts for the Council negotiations (Wessels, 2016, pp. 92–95). According to a Spanish negotiator:

> 'The [European] Council Conclusions were some sort of bible. When we were sitting there at the table negotiating with another country, everybody is ticking off the sentence. It's like

> the 10 commandments. Once it was written on paper and decided by the heads of state, it becomes a mantra that you can throw in at the negotiating table.' (ST4, 2015)

A French negotiator seconded that the Conclusions are 'the only thing which counts following a meeting. You only have a text; the rest is fantasy. (…) It's very important. And every word is important' (FT5, 2015). Yet, often there are ambiguities in the Conclusions, as recalled by a Spanish negotiator:

> 'The beauty of these wonderful sentences is that everybody interprets them as they wish. The same sentences mean one thing for France, another thing for Germany. Then they leave the room and then it's up for the technical groups to fight about it for months.' (ST4, 2015; similar comment by GFM8, 2016)

This was the case with the Euro Summit Conclusions. One senior official in the ECB underlined:

> 'Merkel clearly had another interpretation than Monti. Perhaps the interpretation of the summit results was more important than the results themselves.' (ECB6, 2015)

The Conclusions of the Euro Summit in June 2012 contained ambiguities which led one observer to the question: 'Were Hollande and Merkel at the same summit?' (Financial Times, 2012h). Especially the meaning of the formulation of 'establishing' a joint supervisor prior to direct bank recapitalisations was not clearly defined. These ambiguities are important for the analysis because they open up a can of worms. While the Conclusions were a powerful instrument, their ambiguity enabled actors to re-interpret them and use them to provide cover for their respective preferences. The ambiguity invited the contestation over their meaning. The most important element of the Conclusions was their opening sentence: 'it is imperative to break the vicious circle between banks and sovereigns' (Euro Summit, 2012). The statement specified the ultimate goal the banking union should serve. It reiterated the agreed problem frame, obliging policy-makers to provide suitable solutions and limiting the realm of possibilities. However, how to achieve this goal remained an open question. The actors pursued different solution frames to the commonly agreed problem frame. The goal of breaking the vicious circle was new and no solution was available off the shelf. The topic remained cognitively complex. Under these circumstances, the scope conditions for ideas suggest that they could be a plausible source for policy-makers to mitigate the effect of uncertainty, cognitively complex issues and informational constraints.

5.4. The Preferences of Member States: Paralleling EMU Debates

The eurozone governments continued to be divided into a Northern and a Southern coalition in the SSM negotiations, albeit with some modifications. The Northern coalition remained very strong and cohesive. They consolidated their power during the SSM negotiations. The Spanish government showed some first signs of drifting towards the Northern coalition, adding to the bargaining power of this coalition (ST6, 2015; COM6, 2015). After direct bank recapitalisations had been effectively put on hold, the Spanish government was forced to take out a loan with conditionality and channelled through the state. Being liable for cleaning up the banking sector itself, it showed less appetite for mutualisation. It did not want to grant other governments a free lunch, as it did not get one itself (ST5, 2016). Thus, the distribution of material bargaining power remained favourable to the Northern coalition.

The SSM negotiations were one of the rare instances in the banking union negotiations where the euro outs wielded at least some influence. The United Kingdom was predominantly concerned with the integrity of the internal market. It successfully advocated the introduction of the double-majority principle in decisions of the European Banking Authority (EBA). This principle refers to the requirement that banking regulation can only be amended if a proposal finds a majority of both eurozone and non-eurozone members (Verhelst, 2013b, p. 6). The Eastern European countries were only weakly affected by the creation of a joint supervisor, as their banking systems are predominantly owned by foreign banking groups. They were exclusively interested in questions about the coordination of home and host countries of banks (Howarth and Quaglia, 2013, p. 115). Internal divisions between the out-countries weakened their interest further and permitted for only considering the core preferences of the outs (Spendzharova and Bayram, 2016; Howarth and Quaglia, 2013).

The Northern Coalition: Realigning Control and Liability

The SSM played a vital role in the German government's idea of the banking union because it was thought of as a firewall against moral hazard in the banking union. In this conception, the SSM was supposed to constrain governments up to a degree at which it was reasonable to assume that they could no longer critically influence the fate of their banks. If this was effectively the case, it seemed reasonable to also pool some liabilities, e.g. through a joint resolution regime with a joint fund. Yet, all these following steps were conditioned on a strong and functioning SSM. In the words of a German negotiator in the Finance Ministry:

> 'For most countries in the eurozone this [the SSM] was just about getting access to the ESM [and direct bank recapitalisations]. These countries would never have joined us without the ESM in sight. (...) For Germany, the SSM was a goal in itself.' (GFM4, 2015)

The considerations about moral hazard were shared at the top level. Merkel underlined their importance: 'If I am giving money to Spanish banks… I am the German chancellor but I cannot say what these banks can do' (cit. in Financial Times, 2012i). The remedy against moral hazard was the ordoliberal principle of realigning responsibility and liability. A senior official in the Chancellery described this position in the following terms:

> 'When the negotiations started – and even after the Euro Summit – no one knew really what this term banking union actually meant. It was not defined. But to us it was clear: A correct banking union would be one that realigns control and liability.' (GC1, 2015)

The importance of these principles was even higher in the Finance Ministry. Schäuble established an explicit connection between ordoliberal considerations about moral hazard and German preferences towards the banking union:

> 'We designed the banking union in the same way like the bail-out funds. We made sure that we do not set wrong incentives. (…) We need to restore the old principle: who gets an opportunity, also has to take the risks that are associated with it.' (Schäuble, 2014c; very similar: Schäuble, 2014d)

Schäuble's concerns were obviously noticed by other governments. One Spanish high-level negotiator recalled that '[t]he Germans always focused on moral hazard. (…) Schäuble insisted to align the incentives' (ST5, 2016). The German government could count on support from the Netherlands and Finland in the SSM negotiations. Both were equally eager to create a strict SSM that limited the scope for moral hazard which was a concern they shared with the German government (e.g. Finance Ministries, 2012; Howarth and Quaglia, 2013, p. 112; Agence Europe, 2012a).

Lastly, divisions between the Chancellery and the Finance Ministry influenced the German preference formation. The latter was described as more hesitant, the former more conciliatory (Epstein and Rhodes, 2014, p. 21). A senior official in the Commission is quoted saying that 'Angela Merkel signs up to an idea and her Finance Ministry and lawyers spend a year telling us why it can't be done' (cit. in Financial Times, 2013d). There is a long history of similar situations, as one French senior negotiator remembers:

> 'From 2010 onwards, we have seen a number of occasions where the *Kanzleramt* and the Finance Ministry did not follow the exact same line. (…) In some cases, it was obvious that the priority for one was not necessarily the priority for the other and that in some cases it could conflict. (…) I never felt that Schäuble was particularly convinced by the solution we had found at the summit. They signed up to it, but they were quite hesitant.' (FT5, 2015)

Likewise, a senior official in the European Commission speculated that 'Schäuble probably felt that Merkel had gone too far. Very shortly after this meeting [i.e. the Euro Summit], they made it plainly clear' (COM7, 2015). This played out practically with the Finance Ministry being more hawkish in the negotiations. They were perceived as 'very reluctant to agree to anything. They were mainly destroying whatever proposal came on the table', as one advisor to the French prime minister remembers (FOPM1, 2016). These findings are at first sight not consistent with the roles played by each of them in the previous episode, when Schäuble went further than Merkel, but was called back by his boss. One interviewee in the German Finance Ministry explained their behaviour with a 'good cop, bad cop' strategy (GFM7, 2016). This would be a plausible explanation, but it is difficult[41] to establish to what extent these differences were a strategic instrument, or a non-strategic fact. Regardless of the motivation behind them, the conflict played out with a harder stance of the Finance Ministry. Therefore, French and Italian delegations attempted to circumvent the technical level in the Council and reach a political agreement in the European Council. Yet, the majority of finance ministers were keen to remain in control and did not grant the European Council a greater role. Nevertheless, their bosses kept control over the timing. Their commitment from October 2012 to finalise the negotiations by the end of the same year (European Council, 2012a, p. 7) put pressure on the finance ministers to keep pace.

The strong German advocacy for the SSM is a puzzle for neo-functional explanations. In the absence of crisis pressures, one would wonder why the German government continues to pursue a policy which results in surrendering the control over its banks to the European level. While its policy shift in spring 2012 from rejecting a European banking supervisor to advocating it can be explained by the crisis pressures, one would expect a policy reversal as crisis pressures fade out. As this section showed, the empirical evidence does not confirm this prediction.

[41] Parts of the fieldwork in the German Finance Ministry were conducted in June and July 2015 when the Greek crisis flared up again. At the time, divisions between the Chancellery and the Finance Ministry were a politically sensitive issue, which presumably limited the willingness of interviewees to respond to these questions and/or give honest answers.

The Southern Coalition: One Step Closer to a Joint Fund

At the Euro Summit in June, it was Merkel who had pushed for a tight deadline for the creation of a joint supervisor (Ludlow, 2012b, p. 27). After the negative press reaction at home, she got more cautious and slowed down the pace on the banking union, including on the SSM. This led to reversed roles on the timetable. The German government was pushed to an early agreement on the SSM. This would have cleared the way for negotiating the mutualisation of resources in the next step (Financial Times, 2012c; Howarth and Quaglia, 2013, p. 111). 'The quicker the mechanism is in place, the sooner recapitalisation can take place' (Hollande, cit. in Financial Times, 2012j), but '[q]uality supervision must take priority over an unrealistic timeframe' (Schäuble, cit. in Financial Times, 2012k). Quite typically, also on this occasion, the statements of the European Council were used to remind the German government of the timetable it had originally committed to:

> 'The direction set by the European Council is very clear. It's to complete the discussion in 2012 and to go fast. Otherwise everything remains theoretical and our problems are concrete.' (Moscovici, cit. in Financial Times, 2012c)

The governments in the Southern coalition closely adhered to the goals stipulated in the Euro Summit Conclusions when making the case for the banking union. They reiterated repeatedly and literally that the 'aim is to break the vicious circle between banks and governments' (Moscovici, cit. in Bloomberg, 2013a; see also Hennessy, 2014, p. 161). As from their perspective this goal required risk-sharing, the SSM was not more than an intermediate step. It satisfied German demands for a sharing of control and paved the way for risk-sharing through a joint resolution fund and a joint deposit guarantee scheme. Both were long-term goals of the Southern coalition. In the words of Moscovici:

> 'A fully-fledged banking union – i.e., a system to wind down or recapitalise troubled banks, combined with a Europe-wide bank-deposit insurance scheme – would go a long way towards breaking the feedback loop between weak banks and weak sovereigns (…). Step one is to establish before the end of the year a single banking supervisory mechanism (…). The reason why we want to keep to this timetable is because it was agreed, in June that setting up such a mechanism would be a prerequisite to provide the ESM with the possibility to inject funds into banks directly and retroactively, i.e. recapitalisation. And we want to get there sooner rather than later.' (Moscovici, 2012)

A side effect of the vicious circle was financial fragmentation in the single market. The funding costs of banks still depended on their home state, which is an idea irreconcilable with a level-playing field (Howarth and Quaglia, 2013, pp. 104–106). The SSM was supposed to contribute to equal funding costs by reassuring markets of an equally high supervisory quality in the eurozone. A Spanish top official described their aims as follows:

> 'Our main motivation was to create a level-playing field. It's a simple logic: similar German and Spanish banks should have similar funding costs and this was evidently not the case since 2011.' (ST6, 2015)

At this stage of the negotiations, neo-functionalism would suggest that Southern governments turn against an ambitious agreement. Following neo-functional logics, there would be no strong reason for giving up supervisory powers for their domestic banks in the absence of crisis pressures. The fact that Southern governments did not let the negotiations fail, is difficult to explain for neo-functionalism.

Breaking the vicious circle was the core objective of Southern negotiators. The SSM was the first step in this direction. Conversely, the Northern coalition perceived the SSM as a goal in itself to prevent an uncontrolled pooling of resources. These preferences were set to clash in the negotiations. The next section discusses the two most contentious issues in the SSM negotiations: the role of the ECB in the new mechanism and the scope of the SSM, i.e. which banks it covers.

Table 32: SSM: Preferences of core member states

	Northern coalition	**Southern coalition**
Core preference	No ECB involvement in joint supervision; later: 'Chinese wall' between monetary and supervisory functions Small banks excluded from ECB oversight; neither direct nor indirect ECB supervision	ECB as supervisory authority All banks under ECB supervision, no exceptions whatsoever

5.5. Negotiating the SSM: Delegating Sovereignty

ECB as Institutional Host

The idea of transferring bank supervisory powers to the ECB has a long history, dating back to the Maastricht Treaty negotiations in the 1990s and even earlier instances (Mourlon-Druol, 2016). Art. 127(6) of the Treaty on the European Union explicitly stipulates the possibility for the Council to 'confer specific tasks' to the ECB in relation to bank supervision (TEU, 2012), provided that member states unanimously agree. Unanimity was never reached prior to 2012 (De Rynck, 2016, pp. 125–126), but the crisis created a political momentum towards centralised supervision. This culminated in the Euro Summit Conclusions which explicitly invoked Art. 127(6) TEU to make the ECB the eurozone's bank supervisor (Euro Summit, 2012).

Northern Preferences: Building the Chinese Wall

The German negotiation stance was the result of a complex process of preference formation. While Merkel had unenthusiastically endorsed a supervisory role for the ECB at the summit in June 2012, the negotiations in the Council were conducted under the authority of the Finance Ministry. The topic as such was cognitively very complex. The macro-economic debate on the role of central banks in banking supervision was very inconclusive and provided for little unequivocal advice to policy-makers. One group considered it an advantage having central banks in charge of both monetary policy and banking supervision (Bernanke, 2007; Cecchetti, 2007; IMF, 2006; Goodhart, 2000). The ECB concluded already in 2001 that 'the attribution of extensive supervisory responsibilities (i.e., both macro and micro-prudential) to NCBs [National Central Banks] is likely to prove beneficial' (European Central Bank, 2001, p. 9). The creation of information synergies would help the monetary authority to assess the health of banks as an important indicator of financial stability. This would then, in turn, help the efficiency of banking supervision and stabilise EMU, a strong interest from the perspective of macro-economic preferences based on trade patterns. The banking associations, for instance, gave consideration to this reasoning, notably both private and public banks. The public banks issued a joint statement in which they considered the ECB's role as bank supervisor an 'obvious choice' (BVR/VÖB/DSGV, 2012, p. 2) and refrained from any criticism. The private banks warmly welcomed making the ECB the institutional host (BDB, 2012, p. 1).

The opposite perspective had similarly strong advocates. Their main concern was a conflict of interest between the ECB's monetary policy and its function as bank supervisor. In theory, the ECB could be tempted to sweep supervisory mistakes under the rug by using a lax monetary policy to prevent (badly supervised) banks from failing. The result would be suboptimal monetary policy outcomes (Goodhart, 2000; Alexander, 2014; Masciandaro and Passarelli, 2013). Exactly because of these concerns the experts behind the Commission's Larosière report from 2009 eventually rejected the creation of a joint supervisor at the time (Larosière, 2009, pp. 42–44). These issues could be mitigated by the creation of a so-called Chinese wall between both functions, but a complete separation seemed impossible to implement in practice. The legal provisions in the Treaty stipulated ultimate decisions in both areas would have to be made by the very same institution, the ECB Governing Council. This rendered a separation somewhat incomplete (Verhelst, 2013b, pp. 42–43). In this line of reasoning, the ECB should not become a bank supervisor as this function would risk the independent conduct of monetary policy. The worst outcome would be a higher inflation as a result of these conflicts of interests. This could eventually lead to fiscal costs, making it a less favourable policy from the fiscal perspective.

Faced with both options, the Finance Ministry was divided internally. While a smaller faction was willing to accept the ECB in this role to entrust a highly credible institution with supervisory tasks (GFM8, 2016; GFM9, 2015), the majority view in the Finance Ministry forcefully opposed supervisory powers for the ECB. This larger group, which one senior official dubbed 'the puritans' (GFM9, 2015), was at the helm. They were dogmatic and supported by the minister, who did not believe in the insurmountability of any wall and preferred a clear separation between the two tasks (Schäuble, 2012a). The government eventually formed a preference against the ECB as banking supervisor. Following Schäuble's line, it staunchly advocated a separate institution in charge of banking supervisory powers, but not the ECB.

The discussion above exemplifies that the two options can barely be distinguished by an analysis of their costs and benefits. These were presumably not far apart, but subject to a decade-old debate among economists and eventually hidden behind a veil of uncertainty. Furthermore, their impact on the fiscal position or trade patterns was only indirect and restricted in magnitude. This leaves ample room for internalised ideas to shape the response of policy-makers. Ordoliberalism has incorporated central bank independence as a core principle (Howarth and Rommerskirchen, 2013). The proposal of allocating both monetary and supervisory functions at the ECB was difficult to reconcile with this set of ideas; it was considered 'a deeper shift in economic thinking' (De Rynck, 2016, p. 125) and few in the German Finance Ministry were willing to accept this shift. A German negotiator in the Finance Ministry admitted: 'Banking supervision at the ECB was a big issue for us. The conflicts of interest are massive' (GFM4, 2015). A colleague of him seconded that 'the stability of the system is in question if the central bank is the jury of its own supervision' (GFM3, 2015). A senior official from the German Bundesbank reinforced this argument and emphasised that

> 'for good reasons, the German setup [was] different to the new structure in the euro area. We want to set the right incentives, and in Europe we set the wrong incentives. There are serious issues with moral hazard and we are not happy with that' (GCB2, 2016).

A member of the Legal Service of the Council who observed the negotiations perceived similar issues being raised:

> 'There was an opponent to this [supervisory role of the ECB], which is Germany. It was a big problem for them, because it was running against the German DNA that you cannot mix supervision and monetary functions.' (CEU1, 2015)

One Southern European finance minister noticed that '[t]he ECB as supervisor was a big thing for them. They were hostile towards the idea, which basically goes down to moral hazard again' (SEC2, 2016). In the absence of a strong pull factor among material interests, the many references to the shift in thinking are evidence that different schools of thought did matter in this question. In the German case, it was internalised ordoliberal ideas that guided the thinking. They made the new role for the ECB appear like an undesirable big shift away from realigning control and liability. An issue as abstract and fundamental as that which institution should be entrusted with supervisory functions is likely to be shaped by ideas, not least out of a certain path dependence based on a 'German DNA'. Faced with a very similar payoff from both options under considerations, the government resorted to ordoliberal ideas as the worldview influencing its policies.

Southern Preferences: Creating a Credible Supervisor

The preference formation was less complex in the Southern coalition, which collectively and strongly wanted the ECB in the position as bank supervisor. Hollande had already publicly supported Monti's proposal for a supervisory role for the ECB in his press conference after the European Council in May 2012 (Hollande, 2012c) and reaffirmed his stance after the Euro Summit in June 2012 (Hollande, 2012e). He was at the forefront of giving the ECB supervisory powers (Chang, 2015, p. 18; Financial Times, 2012g). In France, Italy, and Spain, supervisory powers are traditionally allocated at the national central bank (BIS, 2016). They dismissed the concerns of the German Finance Ministry about the potential conflict of interest as purely theoretical and manageable (FT2, 2015).

Two major reasons caused the Southern coalition's unequivocal support for the ECB as institutional host: credibility and feasibility. The ECB had gained a high reputation at financial markets due to its independent conduct of monetary policy (Beck and Gros, 2012, p. 6; Verhelst, 2013b, pp. 28–29; see also Financial Times, 2012l; Financial Times, 2012m). Thus, the core countries in the Southern coalition considered the ECB the ideal institution. Based on the experiences during the financial crisis, an information-exchange between monetary policy and banking supervision was a further tweak to safeguard financial stability (Beck and Gros, 2012). Smaller member states outside the eurozone preferred the EBA (Financial Times, 2012g), but the agency's reputation was certainly not at the level of the ECB's (e.g. Financial Times, 2012l). It damaged its reputation with obviously flawed and politically influenced bank stress test results (Véron, 2011b, pp. 7–8). There was no appetite to risk the new arrangement being hampered by a weak institution. Creating a new agency would have been difficult, as it would have required a different legal basis (Art. 352 TEU). On this legal basis, the new agency would have been the bank supervisor for the whole EU – an undertaking that was bound to be rejected by the United Kingdom (CEU1, 2015). For the same reason, the van Rompuy report in June 2012 had suggested the ECB as joint supervisor (van Rompuy, 2012a, p. 4). The issue under consideration was a low-stake issue for the banks in the Southern coalition. As in all of the Southern countries, there was a long and also encouraging tradition of having the central bank as bank supervisor, there was not much contention about a similar division of labour on the European level. They consented to ECB supervision, albeit demanding a role for national central banks within the new arrangement (e.g. BFM, 2012; BBVA, 2013, p. 12).

Negotiations: The Argumentative Weakness of German Exceptionalism

Schäuble consistently argued in the negotiations that '[t]he right of the last decision cannot be left to the ECB Governing Council (…). A Chinese wall between banking supervision and monetary policy is an absolute necessity' (cit. in Reuters, 2012c). Yet, it was hard for German negotiators to convince their counterparts of what these perceived as an excessively strict separation. The German Finance Ministry stressed the above-explained considerations about the conflict of interest, but their arguments failed to gain support among their peers from other member states. The European Banking Authority did not provide a compelling alternative, given that it would neither have the necessary know-how or staff, nor the necessary clout in financial markets (Financial Times, 2012n). The fact that in only two of the seventeen eurozone countries the national central bank did not perform the tasks of a bank supervisor demonstrated German exceptionalism in this question (European Central Bank, 2001, p. 1). The euro outs were also hesitant about ECB banking oversight, but their reservations were based on the distribution of voting rights (Financial Times, 2012o; Financial Times, 2012p; Financial Times, 2012q). Their influence was fairly small and could not decisively overcome the German government's isolation. The difficulties in convincing the others were acknowledged by a German negotiator:

> 'This separation between monetary policy and banking supervision did not play any role for the others. 14 [sic] or 15 out of 17 eurozone member states had their central bank as bank supervisor and of course they did not say "we have a bad system".' (GFM4, 2015)

A former Southern finance minister considered it 'absurd that they were so much against the new system: their own supervisor was not fool proof [as] they had very high losses' (FM1, 2016). Indeed, the German bank write-downs to GDP were the second highest in the world during the financial crisis (Gros, 2013b, p. 2; Hardie and Howarth, 2013, p. 103). For a credible solution to the agreed problem frame of the vicious circle, the German system could offer only limited support.

The German government was vulnerable as its arguments were perceived as weakly relevant. The Southern coalition used two instruments to overcome the German resistance. The first one was invoking the commitment to break the vicious circle. This implied the need for an efficient system to deliver on this promise. Hollande insisted directly after the Euro Summit in June: 'The European Central Bank is the best equipped, the best armed to carry out this banking supervision' (Hollande, 2012e). A leading French negotiator explained that '[i]t had to be the ECB to be the supervisor, because we needed to build on the reputation of the institution' (FT5, 2015). Considering that '[b]anking union means putting an end to the financial fragmentation of Europe' (Moscovici, 2013), 'entrusting the ECB with supervisory powers provided for sending a powerful signal to financial markets' (FT5, 2015; see also Financial Times, 2012r), according to one senior official in the French Treasury. An advisor to the French prime minister reported that 'Hollande always said it should be the ECB. This is because the house was on fire and we needed the ECB's reputation to extinguish it' (FOPM1, 2016). According to a former Southern European finance minister, '[i]t was a systemic crisis, a self-fulfilling prophecy with the doom loop. Wherever possible, we wanted the ECB to take responsibility' (FM1, 2016). This stretched to granting the central bank a supervisory role.

For the second group of arguments, the Southern coalitions resorted to the Euro Summit Conclusions. They endorsed a supervisory role for the ECB explicitly and thus tied the hands of the German Finance Ministry. The ECB's vice-president Constâncio made use of the Euro Summit statement to beat the drum for his institution: 'It is inside the ECB, as the summit has decided' (cit. in Reuters, 2012c). A Commission official explained: 'We reminded Schäuble all the time – look, here is what Merkel said! Here is the statement' (COM6, 2015). A member of the Council's Legal Service came to a similar assessment: 'That was a strange episode. The summit statement, it was very concrete and precise: a permanent mechanism of supervision in the hands of the European Central Bank' (CEU1, 2015). One lead negotiator in the German Finance Ministry acknowledged the critical role of the conclusions:

> 'Many of us didn't like it, but the Euro Summit Conclusions were important with regard to the role of the ECB. They determined the ECB to be the joint supervisor. And they also specified the legal basis, which was a lot more concrete than many other parts of the Conclusions.' (GFM9, 2015)

With not much room for manoeuvre left, the summit Conclusions became an insurmountable obstacle. They became a powerful rhetorical tool, as they limited the realm of possibilities. They could be pitched as taking the German preference off the table, rendering it unsuitable given the problem under consideration. The Finance Ministry eventually accepted the ECB's role because legal constraints in the Treaty made it difficult to assign supervisory power to another institution (GFM8, 2016). It then readjusted its objectives to constraining it as much as possible. The interviewee in the Council described a switch in the negotiation strategy of the German Finance Ministry: 'they realised that they created a kind of monster. The question was how to deactivate this monster, so how to tighten the power and the scope of the powers of the European Central Bank' (CEU1, 2015). To achieve progress in this endeavour, in the negotiations, the Finance Ministry focused on solidifying the 'Chinese wall' (Schäuble, 2012a) between both policy areas: 'supervisory and monetary policy matters should be strictly separated so as to pre-empt conflicts of interests' (Schäuble, 2012a), which included several safeguards down to a very technical level (GFM8, 2016). While it is legally required that the Governing Council of the ECB – and therefore the very same people that conduct monetary policy – make supervisory decisions (Howarth and Quaglia, 2013, p. 118), it is intended that they merely follow the recommendations of the independent and newly created Single Supervisory Board. As a result of German pressure, a mediation panel comes in when disputes persist (Epstein and Rhodes, 2014, p. 18).

Yet, this adjusted strategy included clearing the way for Southern preferences in favour of a supervisory role for the ECB. Furthermore, Verhelst is doubtful about the effectiveness of the Chinese wall: 'there is hence no Chinese wall between bank supervision and monetary policy. Under a pessimistic view, the separation between the monetary and supervisory functions can be perceived as just as faulty as the separation between the compartments on the Titanic' (Verhelst, 2013b, p. 28). Against the backdrop of this rather fragile Chinese wall, there is a good reason to argue that the final agreement 'departed significantly from Germany's original position' (Epstein and Rhodes, 2014, p. 18). Despite beneficial power asymmetries, the German Finance Ministry had to accept the supervisory role of the ECB, first and foremost due to the Euro Summit Conclusions which had already locked-in a consensus on the new ECB role with the blessing of the German Chancellery. In this environment, the Finance Ministry's arguments were neither assessed as compelling nor as effective in breaking the vicious circle between banks and sovereigns. The previous agreement had already limited the realm of possibilities, making the German preferences appear unsuitable.

Scope of the SSM

The scope of the new mechanism was the single most controversial issue in the SSM negotiations. Discussions revolved around two questions: firstly, if all banks or only the biggest ones would be included in the SSM. Secondly, the negotiators had to decide on the responsibilities in the day-to-day supervision. Even if they were to settle on an all-encompassing scope covering all banks, it was another question whether the ECB or national authorities should carry out the day-to-day supervision.

In contrast to the previous issue on the role of the ECB, the Euro Summit Conclusions were significantly more ambiguous with regard to the scope. The heads of state or government envisaged a 'single' supervisory mechanism in the Conclusions (Euro

Summit, 2012, p. 1). This was by some but not all interpreted as implying a scope encompassing all banks. Hollande left little doubt about his grasp of the outcome in his press conference directly after the summit in June:

> 'Will this apply to all the banks? My answer is "yes". (…) [T]he general view is that there must be supervision of all the banks. (…) The Central Bank must supervise all the Euro Area's banks.' (Hollande, 2012e)

Merkel was more hesitant and limited the scope to 'at least the systemically relevant banks' (Merkel, 2012a), not yet taking an all-encompassing scope for granted. The German Finance Ministry was once again even more hawkish. Schäuble threatened that '[d]irect joint supervision will stand a better chance to be realised if it is limited to the big banks, the transnational banks' (Schäuble, 2012b).

Northern Preferences: A Banking Union for Some

The German government aimed to limit ECB supervision to systemically important banks (Véron, 2014; Agence Europe, 2012b; Financial Times, 2012c; EurActiv, 2012b). While the supervision of these banks was supposed to be strong with real investigation and auditing powers, there was no appetite to set in place a mechanism for all banks regardless of their size (Howarth and Quaglia, 2013, pp. 112–113). The German Finance Ministry proposed that only banks with assets exceeding 100 billion euro would be covered by the SSM. This stance was later softened to 50 billion, but would still have excluded all *Landesbanken* and *Sparkassen* and was worlds apart from the French proposal of 5 billion euro[42] (FT3, 2015; GFM4, 2015; GFM9, 2015). The German government could in the negotiations mainly draw on the support of Austria, Finland, and this time also Belgium (Howarth and Quaglia, 2016c, p. 439).

The macro-economic preference derived from trade patterns – i.e. sustaining EMU – would suggest an all-encompassing scope. Small but fast expanding banks played a key-role in triggering the financial crises in Ireland and Spain (Garicano, 2012, pp. 81–83; Royo, 2013, pp. 171–173). From a perspective of stabilising EMU, there was no rationale for having them excluded. On the contrary, having them included in the European safety net would disable another source of instability. Given the low competitiveness of the German banking sector, a joint supervisor was also expected to lead to an overhaul of the sector. The public banks benefited from regulatory privileges which a supranational

[42] According to Hennessy, the threshold was set even lower by the French government at 2,5 billion euro (Hennessy, 2014, p. 163).

supervisor would unlikely tolerate. It would have been a benefit, given that the German banking sector is uncompetitive on a European scale and characterised by 'low profitability compared to that of European peers' (IMF, 2011, p. 14). It is fragmented, creating the need for parts of the German export sector to rely on foreign banks. Furthermore, the uncompetitive structures caused time and again the need for interventions from the state to bail out failing *Landesbanken* (Hardie and Howarth, 2013; see also IMF, 2013b).

The fiscal position is a more ambiguous determinant of preferences. In principle, an all-encompassing scope would be the strongest form of constraining other governments in their control over the domestic banking sector – an instrument to limit the public funds used to bail out banks and eventually reducing the need for fiscal transfers. However, this reasoning was only of secondary importance because of previous arrangements: by the time of the negotiations, it was a done deal that only the banks under the scope would have access to the resolution fund. Thus, enlarging the scope risked an increase of liability-sharing as also the number of banks with access to the resolution fund would increase. This argument applied asymmetrically to the disadvantage of the German government: it was unlikely that including the savings banks under the scope to ensure their access to the resolution fund would, in fact, yield many benefits. The savings banks have their own security system in place, hence they would neither need nor benefit from a European system (Howarth and Quaglia, 2014, pp. 130–132). This limits the fiscal incentives to have them included. The fiscal position suggests a rejection of an all-encompassing scope as it would lead to an asymmetrical increase of liabilities.

A widened scope would have resulted in easier access to resolution funds, by some considered a 'fiscal union through the back door' (Otero-Iglesias, 2012). This set off the alarm bells from the perspective of realigning control and liability. A public statement of 220 German economists called for a supervisor with 'sufficient authority for effective control' and 'far-reaching intervention rights' (Heinemann and Illing, 2012) to prevent moral hazard resulting from lax supervision. An outcome along these lines was difficult to attain with an all-encompassing scope. A broad scope would have risked a situation with access to mutualised resources in the resolution system, but no effective supranational control. Full supervisory power for the ECB could have resulted in a less stringent banking supervision on the ground as there was a risk of getting a supervisor which would be 'too large to be efficient' (Wyplosz, 2009, p. 4; Epstein and Rhodes, 2014, p. 14; Dombret, 2015). Overburdening the ECB with the supervision of 6,000 banks off the cuff would have put its effectiveness at risk. In fact, also the ECB as future supervisor recognised that it would have been overburdened by the magnitude of this task (Financial Times, 2012b). This shaped the German government's persistent call for real investigation and auditing powers for the new supervisor. Officials in the Finance Ministry emphasised the need for effective supervision:

> 'We were a bit shocked and taken by surprise that the ECB said 'We need six months and then we can supervise 6,000 banks'. Especially as their lawyers told us that the only committee that can take decisions is their Governing Council. We said 'imagine that for each bank you have to take 5 decisions a year. This makes 30,000 decisions for the Governing Council. This won't work. They were not prepared.' (GFM4, 2015)

More radical voices in the German Finance Ministry even cautioned against any liability-sharing, considering the significant leeway of national governments in influencing the fate of their banks with measures not under the remit of the SSM. Given this scope for a misalignment of control and liability, ordoliberal ideas suggest a limited mechanism. This effectively matches the preference of the government, pointing towards a role for concerns on realigning control and liability behind the German preference for a limited scope.

Besides these considerations, the influence of the public banks on the government's preference is noteworthy. The public banks are influential and already fiercely opposed any European influence on their businesses in the past (Seikel, 2014). Remaining outside the scope was by some savings banks perceived as a question of survival. Their interest was a status for banks without international activities as being 'generally exempted' (BVR/VÖB/DSGV, 2012, pp. 1–2) from the SSM, where they first and foremost referred to themselves. The *Sparkassen* hoped to remain shielded under the auspices of national supervisors on whom they could have some influence via the national government (Wyplosz, 2012, p. 20). According to the evidence gathered from negotiators from other member states (presented in the section below), the German government was perceived to defend the interests of the *Sparkassen*. This match between their own interests and the government's preference suggests that they were at least a complementary driver[43]. No

[43] Further complementary drivers were legal issues and internal divisions. Legal constraints should not be omitted either. The Council's Legal Service had engaged in informal consultations with the chairman of the

influence, however, can be assigned to the private banks. They made the case for all banks to be included as they aimed to achieve a level-playing field but apparently, they failed to be heard (BDB, 2012, p. 1; BDB, 2013a, pp. 3–5; Deutsche Bank, 2012).

Southern Preferences: A Banking Union for All

There was not much enthusiasm for the German position on the SSM in the Southern coalition. With France at the helm, it pushed towards the opposite direction and aimed for an all-encompassing scope. The Commission suggested the inclusion of all banks in the scope of the mechanism and gained support from the European Central Bank (Howarth and Quaglia, 2013, p. 112; Agence Europe, 2012b; Agence Europe, 2012c; Financial Times, 2012c). The French government, which acted as leader of the coalition, wanted a significant role for national authorities within a licensing system, but preferred to arrange this system with all banks under ECB supervision; Italy, which was home to many small banks as well, in turn sought prerogatives for small credit institutions, but without risking the integrity of the SSM as a whole. It strongly favoured a one-tier system (Agence Europe, 2012d; Howarth and Quaglia, 2013, pp. 112–113; see also FT2, 2015; FT5, 2015; IT2, 2015). All members of the Southern coalition shared the preference that no eurozone bank should be excluded from SSM supervision. They objected to a division between significant and less-significant institutions.

The question of the scope was inextricably linked with the Southern coalition's core concern: the vicious circle between banks and sovereigns. A joint supervisor with a broad scope was an indispensable element to restore trust in the banking sectors of the crisis states, especially since there were several cases where national supervisors had not done a proper job in the financial crisis (Garicano, 2012, pp. 81–83; Royo, 2013, pp. 171–173). The distinction between systemically significant and less significant banks was dismissed as not particularly well-founded. The crises in Ireland and Spain had forcefully shown that banking crises can be caused by fast-expanding small banks as opposed to big banks

German Constitutional Court Andreas Voßkuhle. According to one attendee of the meetings, he signalled that it would be difficult for them to give a permissive verdict to an all-encompassing scope (CEU1, 2015). The legalistic approach, which also matches the rule-guided ordoliberal approach to economic policies, was a constant source and constraint of German preferences. Also, there were stark differences within the German position. While the Chancellery was more permissive towards an integrated system with all banks being subject to the SSM regulation but national supervisors carrying out the day-to-day supervision for smaller institutions, the Finance Ministry preferred excluding them completely (see also Ludlow, 2012b, p. 29).

(Garicano, 2012, p. 80; Royo, 2013, p. 153; Howarth and Quaglia, 2013, p. 112). This evidence from past experience supported the stance of the Southern European governments. A French senior official explained:

> 'We wanted to have the broadest scope possible, because we were very much convinced that this issue was not only for the major banks, but for any bank. Because we had seen during the crisis that small banks created systemic risks.' (FT5, 2015)

The preference for a broad scope was in line with the banks' interest to put an end to the financial fragmentation of the single market. They had a fundamental interest in stabilising EMU in order to restore funding conditions equal to their Northern European competitors. To them, it was 'essential that all euro-zone banks should be submitted to the same supervision' (FBF, 2012b; see also BBVA, 2013, p. 12; AEB, 2014a, pp. 4–5). When the French banks spoke to the Treasury, they preached to the converted. With either a broad or limited scope the French government would have given up control over almost 90% of its highly concentrated banking sector; a limited scope would have permitted the German government to remain in control over more than 30% of its highly fragmented banking sector (Howarth and Quaglia, 2016c, pp. 444, 451; see also Howarth and Quaglia, 2013, p. 112; Véron, 2014). Achieving a symmetrical distribution of the sovereignty costs was another reason for an all-encompassing scope. An official in the French Treasury remembered:

> 'We had long discussions in Paris. There was a clear debate on how far we should go as to sovereignty transfers of the big French banks. (…) It was an arbitrage between euro area financial stability and sovereignty transfer. I must say, these were not easy discussions.' (FT1, 2015; see also Moscovici, 2012)

As a complementary factor in these difficult discussions, several interviewees pointed to the critical influence of the Director of the Treasury Ramon Fernandez. He was a policy entrepreneur who had the reputation of being a staunch 'European' in favour of a European solution[44] as well as a credible negotiation partner (FT1, 2015; FT5, 2015; FOPM1, 2016; CPEC3, 2015; see also Chang, 2015).

In sum, also in this case the macro-economic interest in stabilising EMU is in line with the interests of the banks, and the two factors together suggest an all-encompassing scope.

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[44] The Treasury was divided on the issue, with divisions breaking up between the European Affairs Department and the Financial Services Department. While the former prioritised the banking union, the latter was not willing to surrender control over the five large French banks (FT1, 2015; FT5, 2015; FOPM1, 2016; CPEC3, 2015).

This matches the preferences of the governments in France, Italy and Spain, which all advocated a broad scope. As the domestic interests were aligned in the respective countries, their configuration did not trigger the scope condition for the ideational approach.

Negotiations: The Quest for an Effective Banking Union

Throughout the negotiations, the German government primarily invoked arguments about the technical feasibility of an all-encompassing scope and the principle of subsidiarity. According to Schäuble, establishing effective supervision in such a short time frame could not be 'realistically expected' (Financial Times, 2012s). 'It's a matter of quality. We just could not picture how the ECB can get prepared to supervise so many banks in so little time' (GFM4, 2015), one negotiator explained. A member of the Council's Legal Service recalled the discussions at the Council meetings along the same lines:

> 'They were invoking the principle of subsidiarity, so the ECB should do as much as necessary and as little as possible, limiting the supervision to ban these transglobal [sic] activities and those with a systemic risk. "When it comes to the others, I will do it, because I am closer to them and I know much better." The idea was fundamentally on subsidiarity.' (CEU1, 2015)

Establishing a new bank supervisor as such for around 120 systemically important banks was an ambitious goal, but making the ECB the direct supervisor for around 6,000 banks in the eurozone was framed as impossible (see also Howarth and Quaglia, 2013, p. 112; Epstein and Rhodes, 2014, p. 18).

These arguments had some clout, but the majority did not perceive them as well-founded. They were mostly perceived as spoiler arguments that did not address the underlying issue, but covered up egoistic preferences, as a French official from the Treasury recalled:

> 'The main argument was it's too bureaucratic, the ECB cannot control all banks, we need to have a clear allocation of responsibilities on the subsidiary principle, blah-blah-blah. They really said that. The national interests were not explained or put forward as such, so they used other arguments.' (FT3, 2015)

There were suspicions that the German government's main interest was to shield its public banks. Several interviewees underlined this perception. A senior official in the Commission admitted: 'I think this was driven by the *Sparkassen*, at least that was the perception here [in the Commission]' (COM7, 2015). A member of the Council's Legal Service agreed:

> 'I think shielding the *Sparkassen* was the reason for the German resistance against a full scope. The lobby of national banks who didn't want to be the target of the control of external powers. That's the perception I recall from the Council.' (CEU1, 2015)

A Southern European finance minister did not hold back his outright dismissal of the arguments put forward by his peer Schäuble in the Council:

> 'The German arguments against a broad scope were totally ridiculous. They said that in order to supervise you have to be there [in the bank]… but come on, we don't live in the 18th century any more. It was ridiculous.' (FM1, 2016)

Faced with a lot of resistance, a German negotiator from the Finance Ministry did not deny that their arguments did not go down well in the discussions:

> 'Most member states considered our arguments to be excuses. We were under suspicion that we delay the project to bring it to a halt eventually.' (GFM4, 2015)

The German arguments on subsidiarity did not pass the giggle test in the negotiations. They were perceived as too weak to be taken seriously and as serving mainly the purpose to shield the *Sparkassen*. Not only that the German solution frame of subsidiarity failed to convince its peers, it was also seen as unsuitable to serve the agreed end to break the vicious circle. Southern negotiators stressed the need for a broad scope to effectively solve the problem of the vicious circle. Moscovici urged his peers to stick with the previously agreed goal:

> 'We have no remit for a dual system of supervision which would call into question the existence of a single system for some banks. (…) The ECB must supervise all banks.' (cit. in Reuters, 2012d)

The ECB's Cœuré warned of inconsistencies:

> 'It is crucial that all banks are covered by the SSM. A two-tier system would result in an uneven playing field, effectively segmenting the banking sector, which is precisely what we are trying to repair.' (Cœuré, 2012)

Likewise, Moscovici emphasised the fundamental importance of having some kind of centralised supervision for all banks: 'In the end it must be the ECB that has the responsibility on the whole. Otherwise, there is no real system of banking supervision' (cit. in EU Observer, 2012b). The German position delayed the conclusion of the SSM and conflicted with the European Council's mandate, as Moscovici laid out:

> 'The direction set by the European Council is very clear. It's to complete the discussion in 2012 and to go fast. Otherwise everything remains theoretical and our problems are concrete.' (Moscovici, cit. in Financial Times, 2012c)

The Irish finance minister Noonan recalled the risks posed by a limited scope for the ultimate goal of the banking union and emphasised the importance of a single system:

> 'The single supervisor is the core element of banking union and a vital step in breaking the vicious link between the banks and the sovereigns.' (cit. in Financial Times, 2013e)

After the German government had received much headwind, the issue was eventually lifted to the European Council at its meeting in October 2012. Merkel conceded a system according to which the ECB obtained the ultimate responsibility for all banks in the eurozone regardless of their size. This system included the German regional and savings banks. In turn, the German government secured that the ECB supervision should be carried out 'in a differentiated way' (European Council, 2012a, p. 7). This implied a strong role for national supervisors acting as agents for the ECB in the supervision of non-systemically relevant banks (Agence Europe, 2012a). However, the ECB could at any time assume supervisory powers for any bank in the eurozone without giving any reason for it. After intensive Franco-German consultations (IT2, 2015; GFM9, 2015) and following an Italian compromise proposal (IT2, 2015), the previously agreed principle was translated into a concrete threshold[45] between so-called 'significant' institutions directly supervised by the ECB and 'less significant' institutions under indirect ECB supervision at an asset size of 30 billion euro – in-between the German proposal of 100 and the French of 5 million, but most importantly including all *Landesbanken* (except the tiny LB Saar from the state of Saarland) and also one of the *Sparkassen*.

The inclusion of the *Landesbanken* makes their eventual resolution much more likely in the future, given their crisis-prone business activities. Having one single *Sparkasse* within the scope is more significant than it looks like at first sight. It was a French preference to have at least one *Sparkasse* included, as it implicates the need to apply at the ECB for approval of their own institutionalised resolution fund. The latter has the power to pull the plug of their separate system at any time. As a result, the German government 'has gradually given way to a more expansive notion of ECB banking supervision than it had originally deemed acceptable' (Epstein and Rhodes, 2014, p. 17). It therefore comes as no surprise that one negotiator from the Finance Ministry admitted that '[t]he intervention

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[45] More precisely, a bank is 'significant' if one of the five criteria is satisfied: (1) the value of the bank assets exceed 30 billion euro, (2) the value of the bank assets exceed 5 billion euro and simultaneously 20% of the GDP of the host member state, (3) the bank is among the three 'most significant' banks in the country, (4) the bank has 'large' cross-border activities or (5) the bank receives direct financial assistance from the European Stability Mechanism (ESM) and/or the European Financial Stability Fund (EFSF) (Art. 6 (4), Regulation 2013/1024/EU).

rights for the ECB... this was quite a pain for us to accept' (GFM4, 2015). The *Sparkassen* 'lobbied consistently to retain national supervision and resolution funding, but have lost on both' (Epstein and Rhodes, 2014, p. 24).

Notably, the German government was not isolated in these negotiations. The regular triple A coalition was intact (albeit with weaker support from the Netherlands) and strengthened by governments from the Benelux countries and Eastern Europe. Some member states even issued a joint non-paper in the negotiations (Agence Europe, 2013b; Agence Europe, 2013a; Howarth and Quaglia, 2013, pp. 112–113; Howarth and Quaglia, 2016c, p. 439). This sustains the perception that the German government benefited from a favourable distribution of material bargaining power, but failed to impose its preferences on the other member states. The evidence suggests that rhetorical processes played a decisive role. The analysis demonstrated that German arguments were perceived as extraordinarily weak in substance, idiosyncratic, and merely covering up the egoistic preference to shield the public banks. Other governments stressed that a two-tier system as preferred by the German government was an unsuitable response to the collectively agreed problem frame of the vicious circle. It would have hampered the banking union's capacity to break the vicious circle. For this reason, it was perceived as being no longer within the realm of possibilities, given the agreement on the problem frame of the vicious circle. Yet, the German government continued to hold on to its preference of excluding small banks, but ended up being cornered and eventually had to accept 'what one permanent representative described as Germany's 'fall-back' position' (Ludlow, 2012b, p. 29).

5.6. Conclusion

This chapter analysed the negotiations on the Single Supervisory Mechanism. They were not as messy and chaotic as those at the chaotic Euro Summit in June of the same year, but nevertheless of highest importance for the future of the eurozone. The German government woke up to the concessions it made at the Euro Summit, but while its backtracking efforts were successful with regard to direct bank recapitalisations, they failed with regard to the role of the ECB in banking supervision and the scope of the SSM. On both of these issues, the German government was forced to make concessions. It could not extract concessions regarding the ECB's role in the new mechanism. The agreement on the scope does not correspond to the German ideal point either. While there is a separation between significant and less significant banks, the ECB has the ultimate say over all banks. Intervention rights allow it to assume supervisory powers at any point in time and narrow down the scope of national supervisors to shield their national non-significant banks effectively. These concessions exceed what one could deem minor concessions in a strategy of benign hegemony by the German government, which speaks against the power hypothesis. The analysis brought to the fore that fellow negotiators perceived German preferences on both of the issues as not argumentatively well-founded. They could not measure up to the expectations created by the Summit's promise to break the vicious circle between banks and sovereigns. Southern European negotiators successfully cancelled them out as ineffective. They revoked the shared commitment as well as the collective Euro Summit statement to make the case for a strong supervisor allocated at the ECB. Likewise, they made the case for an all-encompassing scope because of its importance for breaking the vicious circle and reducing financial fragmentation. The German government's counter-arguments were readily dismissed. While the Northern coalition was cohesive in the SSM negotiations and partly reinforced by the Spanish government, they were forced to give in to the arguments from their peers in Southern European governments. In all, this is strong evidence for the rhetorical action hypothesis, overall.

The private material interest hypothesis on the formation of domestic preferences can be refuted most strongly in the case of German preferences towards the role of the ECB in the SSM. The government and especially the Finance Ministry were strictly opposed to the ECB involvement in banking supervision, which was different to the interests of the public and the private banks. From a perspective of macro-economic preferences, it was difficult to identify one policy as clearly more rational than its contender. On the one hand, one could reasonably expect a stabilisation of EMU by means of ECB supervision. It would have yielded significant benefits in terms of better and more credible supervision. On the other hand, there were strong concerns that supervisory powers for the ECB could at the end of a longer causal chain result in higher inflation because of conflicts of interest between supervision and monetary policy, leading to suboptimal monetary policy outcomes. There is no clear assessment possible of the costs and benefits, but the evidence suggested that ordoliberal concerns about moral hazard guided policy-makers in their preference against ECB supervision. Their discourse refers to the need to realign control and liability, suggesting causality between ordoliberal ideas and the preference of the government.

There is a somewhat different picture regarding the scope of the mechanism. The German insistence on an effective SSM with real auditing rights matches ordoliberal predictions; yet, the preference of excluding the savings banks also reflects the power of the *Sparkassen*, which, besides ordoliberal ideas, certainly influenced the government to some extent, against the opposition of the private banks. It was feared that the ECB would have been overwhelmed by the direct oversight of all banks and the evidence suggests that the intention to ensure effective supervision led to the German preference for a limited scope. There was a parallel impact of the public banks on the German government's preference. In the Southern coalition, the evidence supports the hypothesis concerning the impact of material interests. The fragmentation of the single market worsened the funding conditions of the banks in the Southern European countries. This affected their economies as well, providing a strong reason in favour of an effective supervisory mechanism as a cornerstone of a full-fledged banking union. The SSM was the entrance fee for access to mutualised resources in the resolution system.

Notably, the agreement on the creation of a joint supervisor does not fit neo-functionalist predictions. The crisis pressures had significantly weakened in the second half of 2012. The negotiations, however, did not break down at this stage, but were successfully concluded. One could argue that EU negotiations rarely fail completely, but their failure is concealed behind void compromises. This is not applicable to the SSM whose institutional design is ambitious and exceeds the smallest common denominator of the member states.

After the deal on the single supervisory mechanism was struck in December 2012, the way was cleared for the negotiations on the Single Resolution Mechanism. The discussions of this second pillar of the banking union were even more difficult: while the German government had a strong interest in pooling control in the SSM, it was less interested in pooling liabilities in the SRM. This led to lengthy and protracted negotiations, which the following chapter analyses.

Chapter 6: The Single Resolution Mechanism

6.1. Introduction

With the Single Supervisory Mechanism, European banks were brought under a joint eurozone supervisor. According to a quip by Mervyn King and Charles Goodhart, banks under SSM supervision were 'European in life', but they would remain 'national in death' in the absence of a joint European resolution system (cit. in Véron, 2015, p. 22). To break the vicious circle between banks and sovereigns, a swift agreement on the Single Resolution Mechanism was indispensable. While it had already been difficult to agree on the surrender of supervisory powers to the European level, an even bigger challenge was negotiating the supranational resolution of national banks. Mutualisation has been a contentious issue in all EMU negotiations, and the chaotic rescue of Cyprus in spring 2013 demonstrated that bailing-in investors was by no means an easy task. This chapter explores the political battles that led to the shift of resolution powers to the European level, including a significant pooling of resources with a joint resolution fund.

The European Commission published a legislative proposal for the SRM regulation on 10 July 2013. The Council's General Approach from 19 December 2013 cleared the path for negotiations with the European Parliament. The latter adopted the SRM regulation[46] on 15 April 2014; the legislation included the Bank Recovery and Resolution Directive[47] establishing bail-in rules and an intergovernmental agreement[48] on the transfer and mutualisation of contributions to the Single Resolution Fund (SRF) that was signed by the member states on 21 May 2014. The SRM regulation entered into force on 30 July 2014 (European Commission, 2016b).

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[46] Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010.

[47] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council Text with EEA relevance.

[48] Agreement on the transfer and mutualisation of contributions to the Single Resolution fund, ST 8457 2014 COR 1.

The Single Resolution Mechanism is a eurozone-wide scheme, which resolves or restructures failing banks in the eurozone. The SRM is mandatory for all eurozone member states and open to other member states willing to join the banking union. If a bank is failing or likely to fail, the SSM's Single Supervisory Board notifies the SRM's Single Resolution Board (SRB) about the bank's financial distress. The SRB triggers the resolution process and adopts an institution-specific resolution plan. The resolution is executed in line with the SRB's proposal, unless the European Commission and the Council reach an agreement on amending it ('objection procedure'). The bank resolution begins with a bail-in of up to 8% of the bank's balance sheet. A bail-in is a mandatory involvement of shareholders, bondholders, and senior depositors of the bank in question in the solution costs. Their assets (or parts of them) are written off.

The size and the automaticity of the bail-in requirement became a first contentious issue of the negotiations. In case the bail-in does not suffice to cover the resolution costs, the Single Resolution Board can mobilise another contribution of up to 5% of the bank's balance sheet from a joint resolution fund. The target volume of the fund is 1% of all covered deposits in the eurozone, which corresponds to a sum of roughly 55bn Euro. This Single Resolution Fund is financed by bank levies and initially divided into national compartments. They are progressively mutualised over an eight-year build-up period, front-loaded with 40% in the first and 60% in the second year. However, whether the fund should be mutualised, and at what pace, was contested, making it the second contentious issue in the analysis. The Single Resolution Board decides on the use of the funds. To what extent member states should be allowed to have a say in the decision-making process was the third contentious issue in the negotiations.

The analysis of the preference formations shows that the German governments consistently preferred control over efficiency, hereby matching the macro-economic preferences as derived from the fiscal position. This, however, seriously jeopardises the ability of the banking union to stabilise EMU, which would benefit from a minimum level of risk-sharing (Asdrubali *et al.*, 1996). The preference, therefore, does not match the expectations derived from trade patterns. While the banks continued to hold diverging preferences, the analysis suggests that ordoliberal ideas tipped the balance between the fiscal position and trade patterns to the benefit of the former. Their policy implications consistently match the government's preferences as preventing moral hazard and aligning control and liability is a key aspect of ordoliberalism. This suggests that worldviews based on ordoliberal ideas guided the government in this situation with competing rational material interests. The analysis of Southern European preferences provides further evidence for the explanatory power of their macro-economic preferences, which were unequivocally geared in favour of a mutualised system with significant liability-sharing and a broadly favourable stance of the private banks. Acute crisis pressures had almost completely ebbed away by April 2014 when the SRM was concluded. From a neo-functional perspective there would have been no incentive to agree the creation of the SRM. The fact that it did come about is evidence against the neo-functional hypothesis.

The shared goal of breaking the vicious circle remained a constraint on the German government, as the analysis of the interstate negotiations demonstrates. It set the terms of the debate on the SRM and proved a stumbling block the German government could not easily overcome. Given the overarching importance of some of the SRM's elements for breaking the circle, such as a joint fund, the SRM proved a suitable target for rhetorical action. Member states, EU institutions and experts continued to consider Southern coalition's arguments about risk-sharing more suitable responses than German arguments about risk-reduction and structural reforms. They were the rhetorical device that enabled Southern European governments to extract concessions from the German government.
With the benefit of hindsight, it is worth noting that the SRM negotiations represent, to some extent, a turning point. The German government began to transform its structural reform solution frame to one of measures for risk-reduction. Over the following years, it should become a strong contender to risk-sharing. However, during the SRM negotiations, the adjusted frame remained under-specified and could not make up the weaknesses of the structural reform frame, which the audience continued to consider weaker than risk-sharing.

The analysis in this chapter begins with a review of the observable implications of each hypothesis. Having provided a strong link between theory and empirical analysis, it then turns to an analysis of preferences and interstate negotiations for each of the three contentious issues, i.e. the bail-in rules, the Single Resolution Fund, and the resolution decision-making.

6.2. Observable Implications

The four hypotheses can be empirically tested in the SRM negotiations with the following observable implications. To begin with the German government, if the private banks influenced its preferences, we would expect it to be in favour of a full-fledged banking union with strong and automatic bail-in, a mutualised fund (if no banks were exempted) and no national veto rights in the resolution decision-making (BDB, 2013a; BDB, 2013b). The public banks shared the private banks' opposition to national veto rights, but opposed the private banks on the other two issues: they advocated weak and non-automatic bail-ins and strongly opposed a mutualised European resolution fund (BVR/VÖB/DSGV, 2013). If, for the reasons stated in previous chapters, the fiscal position was the determinant of the macro-economic preferences of the German government, we would expect the government to seek limits on fiscal transfers. The best way to achieve this would be an automatic bail-in, no mutualised fund and national veto rights over the use of funds (Véron, 2013, p. 11; Gros, 2013b). If, by contrast, sustaining EMU (and trade patterns) was the overriding concern, something would have to give: we would expect a discretionary bail-in, a mutualised resolution fund and an efficient resolution decision-making without national veto rights (De Grauwe, 2011b; De Grauwe, 2013c). Ordoliberal worldviews would suggest an emphasis on limiting moral hazard and realign responsibility and liability. Indications for their impact would be a preference for a strong bail-in (to make investors liable), no mutualised fund (to make single governments liable) and national veto rights over the use of the funds (ditto). The neo-functionalist approach would predict the negotiations to break down in the absence of crisis- pressures. Therefore, the governments in North and South would not move but oppose giving up sovereignty. They would be against automatic bail-ins, reject a mutualised resolution fund, and seek to obtain veto powers in bank resolution decisions.

Table 33: SRM: Domestic preference formation, German government

	Macro-economic preference: fiscal position	Macro-economic preference: trade patterns	Private material interest: public banks	Private material interest: private banks	Ideas: ordoliberalism	Neo-functionalism: crisis pressures
Strong bail-in rules	In favour	Against	Against	In favour	In favour	Against
Mutualised Single Resolution Fund	Against	In favour	Against	In favour	Against	Against
Veto rights in SRM decision-making	In favour	Against	Against	Against	In favour	In favour

If macro-economic preferences influenced the governments in the Southern coalition, we would expect them to advocate a fully mutualised resolution fund with an efficient decision-making procedure (no veto rights) to ensure the functionality of the new mechanism as a means to redistribute funds across the euro area. They would oppose bail-in rules as these could potentially reinforce financial fragmentation (De Grauwe, 2011b; De Grauwe, 2013c; Véron, 2015, p. 36). Since banks in the Southern coalition would have been beneficiaries of a mutualised fund, but negatively affected by bail-in rules, they advocated a mutualised and efficient fund, but no introduction of bail-in rules (EBF, 2013; EBF, 2013; FBF, 2012b; ABI, 2012c; BBVA, 2013, p. 13; ABI, 2013, pp. 6–8). The policy implications of post-Keynesianism would slightly differ in regard to veto rights in SRM decision-making. Given its more positive take on government interventions, we would expect a favourable position towards veto rights. It would furthermore suggest a preference for a mutualised resolution fund and discretion in the application of bail-in rules as a means to avoid unpredictable market upheaval, considering that post-Keynesians are much more sceptical towards market rationality than other streams in economics.

Table 34: SRM: Domestic preference formation, Southern coalition

	Macro-economic preference: fiscal position and trade patterns	**Private material interest: banking sector**	**Ideas: post-Keynesianism**	**Neo-functionalism: crisis pressures**
Strong bail-in rules	Against	Against	Against	Against
Mutualised Single Resolution Fund	In favour	In favour	In favour	Against
Veto rights in SRM decision-making	Against	Against	In favour	In favour

Turning to the interstate negotiations, the observable implications for the power hypothesis are an outcome along German preferences. The governments would agree automatic bail-in rules, a network of national funds (instead of a joint fund), and veto rights for national governments in the SRM resolution decision-making. Depending on the respective solution frame, two different outcomes would support the rhetorical action hypothesis. If the risk-sharing solution frame was powerful, we would expect the German government to make significant concessions towards a full-fledged banking union. We would expect a mutualised fund, an effective decision-making and exemptions and non-automaticity for the bail-in in order not to put financial stability at risk. If, however, the structural reform solution frame gained ground for the German government, the outcome would be strong and automatic bail-in rules, no mutualised fund and veto rights for national governments as safeguards against mutualisation.

Table 35: SRM: Interstate negotiations

	Power: material bargaining power	**Rhetorical action: risk-sharing**	**Rhetorical action: structural reforms/ risk-reduction**
Strong bail-in rules	Part of the agreement	Not part of the agreement	Part of the agreement
Mutualised Single Resolution Fund	Not part of the agreement	Part of the agreement	Not part of the agreement
Veto rights in SRM decision-making	Part of the agreement	Not part of the agreement	Part of the agreement

6.3. The Transition to a More Complete System

The creation of a system for bank resolutions marked a further step in the direction of a genuine banking union. This development could by no means be taken for granted when the Euro Summit in June 2012 had reached a fairly limited agreement on a mechanism for direct bank recapitalisations and a joint supervisor (Nielsen and Smeets, 2017). The Conclusions of the Euro Summit did not mention a resolution mechanism with a single word (Euro Summit, 2012). Many negotiators involved in the birth of the banking union at the Euro Summit were taken by surprise that a joint system for orderly bank resolution eventually materialised. An official in the French Treasury was 'surprised by this evolution. I felt we could only agree on direct bank recaps and supervision. And eventually, we got a much broader construction' (FT1, 2015, p. 4). A colleague came to a similar assessment: '[e]veryone understood from the start that the link between direct recap and supervision was immediate. The link between the supervision and the resolution was much more difficult' (FT5, 2015).

For the reasons explained in the previous chapter (see section 5.3), the German government reconfigured its interests in a joint resolution mechanism. It buried the idea of direct bank recapitalisations, but changed it to a more encompassing system of bank resolution. A strong incentive for this positional adjustment was provided by the fact that while 'direct bank recapitalisations were taxpayers' money [from the ESM], the resolution fund is financed by banks' (NT1, 2016). These differences made it easier to sell mutualisation politically. This led to the logic that 'if you have a resolution system, you do not need direct recapitalisations anymore' (GC1, 2015). Additional drivers were economic and political incentives to complement a joint supervisor with a joint resolution authority.

From the economic point of view the absence of a resolution scheme ties the hands of the supervisor because they cannot act if a bank is in trouble (Garicano, 2012, pp. 6–7; Herring, 2013, pp. 18–22); politically, it is difficult to force resolution schemes on the national level to cover the costs of banks that were supervised on the supranational level.[49] Figuring out the precise balance between a European scheme and its national counterparts while also maintaining economic efficiency and finding a suitable institutional framework that would accommodate the diversity of national banking sectors in the euro area was everything but a simple task. Its complexity was remarkable and challenged policy-makers across the euro area. Any solution would be agreed under a veil of uncertainty whether it would work in practice. Considering the scope conditions for ideas, it can reasonably be assumed that actors consulted ideational factors to find guidance for navigation in this environment.

The Conclusions of the European Council partly reflect the progress in the direction of a resolution mechanism. The heads of state or government 'note[d] the European Commission's intention to propose a single resolution mechanism' (European Council, 2012a, p. 8) in October 2012, but also remained hesitant by 'call[ing] for the rapid adoption of (…) the harmonisation of *national* resolution and deposit guarantee frameworks' (European Council, 2012a, p. 8; emphasis added). It was only in December 2012 that the European Council agreed that in 'a context where bank supervision is effectively moved to a single supervisory mechanism, a single resolution mechanism will be required' (European Council, 2012b, p. 4) and that the 'Commission will submit in the course of 2013 a proposal for a single resolution mechanism for Member States participating in the SSM, to be examined by the co-legislators as a matter of priority' (European Council, 2012b, p. 4). The SRM eventually was on top of the European agenda.

The European Council Conclusions from December 2012 have important implications for neo-functional explanations. Considering that the creation of a resolution mechanism had not been part of the package agreed at the height of the crisis in June 2012, it is difficult for neo-functional explanations why the heads of state or government added this important pillar to the conception of the banking union. Crisis pressures had diminished

[49] However, it should be noted that this functional logic can hardly be seen as a sufficient condition for a resolution mechanism to come about. Functional reasons have often been proven insufficient to explain the state of play in EMU. The history of the currency union is rich of examples where functional pressures led to inefficient solutions (Dyson and Featherstone, 1999).

markedly in December 2012. Taking this into account, neo-functionalism would predict that such a far-reaching step of further integration is kept off the agenda in the absence of material pressures. To be sure, material crisis pressures were important for the agreement at the Euro Summit in June 2012 as they forced governments to act. However, the evidence presented shows that they were less relevant for the creation of the SSM and even less relevant for the SRM.

6.4. The Preferences of Member States: How Much Mutualisation?

For the SRM negotiations, the main coalitions were again composed of countries in Northern Europe, on the one hand, and Southern Europe, on the other. There was little change in this regard between the SSM and the SRM negotiations. The Spanish government continued to drift to the North, affecting the balance of power between the two coalitions. They remained in principle favourably inclined towards mutualisation. Yet, having been subject to the conditionality of a limited ESM programme, they reconsidered their stance and were less enthusiastic towards full mutualisation (ST4, 2015; ST5, 2016). The ambiguous position of the Spanish government undermined the political power of the Southern coalition further.

The Northern Coalition: Joint Resolutions, National Liabilities

The SRM negotiations were a difficult issue to handle for the German government. It stuck with its resistance of the mutualisation of debt, transfer payments and shared liabilities (Howarth and Quaglia, 2013, p. 114). At first sight, there was not much to gain in this regard with the creation of a resolution mechanism, which was essentially about a common liability for bank failures. Therefore, the goals of the German government remained unchanged:

> 'We are completely sticking to our scheme: benefit, counter-benefit, conditionality and control. I think we have done something important but remained faithful to our philosophy: no benefit without counter-benefit.' (Merkel, cit. in Reuters, 2012e)

This effectively led the government to pursue two main goals. The first one was limiting the mutualisation in the system as much as possible. A senior official in the German Finance Ministry made plainly clear in the negotiations that '[r]isk-reduction comes before risk-sharing. For the sheer reason that Germany cannot bear all costs on its own. In the long run, this will tear us down the cliff as well' (GFM8, 2016). The SSM mitigated the problem of adverse incentives for Southern governments. European supervision made it more difficult for them to exploit their banks in the search for short-term gains, and then shift the costs to the European level. However, the problem was only mitigated, it was not solved. Governments in the euro area remained in charge of many other means to influence their banks beyond the supervisor, and many of them were not under European control. One lead negotiator in the German Finance Ministry explained their considerations:

> 'We wanted to set the incentive that the national level remains responsible [for resolution costs] through national funds to make sure you can't just get rid of your banks by shifting them to the European level. This is tricky because governments have a number of instruments to influence their banks where the supervisor cannot do anything really. If a state subsidises mortgages that clearly has an impact on banks. It was important for us to signal to all other member states that their national banks are important and that they should care.' (GFM1, 2015)

Shifting the resolution costs from the taxpayer-funded ESM to the bank-sponsored SRF was one means to shield the domestic taxpayer. More central was the second goal of the German government: the implementation of bail-in rules. Bailing-in private investors did not only allow governments to spare the public purse, but became increasingly central as the preferred Northern solution to the vicious circle problem. Shielding the sovereign from the fallout of bank resolutions by bailing-in private investors was thought to contribute to breaking the vicious circle. One official in the German Finance Ministry emphasised the importance of bail-in for the German government:

> 'Bail-in was our response to the vicious circle. Especially the minister always emphasised: we don't break the vicious circle by swapping one taxpayer for another one, that's not a proper break.' (GFM1, 2015)

The German preference for the adoption of bail-in rules represents an adjustment of the solution frame endorsed by the German government. As the analysis of the Euro Summit and the SSM negotiations (see sections 4.6 and 5.5) showed, its previous emphasis on structural reforms and put-your-own-house-in-order policies was by other governments perceived as a not very targeted response to the problem of the vicious circle. Structural reforms are measures predominantly in fiscal and economic policy. They tackle the vicious circle only indirectly by increasing the resilience of the sovereign. Bail-in is a financial policy, more closely tailored to the vicious circle as the problem under consideration. While bail-in rules are fully consistent with the previous preference for structural reforms and cannot be seen as a departure of the latter, they do represent a change of emphasis. To some extent, they increased the German government's rhetorical tools in the negotiations.

The adjusted resolution frame is an ideational innovation. It culminated in a non-paper that was published on 8 September 2015 and laid out a coherent risk-reduction agenda. It was based on three pillars: first, a strengthening of banking supervision and an effective resolution mechanism with a strong bail-in component to shield the taxpayer, but no (mutualised) fiscal backstop to the bank resolution fund; second, a limitation of sovereign risks on bank balance sheets. That is, banks should not be allowed to hold a significant proportion of sovereign debt, as it has been the case in particular in Italy; and third, a sovereign default mechanism to be able to send governments into insolvency and restructure their debt instead of bailing them out with costs for other governments (German Finance Ministry, 2015). This agenda, which as mentioned was only published in September 2015, had not yet been in place when the SRM was negotiated over the course of 2013 and the first quarter of 2014. It shows, however, that the German government had started to readjust its preferences and prepared to unlock the rhetorical entrapment. The analysis of the interstate negotiations in the section 6.5 will show to what extent these early attempts of promoting the risk-reduction agenda were successful.

Yet, any form of involving the private sector in the crisis costs was impossible in the acute crisis situation in June 2012 because of the expected market turmoil following their announcement. Markets would certainly have reacted negatively to any attempt of involving them in bearing the costs of the crisis. Measures of this type were off the table at the height of the crisis. The easing market pressure, however, increased the chances of bail-ins to be implemented in the course of 2013 and 2014, as the bail-out (and bail-in) in Cyprus had already shown. The German government desperately wanted bail-in rules, and there was little it could achieve on the national level only. As the financial crisis had demonstrated in various cases (e.g. Véron, 2015, p. 33; European Central Bank, 2013, p. 2), it was almost impossible to resolve transnational banks at the national level effectively. This provided for a genuine interest of the German government in the SRM: 'The banking union made it possible to involve the banks in taking the resolution costs' (GC1, 2015), as one senior official in the German Chancellery put it.

The Northern coalition was broadly cohesive on the SRM (Bloomberg, 2013b). Yet, the Dutch government was somewhat more conciliatory than the German and the Finnish. They started from a different problem analysis. The question from their perspective was not *if* there was mutualisation, but *where*, as one central banker explained:

> 'There was lots of risk-sharing through the ECB. Let me just mention Target2 imbalances. Taking this into account, it was clear that in one way or another you're liable for the losses in the South. It was eyewash to pretend that the rejection of the fund results in no joint liabilities. We preferred a clean solution. But there were no regrets for having been tough, of course' (NCB2, 2016)

So the Dutch hoped to reap more benefits from a joint resolution mechanism than the German or Finnish government. 'We were very supportive of the whole idea of the banking union. We were more open than the Germans, provided that our conditions were met' (NMGA1, 2016), as a close advisor the Dutch prime minister summarised their position. Overall, the goals of member states in the Northern coalition were clearly defined. They had an interest in a resolution mechanism, but not at all costs and only if the extent of mutualisation was limited with bail-in as the main resolution tool – a position that was set to conflict with Southern European preferences.

The Southern Coalition: Joint Resolutions, Joint Liabilities

There was no doubt about the goal of the Southern coalition in the negotiations either:

> 'That is the point of today's proposal for a Single Resolution Mechanism: by ensuring that supervision and resolution are aligned at a central level, whilst involving all relevant national players, and backed by an appropriate resolution funding arrangement, it will allow bank crises to be managed more effectively in the banking union and contribute to breaking the link between sovereign crises and ailing banks.' (Barnier, cit. in European Commission, 2013)

Support mechanisms were a long-standing preference of Southern European eurozone members (Howarth and Quaglia, 2013, p. 111). After these efforts had failed in the fiscal dimension through eurobonds, the banking union provided the opportunity of yet another try for a fiscal union, this time through the backdoor by means of a fiscal backstop for a bank resolution system (Otero-Iglesias, 2012). The SRM was another attempt to bring about more risk-sharing. Despite additional burdens to its banks, the French government acted as one of the main drivers behind a European resolution mechanism. It forcefully supported the SRM as a means of further burden-sharing in the eurozone (e.g. Hollande, cit. in Le Monde, 2012b).

The main interests behind the SRF remained unchanged, as Barnier's introductory quote already laid out: a full-fledged banking union with significant risk-sharing and mutualisation. This was, in particular, the case for the Italian and Spanish governments. They were existentially threatened by fragile public finances. A mutualised resolution mechanism was expected to go a long way towards burden-sharing arrangements more favourable towards their needs. Moreover, the banking sectors in the Southern coalition were strongly affected by higher funding costs as a result of the fragmentation of the single market. The Italian ABI wanted an effective banking union because 'as laid down in the Conclusions of the Euro Summit of 29 June the banking union project stems from the necessity to "break the vicious circle between banks and sovereigns"' (ABI, 2013, p. 2; see also Reuters, 2013a). Likewise, the Spanish AEB 'unreservedly back[ed]' (AEB, 2013, p. 27) the establishment of the Single Resolution Mechanism. French banks provided lukewarm support. In principle, they stood to benefit from a European mechanism because of the reduction of red tape and double layers of regulation (Howarth, 2013). However, their enthusiasm was somewhat reduced by the prospect of paying into a fund being filled ex-ante (and not ex-post as in the French system) (FBF, 2014; FBF, 2013, p. 2; also: FT2, 2015).

Table 36: SRM: Preferences of core member states

	Northern coalition	**Southern coalition**
Core preferences	Strong bail-in rules, automatically triggered Network of national resolution funds, no joint fund National veto rights for bank resolution	Non-automatic bail-ins, discretion for national and EU authorities Joint fund, fully mutualised No national veto rights, functional procedure for swift resolution

6.5. Negotiating the SRM: The Shift from Mutualisation to Bail-In?

This section analyses the three contentious issues in the process that led to the decision to establish the Single Resolution Mechanism. The first contentious issue is the bail-in rules; it is followed by the discussion on the Single Resolution Fund and the bank resolution decision-making.

The Bail-In Rules

The bail-in rules were the pet project of the governments in the Northern coalition. They were supposed to represent the transition of the agenda from risk-sharing to risk-reduction, for which the North was striving. The Bank Recovery and Resolution Directive containing the bail-in rules was negotiated separately to the other elements of the resolution arrangements because it applies to all EU members and not only the eurozone (European Commission, 2014).

Northern Preferences: Protecting the Taxpayers

The German government considered bail-in rules the cornerstone of the banking union (Financial Times, 2013f). It continued to be 'guided by the conviction that the financial sector has to contribute an appropriate share to the costs of dealing with the financial crisis' (Merkel, 2012a). Much earlier, Schäuble had already emphasised that 'private investors and markets should no longer be able to rely on a bail-out by European taxpayers' (Schäuble, 2010b). The importance of a joint fund for the Southern coalition was countered by the German government's insistence on a bail-in prior to any bail-out. It sought to make the rules as strong and automatic as possible. Bail-ins should be sizeable, and there should be no discretion that could enable governments to escape bail-ins. The German government pushed for as few exemptions as possible (Agence Europe, 2013h; Financial Times, 2013g; Financial Times, 2013h; Hennessy, 2014, p. 164). According to Schäuble, '[w]e need room for discretionary decisions, but that room must be very limited...that's the lesson learned [from the bail-in] in Cyprus' (cit. in The Guardian, 2013). Especially the Dutch Treasury was hawkish by insisting on a bail-in of up to 20% of a bank's balance sheet[50] (NT1, 2016).

As all too often, the German banks failed to reach a common position. The domestically-oriented savings banks (*Sparkassen*) categorically opposed the bail-in rules on the grounds of seeing them as an unnecessary constraint with a negative impact on their lending capacity (BVR/VÖB/DSGV, 2013, p. 6). At a minimum, they sought to significantly

[50] A bail-in of 20% was by many governments seen as excessive. The bail-in threshold in the final compromise is 8%, which is still very high by international standards.

delay their entry into force (BVR/VÖB/DSGV, 2013, p. 8). By contrast, the Association of Germans Banks (BDB), which represented the private banks, was willing to accept bail-ins, provided that all banks were obliged to follow the same rules. Their goal was consistent with their long-standing interest in creating a level-playing field (BDB, 2013b). It also advocated an earlier entry into force of the BRRD, preferably at the same time as the other elements of the resolution mechanism (BDB, 2013a, p. 9; BDB, 2013b).

Considering the expected positive effect of bail-ins on public finances, the German government's fiscal position provides an explanation for its advocacy for automatic and strong bail-in rules. If bail-ins work as they are supposed to do, they become a powerful instrument to protect national taxpayers. Instead of bailing out banks, the taxpayer is sitting on the fence and watches how investors bear the costs of their wrong investments decisions. As a result, these bail-in rules would lead to lower costs for the European taxpayer (Véron, 2013, p. 11; Gros, 2013b).

Bail-in was the Northern instrument to break the sovereign bank doom loop at no costs for the (German) taxpayer – at least in theory (IMF, 2012a; Enria, 2013). From another perspective, it was questionable to what extent automatic bail-in rules were suitable and effective in shielding the taxpayer. For instance, de Grauwe gave a devastating verdict on the bail-in approach: 'it increases the systemic risk in the eurozone and makes future bank crises more likely' (De Grauwe, 2013c, p. 1). According to this logic, involving banks in the costs of bank failures is a trigger for contagion in the banking system. Losses are spread in the financial system, tearing down other banks as well and eventually resulting in a bank-bank vicious circle (De Grauwe, 2011b; De Grauwe, 2013c). A non-automatic bail-in would provide governments with sufficient discretion to prevent these systemic effects. As will be shown in greater detail below, the risks attached to the concept would justify taking a more cautious approach as to avoid risks for the stabilisation of EMU. The IMF, for instance, cautioned against bail-ins, as they were 'untested in a systemic crisis' (IMF, 2012a, p. 22). Yet, the evidence about the utility of bail-ins was everything but conclusive at the time.

Given this uncertainty in a situation with a large diversity of interests, the congruence between the fiscal considerations and the government's bail-in policy is not self-evident. It is worth noting that allowing banks to fail is one of the core principles of ordoliberalism, not least connected to Eucken's principle of liability which applies to both sovereigns and banks. In line with this idea, 282 German economists had pushed very strongly for bail-in rules with a similar reasoning: 'Banks must be allowed to fail. If the debtors cannot repay their debt, there is only one group which should and which could carry the burden: the investors' (cit. in FAZ, 2012; see also Heinemann and Illing, 2012 for a similar statement of another 220 economists). Government representatives followed a very similar reasoning. Schäuble emphasised the goal to 'ensure that failed banks can be wound up at no cost for European taxpayers. Bail-in instruments and mandatory haircuts should make this possible and ensure that banks' financiers price the risks of their investments realistically' (Schäuble, 2012a). Merkel clarified that '[w]ho takes a risk also needs to be liable for the losses – and not the taxpayer' (Merkel, 2014). As Schäuble put it: 'Who gets an opportunity, also needs to take the risk. (…) This, Ladies and Gentlemen, is ordoliberalism' (Schäuble, 2014c) (see section below on negotiations for further evidence for ordoliberal reasoning). While liberal intergovernmentalism as such does not explain why the fiscal position trumped competing interests, the analysis suggests that ordoliberal ideas internalised in the Finance Ministry resonated with the interest in radically shifting the costs to the private sector. This policy served to shield the taxpayer and set incentives that were supposed to prevent moral hazard in the financial system.

Southern Preferences: Sustaining Financial Stability

The coalition of Southern European member states did, of course, share the Northern interest in protecting the taxpayers. They did not oppose bail-in rules as such, but from their perspective bail-in was merely a plan B. Mutualisation remained the most favourable option, as it would not have entailed the risk of triggering financial instability. Maintaining financial stability after a period of severe market turbulence came first, protecting the taxpayer was relegated to second place. They advocated a very different design of the rules. Having been heavily affected by the crisis, many banks in Southern Europe remained vulnerable to market shocks. Bail-in rules caused concerns as they could have a further destabilising effect on national financial systems. A bail-in of bank debt spreads losses in a country's financial system and arguably creates a genuine risk of contagion in and to other banks in the countries of the Southern coalition (De Grauwe, 2013c). Against this backdrop, the macro-economic considerations urge towards more caution. More flexibility would permit governments to react if a bail-in triggers contagion in the financial system. The line of reasoning in the Italian Treasury was that 'a bail-in should have a limit when there is contagion. Otherwise you might be worse off than without bail-ins' (IT2, 2015). Led by the French government (Financial Times, 2013f; Financial Times, 2013g), the Southern coalition sought to weaken the rigidity of the rules by introducing exemptions, such as the precautionary recapitalisation of distressed banks (Agence Europe, 2013g; Agence Europe, 2013h; Agence Europe, 2014a; Hennessy, 2014, p. 164) and the possibility to support banks with public guarantees from the national central bank (Agence Europe, 2014a).

The potentially destabilising effect of bail-ins, as well as their impact on bank lending, led to the objection of bail-in rules by Southern European banks. The Italian ABI stated that 'the introduction of the bail-in is unpractical, unnecessary and counterproductive' (ABI, 2012c, p. 8) and proposed a 'pragmatic approach' (ABI, 2012c, p. 2). This meant to delay the introduction of the new rules for as long as possible and in any case not before 2019 (ABI, 2012c, p. 3). Furthermore, they advocated bail-ins to be 'as broad and as flexible as possible' (ABI, 2012c, p. 6). These concerns were mirrored by Spanish banks (BBVA, 2013, p. 13). By contrast, French banks slightly diverged from their common position, as they advocated bail-in rules without national exemptions, which they condemned as a source of uncertainty (Reuters, 2013b). Yet, their stance was not reflected in the position of their government. This evidence again corroborates the earlier finding that they were a rather weak domestic actor in France.
Overall, the Southern coalition was by far less enthusiastic towards bail-ins than their Northern counterparts. They feared to be hardest hit by the consequences of bail-ins for financial stability. The preference in the Southern coalition was to maintain flexibility for state action – a preference diametrically opposed to the North which wanted rigid rules to prevent loopholes.

Negotiations: A Bail-In with Loopholes

The German government's main justification for its preference for automatic bail-ins in the negotiations was to hammer home 'that shareholders and creditors are liable first and foremost' (Schäuble, cit. in Bloomberg, 2013c) for their investment decisions – and not the taxpayer. Schäuble highlighted: 'We will ensure that it is no longer the taxpayer who takes the risk, but the financial industry' (Schäuble, 2014c). An automatic bail-in should shield the taxpayer from resolution costs, as the German government emphasised time and again in the negotiations. In line with the beginnings of the adjusted German resolution frame, it attempted to frame bail-ins as a response to the problem frame of the vicious circle. In the words of a senior official in the German Finance Ministry:

> 'I thought from the start the direct bank recapitalisations was totally the wrong idea. Bail-in was the right idea. I wanted bail-in, that would have been the only right answer.' (GFM3, 2015)

A colleague explained in more length the considerations behind the solution frame:

> 'You cannot break the nexus by sharing the risks. This buys you time to take a breath, but eventually you will have uploaded the doom loop from the national to the European level. If we share all costs but do not reduce the costs in the first place, we will soon be at a point, where even we are financially in trouble. I do not see an alternative to letting those pay who actually cause the costs.' (GFM2, 2015)

There was 'a strong agenda' (NT1, 2016) to eventually shift the costs of bank failures to financial markets in the Northern coalition. Explicitly framing bail-ins as a response to the vicious circle was supposed to impede the strategic use of this problem frame by Germany's counterparts. While at previous occasions, breaking the vicious circle had served as ammunition to justify a risk-sharing resolution frame, the German government attempted to turn the table on this issue. However, this strategy did not mute the arguments from its opponents. While Southern governments did not question the German government's stated willingness to protect the taxpayer, they did question the effectiveness of bail-in to achieve this objective. Rhetorical ammunition for their position was provided from influential and renowned experts. Véron cautioned that bail-ins 'are not a magic formula' (Véron, 2013, p. 11). It would be 'entirely unrealistic to envisage bank resolution regimes, the aim of which is to maintain trust and to preserve financial system stability, as purely mechanistic, rules-based processes' (Véron, 2013, p. 11). De Grauwe called the bail-in rules 'a recipe for banking crises and depression in the euro zone' (De Grauwe, 2013c). The IMF was equally hesitant to endorse bail-in rules (IMF, 2012a, p. 22). Considering that markets were already in turmoil, shifting bank resolution costs to the private sector could have led to further market reactions. If shareholders and bondholders expect to be bailed-in, they are likely to sell their assets. Similarly, depositors are likely to withdraw at least part of their deposits. This, in turn, can exacerbate market pressure – and eventually increase the costs for the taxpayer (De Grauwe, 2011b; De Grauwe, 2013c; Buch *et al.*, 2015, p. 5).

These objections were willingly taken up by the Southern coalition. An Italian negotiator expressed his doubts about the effectiveness of the German solution frame to solve the agreed problem frame: 'They [the German government] wanted to break the loop, but for the bail-in, we were somewhat concerned about the financial stability and financial contagion issues' (IT2, 2015). These concerns were echoed by the ECB where financial stability concerns traditionally rank high. Constâncio warned:

> 'We need to bear in mind that it is not only direct public support for banks that has a cost for taxpayers, but also financial instability – indeed, the costs of the latter may be higher. Compare the worldwide costs for taxpayers stemming from the absence of public intervention to rescue Lehman Brothers, with the zero cost for taxpayers following the USD 700 billion injection into US banks in 2008 (which have by now been totally repaid by the banks). In other words, financial instability can have a meaningful cost to taxpayers even if it is not visible in the very short term – a notion that all policy makers should keep in mind.' (Constâncio, 2014)

Another ECB Executive Board member, Lorenzo Bini Smaghi had argued earlier that the 'idea [of bail-ins] is fraught with complications and, if done unwisely, may actually be very damaging, and turn out to be more costly for taxpayers. (…) This is how a good idea can turn into bad practice. Continuing to pursue it suggests strong masochistic tendencies' (Bini Smaghi, 2011).

Given these risks, a negotiator from the French Treasury argued that it was necessary 'to create some space for a public intervention before you can bail-in creditors. Because otherwise you can create the same old story of contagion and self-fulfilling crises' (FT5, 2015). The Italian finance minister Saccomanni insisted that '[i]n case of a systemic crisis, public intervention would be preferable to the risk of contagion generated by an extended use of bail-in' (cit. in Reuters, 2013c).

One negotiator from the French Treasury explained: 'They wanted it because of the mutualisation debate. But we were more hesitant, we made clear throughout: we need flexibility, otherwise we will regret that very soon' (FT2, 2015). The history of German EMU policies nurtured the doubts about the effectiveness of its crisis policies, as one senior official in the European Commission explained: 'Around money, everything hinges because the Germans were terrorized that at the end of the day, we'll go and take the German money. And they put all sorts of safeguards in place: bail-in, extreme bail-in, excessive bail-in, all of that. And at the end of the day, we don't solve the problem' (COM8, 2015).

The German government attempted to turn the table by using an adjusted solution frame to the vicious circle, but suffered a backlash. Governments and institutions in the counter-coalition rebuked German arguments. They drew on the risks to financial stability and the potential consequences for taxpayers to make a strong argument about the ineffectiveness of bail-in rules for breaking the vicious circle. Dutch negotiators openly recognised the problems attached to bail-ins with markets still in turmoil:

> 'We were convinced of bail-ins, but we had to wait for a suitable opportunity to put it to a reality test. It sounded good in theory, but Italy was not the right case to test it. The concept was new and Italy was just too risky to try it out.' (NMGA2, 2016)

The outcome of the negotiations suggests some success for the Southern European strategy of weakening bail-ins, evidenced by a high number of exemptions. While it is required to bail-in up to 8% of a bank's total assets (Agence Europe, 2013i; Financial Times, 2013h), around 150 exemptions offer ample opportunities to avoid or at least soften a bail-in (Council of the European Union, 2015). For instance, governments are allowed to use precautionary recapitalisations to circumvent a mandatory bail-in (Buch *et al.*, 2015, p. 24). The rules leave significant room for manoeuvre to national governments (Gros, 2013b, p. 2). After an initial bail-in, public authorities obtain further leeway for interventions in the banking sector. It is reasonable to conclude that the application of bail-in rules is subject to a 'wide array of discretion' (Buch *et al.*, 2015, p. 24; see also Financial Times, 2013h), which runs counter to German preferences.

The German government had adjusted the resolution frame, but in the absence of successful precedents that could show that its new frame based on bail-ins would work, it failed to gain support. With the new frame still being work in progress, it lacked the credibility that was needed to be of help in the negotiations – as admitted by the Dutch negotiators quoted above. This has two important implications for the theoretical framework and the use of rhetoric. First, it shows that government can readjust their arguments in negotiations. However, this is costly and takes time and resources (Krebs and Jackson, 2007, p. 45). As put by a senior official in the Council, 'you can change your reasoning after a change of government, but you cannot change your argument every week' (CEU2, 2016). When the bail-in was negotiated, the investment in the new frame had not yet delivered results.

Second, the evidence confirms the argument advanced by Krebs and Jackson that arguments are considered strong if they build on commonplaces that are already present in the rhetorical field (Krebs and Jackson, 2007, p. 45). Bail-ins, however, were untested and not yet present; negotiators in the Southern European coalition managed to stress this as a means to reduce the credibility of the argument. Against this background, it is no wonder that the German agenda of risk-reduction only gained traction after it could be applied in Cyprus, whose size and debt pile was small enough to put the tool to a test. After this was assessed as a success, bail-ins and the broader risk-reduction agenda entered the negotiations as a serious contender (Beach *et al.* 2017).

Notably, German concessions are not explained by an unfavourable distribution of bargaining power on this issue. The German government was supported by a strong coalition comprising Belgium, Denmark, Spain, Finland, the Netherlands, the United Kingdom and Romania (Agence Europe, 2013h; Agence Europe, 2013g; Agence Europe, 2013e; Agence Europe, 2013a; Agence Europe, 2014b; Financial Times, 2013b; Financial Times, 2013i; Financial Times, 2013j). This coalition can reasonably be expected to be sufficiently strong to avoid making concessions.

The Single Resolution Fund

The single most important issue in the entire banking union negotiations was about money: whether there should be a joint fund to deal with the costs of bank failures. A banking union without financial firepower would be a toothless tiger: a joint supervisor is powerless if it does not have the resources it needs to put a bank into resolution or shut it down. At the same time, pooling resources bore the risk of a fiscal union through the backdoor. The creation of a joint fund was not only the most important, but also the most contentious issue of the banking union negotiations. On a larger scale, the debates about a joint fund were ultimately linked to the establishment of a fiscal backstop, i.e. money from national taxpayers that could be used in situations with the resolution fund being exhausted.

Northern Preferences: Preventing a Free Lunch

A pooling of resources had both up- and downsides for the German government. Most obviously on the upside was the higher capacity of a mutualised fund to stabilise EMU. While immediate problems had already been dealt with by the time the SRM was negotiated, several countries had prohibitively high levels of private debt, making a clean-up of the banking sector the post-crisis homework. A mutualised fund would go a long way towards incentivising this step. Using it for this purpose would of course incur financial costs for Northern countries, but as the fund was paid in by banks, it would make such measures politically less toxic, and eventually help to protect the taxpayer by promoting economic recovery (Belke, 2013, p. 57; Gros, 2013b, p. 2). Given the huge trade surpluses of especially Germany and the Netherlands, they stood to benefit from a robust bank resolution framework as many investors would be German or Dutch (Gros, 2013b, p. 2). These arguments were considered in the debates in the Finance Ministry (GFM6, 2015), also against the background of the fragility of the German banking sector:

> 'The [national] fund we created in Germany would one day have a target volume of 15bn Euro, it would take around 100 years to reach this volume, and the balance sheet of Commerzbank alone is 18bn. The joint fund we agreed upon with the other member states has 55bn Euro. Admittedly, that can also be useful for us.' (GFM9, 2015)

However, these considerations were eventually dismissed by the German government. The main reason was the risk that a joint fund could become a harbinger for moral hazard. Regional transfers in a mutualised resolution scheme can amount to a very significant size. The concern about being liable for bank debts in the periphery was key for the German opposition to a joint fund. This policy fell in line with its general preference for resisting the sharing of liabilities (Howarth and Quaglia, 2013, p. 114; Financial Times, 2013j) .
For the same reasons, the German government strongly objected to employing the ESM to back up the resolution fund ('fiscal backstop') in a systemic crisis (Agence Europe, 2014c; Agence Europe, 2014d; Financial Times, 2013k). Schäuble made this preference plainly clear: 'We don't want to shift responsibility for the legacy assets of banks in one country to taxpayers in another country' (cit. in Bloomberg, 2014a). Instead, he and his government advocated a network of national funds (Agence Europe, 2013a; Agence Europe, 2013j; Financial Times, 2013i). Furthermore, the German government made repeated attempts to delay the contribution period during which banks would progressively fill the funds. The stated argument was to mitigate the adverse effects of the contributions on the banks' lending capacity (Bloomberg, 2014b; Agence Europe, 2014b; Reuters, 2014). The consideration for a long contribution period was strongly supported by both public and private banks (VÖB, 2014; BVR/VÖB/DSGV, 2013, p. 12; BDB, 2013b; BDB, 2013a, pp. 6–7), which were divided again on the issue of whether the fund should be mutualised for a level-playing field (private banks, BDB, 2013a, p. 1) or not (public banks, BVR/VÖB/DSGV, 2013, p. 12)[51].

[51] The public banks already had an institutional protection system in place (DSGV, 2016). This rendered the benefits of the SRF marginal (Howarth and Quaglia, 2014, p. 132).

The discourse suggests that the overarching consideration in the Finance Ministry was the aim to prevent Northern funds from being transferred into struggling banks in the periphery any time soon, be it via mutualised funds or lending between national resolution funds (Howarth and Quaglia, 2013, p. 114). As one senior official in the German Finance Ministry explained:

> 'A long contribution period is necessary to remove any incentive to wait for the funds to be mutualised. Governments will only clean up their banks if they know that our money is not in sight. 5 years is not enough, a 10-year period comes close to serve that purpose.' (GFM9, 2015)

Likewise, Schäuble explained the logic behind this preference in ordoliberal terms of moral hazard:

> 'As a member of the German government and of the German parliament, I bear the responsibility for German banks to pay their levy in the fund. But I can't take responsibility for Danish or Italian bank levies. The Danish and the Italians and the others have to do that. And that's why I say: As long as the levy is not paid in, the member states remain liable. And if the member states cannot ensure that their levy is paid, they can get a bail-out programme. Then they get the troika and conditionality – and because they don't want that, they will make efforts to prevent it. That's how effective prevention looks like.' (Schäuble, 2014c)

Merkel seconded: 'We don't think there should be lending between national resolution systems because we think that control and liability should be aligned' (Merkel, 2013). Schäuble championed this reasoning:

> 'We followed ordoliberal principles when creating the banking union. The rules we've got now for the liability of creditors and the resolution of banks with a fund the banks have to pay for themselves are reasonable from an ordoliberal point of view. (…) Many of my colleagues wanted to do things differently. But we agreed that every member state should charge the levy on the national level. This ensures there is no joint liability of the European states for the banks as a whole.' (Schäuble, 2014d)

The analysis showed that two competing macro-economic preferences were on the table: shifting adjustment costs as a means to protect the fiscal position as well as agreeing to a limited risk-sharing to clean up bank balance sheets and accelerate the economic recovery. Private material interests were divided and, thus, of minor importance only. Interviewees and representatives of the German government suggest through explicit references to ordoliberal ideas that realigning control and liability was the key consideration for the government. Faced with fragmented interests, ordoliberal worldviews caused a prioritisation of safeguards against moral hazard over systemic considerations on preserving EMU. This played out practically in a German preference in opposition to a joint resolution fund. However, the price to be paid for a mere network of national compartments and a long mutualisation period would have been a limited capacity of the SRM to actually resolve banks because of funding shortfalls. This met with strong resistance in Southern Europe.

Southern Preferences: The Need for Mutualisation

The creation of a single fund was a critical component of the banking union for the Southern coalition. It was a decisive element to measure up to the expectations the Euro Summit in June 2012 had generated. All actors involved were aware that a joint fund was a prerequisite for effectively breaking the vicious circle (e.g. Véron, 2015, p. 36). They perceived the German preference for a network of national funds as abandoning the very idea of the banking union (Agence Europe, 2013d). A German-style system with national funds would not have changed the detrimental impact of national governments remaining responsible for their banks' debt. These macro-economic considerations made a preference for a joint fund imperative. Sharing the burden of bank losses that occurred in one country across governments in the entire eurozone was a 'key ingredient' (De Grauwe, 2013a, p. 29) for overcoming the fragmentation of the single market. It would have caused a more symmetric distribution of crisis costs. The crowning of these solidarity mechanisms would have been a fiscal backstop to the resolution arrangement. The reasoning was strongly supported by almost all members of the Southern coalition (Agence Europe, 2013k; Agence Europe, 2013l). It was based on the premise that only a sharing of resources would be effective in making EMU more resilient. Especially the Italian Banking Association insisted on a joint fund with a fiscal backstop 'to be consistent with the banking union project as an efficient tool to break the vicious circle between bank risks and sovereign risks' (ABI, 2013, pp. 8–9; see also EBF, 2013; EBF, 2013; FBF, 2012b; ABI, 2013, pp. 7–8; AEB, 2014a, p. 5).

To increase the effectiveness of the mechanism, governments in the Southern coalition advocated a short contribution period to have the funds available as soon as possible, albeit on this issue acting without support of their banks which feared being overburdened (FBF, 2013, p. 2; AEB, 2014b, p. 32; ABI, 2013, pp. 7–8). They aimed to decouple the mutualisation period from the contribution period, which meant that full mutualisation would be reached prior to the fund being filled completely. In line with many governments, ECB president Draghi demanded a mutualisation period of five years and a build-up period of ten years. However, decoupling both periods met the resistance of the German finance minister Schäuble, for the stated reasons (Draghi, 2014; Bloomberg, 2014b).[52]

Southern preferences were strongly in favour of a mutualised resolution fund. It constituted the single most important issue in the SRM negotiations in line with their interest in easing the burden on their economies. Private interests were broadly aligned with this preference. Yet, in light of the German government's preferences, the negotiations had to bridge large differences to reach an agreement.

Negotiations: Extracting Concessions to Break the Circle

The negotiations on the fund dragged on until the very end of the legislative package of the resolution mechanism – another sign for their contentious nature. One of the reasons for the protracted situation was the principled arguments put forward by both coalitions. The German government justified its rejection of a joint fund with moral hazard considerations:

> 'We are very much influenced by the overarching necessity to prevent setting the wrong incentives. As much as we see the economic logic that it is helpful to create joint funds, we are also very aware of wrong incentives that potentially emerge.' (GFM5, 2015; see also Financial Times, 2013d)

Schäuble pointed to the limitation of the German government's control over other countries in the euro area. This justified a corresponding limitation of liability-sharing. A speedy mutualisation was considered unhelpful because it would have distorted the incentives:

> 'If we mutualise and then we set up a lending capacity and then we agree to joint liability, and then the bill and the risk remains with the taxpayer, this is exactly what we're not going to do.' (Schäuble, cit. in Bloomberg, 2014c)

While governments in the North did not deny that the single supervisor mitigated the risk of moral hazard to some extent, they remained hesitant as a range of other policy channels still allowed governments to influence their banking sector. A negotiator in the Dutch Treasury explained their concerns as follows:

52 Likewise, the Commission proposed a seven-year mutualisation period (Agence Europe, 2014b; Howarth and Quaglia, 2014, p. 136).

> 'We put conditions (…) because we knew that the supervisor can't control all policy channels for national governments to influence their banks. That would only have been the case if we had some kind of what the Germans call "political union".' (NT1, 2016)

However, a political union remained out of sight. Therefore, the German government rejected a pooling of resources, but came under heavy fire for it. Many influential economists considered a joint fund indispensable to break the vicious circle between sovereign bonds and banks, essentially linking it to the problem frame as a powerful solution (e.g. Howarth and Quaglia, 2013, p. 111). Véron warned that 'national funding would perpetuate market fragmentation, as it would be linked to the country's sovereign credit strength. Conversely, European funding would contribute to the weakening of the bank-sovereign link' (Véron, 2015, p. 36). Gros and Schoenmaker argued that while the cases of Ireland and Spain had already demonstrated the limits of national arrangements an EU-funded scheme could 'make a material difference because it would provide an external loss absorption mechanism that is independent of the solvency of the sovereign' (Gros and Schoenmaker, 2014, p. 533). They considered German arguments against a joint scheme exaggerated (Gros and Schoenmaker, 2014, p. 532).

The expert assessment supported the positions taken by Southern negotiators and their allies in the institutions. German arguments were rebuked with reference to their ineffectiveness to achieve the commonly stated goal of breaking the vicious circle between banks and sovereigns. They were perceived unsuitable to the problem frame. President Draghi warned the finance ministers of creating a system 'that is single in name only' (cit. in EU Observer, 2013a). He urged the decision-makers to agree on a mechanism with 'a single system, a single authority and a single fund' (cit. in EU Observer, 2013a). In a letter to the Council Presidency, also the Italian finance minister Saccomanni framed a mutualised fund as a necessity to break the vicious circle:

> 'I am also confident that we also share a common goal, which is precisely the one for which the Member States have decided to set up the Banking Union: to break the nexus between banking and sovereign risks and restore the orderly functioning of the Single Market for financial services. In order to break the nexus I recalled, we have to establish a system which is effective in tackling the tail risks of the banks and in reducing the risk of contagion. It has to rely on common financial resources, so that the tail risks are mutualized.' (Saccomanni, 2013, p. 1)

Moscovici underlined that 'there must be a clearly identifiable financial backstop (…). A single resolution fund is a necessity. I think that is a key to the discussions' (cit. in Financial Times, 2013l). His Italian counterpart Saccomanni underlined that 'the main thing is that it's going to be progressively mutualized' (cit. in EU Observer, 2013b). He argued that the existence of a joint fund would assure markets and make the actual use of these funds less likely:

> 'Backstops are not something one would want to resort to on a day-to-day basis. (…) So I believe that the existence of a mechanism that would ensure an orderly resolution of a crisis, avoiding contagion is in itself an element which should defuse tensions in the European markets.' (cit. in Bloomberg, 2013d)

Moscovici increased pressure on Schäuble with a reference to the Conclusions of the European Council. He emphasized that he wanted an agreement that is 'credible and strong' to satisfy 'the demands of the European Council to break the vicious circle between the banking crisis and the sovereign crisis which was destabilising during the financial crisis. This is one more step towards the stabilisation of the eurozone' (cit. in AP, 2013). The ECB again took up German arguments to defy them afterwards. While the German government aimed to reject a mutualised fund in order to protect the taxpayer, the European Central Bank tried to corner their German opponent with a gradual readjustment of their solution frame: they argued that precisely to protect the taxpayer, there would be no way around a mutualised fund:

> 'By pooling resources, the [SRF] will be able to protect taxpayers more effectively than under national arrangements, and thus break the adverse nexus between banks and their respective sovereigns.' (European Central Bank, 2013, p. 8)

The German government was about to be cornered by its opponents. In this situation, the Eurogroup president Dijsselbloem launched several compromise proposals, which paved the way to an agreement (Howarth and Quaglia, 2014, p. 134; Financial Times, 2013a; NCB1, 2016). The eventually accepted one suggested the creation of a fully mutualised fund, albeit with a mutualisation period of ten years. At a later stage in the negotiations with the Council, the European Parliament successfully shortened the mutualisation period to eight years (Council of the European Union, 2014a). Notably, the mutualisation and contribution periods are desynchronised. After only two of the eight years, 60% of the funds will already be mutualised (Council of the European Union, 2014a). This outcome contains concessions from both coalitions. The lack of a fiscal backstop is the biggest German success. It only says in the intergovernmental agreement that '[a] common backstop will be developed during the transitional period' (Council of the European Union, 2014b, p. 11; see also Howarth and Quaglia, 2014, p. 135). The South obtained what observers called a 'big concession' (Gros, 2013b, p. 2) and a 'major concession' (Agence Europe, 2014d): Schäuble acquiesced in establishing an (eventually) fully mutualised fund. It is a 'critical decision' that leads to 'a significant form of fiscal transfers' (Epstein and Rhodes, 2014, p. 23) – the core of what the German government sought to prevent. These concessions and the way they came about suggest that the German concern with moral hazard appeared unsuitable to the problem under consideration. Against the backdrop of the importance of the joint fund, German preferences unleashed a storm. For many governments, the agreement on breaking the vicious circle between banks and sovereigns took the possibility of national solution funds off the table, given that a mutualised fund was a necessary condition to deliver on the collectively agreed goal. Southern governments framed German arguments as not effective with regard to this collectively professed goal and extracted wide-ranging concessions. They exceeded what one would expect based on material bargaining power, given the cohesiveness of the Northern coalition on this issue (Agence Europe, 2013a; Agence Europe, 2013f; Agence Europe, 2014b; Bloomberg, 2014d; Howarth and Quaglia, 2013, p. 111) (see section 3.4).

Remarkably, the resolution fund is an issue where German material bargaining power was extraordinarily high. It was directly linked to financial resources, given the size of the country and its banking sector. A joint fund without German contributions would not have been credible at markets. The fact that the government could not prevent concessions underlines the importance of variables other than material bargaining power for the negotiations of this issue.

SRM Decision-Making

Bank resolutions can have very far-reaching consequences for countries and their economies. For these reasons, it was a contentious issue which institution should be entrusted with the power to decide about resolutions.

Northern Preferences: Control Trumps Efficiency

The main question in the Northern coalition arouse out of the trade-off between efficiency and control. Delegating bank resolution powers to a supranational authority with minimalist national interference would maximise efficiency, but reduce the control over the funds used for the resolution. Conversely, an involvement of the Council, let alone veto rights for individual member states, would maximise control, but seriously jeopardise the functioning of the mechanism. An efficient decision-making was by many experts seen as indispensable for a functional banking union (Verhelst, 2013c). Resolution decisions must usually be taken over a weekend, as otherwise financial markets react to emerging bank failures. A fast-paced resolution process is imperative to minimise the financial fallout. A complex procedure could become a 'real obstacle' (Gros, 2014, p. 2; see also Howarth and Quaglia, 2014, pp. 136–137) to this goal. Making the resolution mechanism dysfunctional would have jeopardised its benefits for stabilising the economically weak member states of the eurozone. This, however, would have run counter to the German interest either, not least because governments overburdened by resolution costs were likely to call on their peers' purse via an ESM loan – and the buck would eventually stop at the German taxpayer. Yet, these considerations were outweighed by the fear of giving ground to moral hazard. Surrendering the control over bank resolutions would have increased the efficiency, but also deprived the German government of having a say about the use of the funds. Having for instance the Commission in charge would have opened a backdoor for a much more favourable treatment of peripheral governments, where the German government would instead have insisted on put-your-own-house-in-order-policies. According to the logic prevalent in the German government, credit institutions in the periphery were in the overwhelming number of cases in crisis because of domestic policy failures (Howarth and Quaglia, 2014, p. 133):

> 'Ireland and Italy are two cases where the problems are caused by domestic policies in the countries themselves. It was regulatory arbitrage and we have witnessed an unbelievably low quality of banking supervision – they had the benefit, so let them pay for it now.' (GFM3, 2015)

A misuse of the fund to cover up domestic policy failures would have been a case in point for moral hazard and conflicted with the German government's perspective on its macro-economic preference: to protect the German fiscal position and prevent a transfer union. Finance minister Schäuble explained German preferences on this issue: 'Our goal was a sensible decision-making mechanism with effective control of the resources and a minimization of risks to taxpayers' (cit. in Bloomberg, 2014d). The efficiency of the mechanism had to give way (at least partly) to maintaining control. It is the result of an apparent trade-off between control and efficiency in this question. While efficiency considerations would have been in line with the goal to fix EMU as a means to maintain a favourable trade environment, control matches the aim to protect the German fiscal position.

While both strategies appear plausible, the internalised ordoliberal consensus in the Finance Ministry contributed to tipping the scale in the direction of control. Schäuble eloquently explained the policy implications of ordoliberal ideas for the distribution of decision-making competences:

> 'Everything is centred on the fundamental ordoliberal question to design the system in a way that it sets the rights incentives and avoids false incentives. That's what we call the issue of moral hazard. Decision-making and liability need to be in one single hand. Who has decision-making responsibility needs to be liable for the consequences of their decisions and not be able to shift them to someone else. Only then sound decisions will be made.' (Schäuble, 2014d)

Likewise, a German negotiator of this issue in the Council insisted that 'either we have a full political union – which is out of reach – or we do not mutualise. A compromise can be that we mutualise, but remain in control – just as we did it for the ESM, where we also have a veto right.' (GFM1, 2015). With domestic interests being fragmented, the emphasis of ordoliberal ideas about realigning control and liability settled the argument in favour of control, as suggested by the fiscal position. As a result of these considerations, the German government sought to create a mere network of national authorities, but no centralised decision-making (Financial Times, 2013m). After attracting much criticism, it conceded a centralised authority early in the negotiations, but favoured an independent and newly created agency over the Commission (GFM1, 2015; GFM9, 2015). Yet, it subsequently followed from several legal opinions that only an EU institution could be entrusted with resolution powers in conformity with the law as established by the Court of Justice in the Meroni case (Agence Europe, 2013c; Agence Europe, 2013m; Financial Times, 2013n). The German government then favoured the idea of an independent resolution board, whose draft resolution plans would be merely rubberstamped by the Council to formally comply with the legal requirements. It considered the ECB not eligible for this role because of conflicts of interest with its tasks as supervisor (Agence Europe, 2013m). Facing the choice between the Commission and the Council, the German government strongly advocated the Council to safeguard its control (Agence Europe, 2013a; Financial Times, 2013j; Howarth and Quaglia, 2014, p. 133).

Notably, the government's preference was neither supported by the public, nor by the private banks. Both groups shared the government's opposition to the Commission's role as future resolution authority, but objected to a Council involvement as jeopardising decision-making efficiency (BVR/VÖB/DSGV, 2013, pp. 9–10; BDB, 2013a, p. 4). The private banks were in favour of creating a new institution (BDB, 2013a, p. 4) (despite legal opinions ruling out such solutions); the public banks rejected the very idea of a European resolution authority and wanted a network of national authorities (BVR/VÖB/DSGV, 2013, pp. 3–4).

Southern Preferences: Efficiency Trumps Control

Concerns about the effectiveness of the mechanism were much more important in the Southern coalition. The entire coalition was aware that involving national governments through the Council would open a Pandora's box and eventually render the resolution mechanism ineffective. Resolution decisions need to be taken over a weekend and the Council's capacity for quick decision-making was doubtful, to say the least. An official in the French Treasury summed up these concerns: 'Our view was that you need to have something which is manageable, so you cannot have a blocking majority too easily. Otherwise the whole system breaks down' (FT5, 2015). An efficient mechanism was key to deal with bank failures more efficiently than in the past because 'the endgame of resolution is driving incentives for supervision' (Gros and Schoenmaker, 2014, p. 532). The break-down of coordination of national resolution authorities was one of the reasons for the high costs for taxpayers in the financial crisis, as cases such as Fortis had shown (Wiggins *et al.*, 2015). There was little to no appetite in the Southern coalition to compromise on the decision-making effectiveness of the new mechanism (EU Observer, 2013a; Reuters, 2013d; Saccomanni, 2013, p. 1). An efficient mechanism was considered a core element to make banking union deliver on the stabilising impact it was supposed to have (e.g. European Central Bank, 2013, p. 2). The French, Italian and Spanish governments were leading a group of member states that within the existing legal constraints opted for the European Commission as final decision-making authority (Financial Times, 2013n). They supported the creation of an independent and newly created resolution agency (the Single Resolution Board), but the European Commission – and not the Council – should rubberstamp the resolution plans (Agence Europe, 2013c; Agence Europe, 2013b; Agence Europe, 2013a; Agence Europe, 2013l; Agence Europe, 2013n). Some governments, such as the French government, also aimed to increase the influence of national resolution authorities, but ruled out any veto rights (Financial Times, 2013n). The Southern coalition's preference would have satisfied the legal requirements without sacrificing the efficiency of resolution decision-making. This macro-economic preference for an effective banking union was reinforced by the banks, which, like their German counterparts, were in strong support for an efficient mechanism. The French Banking Association FBF called for a streamlined system that would be able to take quick decisions (FBF, 2013, p. 2). This was echoed by Spanish banks (e.g. BBVA, 2013, p. 13) and their Italian counterparts, which pointed out that the SRB and not member states should make resolution decisions (ABI, 2013, pp. 6–8).

These preferences of the Southern coalition pitted it against the group of Northern European governments. German proposals were perceived as overly complex and being an obstacle for the required effectiveness of time-sensitive resolution decision-making as an essential contribution to break the vicious circle. Lengthy negotiations among the ministers themselves had to reconcile their different views and pave the way for an agreement.

Negotiations: Towards an Effective SRM

The negotiations revolved predominantly around legal and efficiency arguments. The German government defended the rejection of a joint resolution authority on legal grounds. In their view, the Treaty article 114 TFEU did not provide for transferring these powers to a European resolution authority. They demanded a Treaty change (Schäuble, 2013), which was clearly out of sight (Agence Europe, 2013c; Agence Europe, 2013m; Financial Times, 2013j; Financial Times, 2013n) and, thus, perceived as a spoiler argument to delay the negotiations. Moscovici attempted to force the German government to acquiesce in an agreement by being clear that a Treaty change 'must not be used as a pretext to stop banking union' (cit. in Financial Times, 2013d). Some negotiators were suspicious of the German government that its legal assessment was 'actually based on the desire by the German authorities to preserve the power of decision over bank resolution in Germany' (Gros and Schoenmaker, 2014, p. 532). Furthermore, there was vast evidence against the results of the German government's legal assessment. The legal services of the European Central Bank, the European Commission, the Council as well as of the Lithuanian Council Presidency were of the opinion that Art. 114 TFEU would provide for instating a joint European resolution authority (Agence Europe, 2013c; Financial Times, 2013o). Moscovici explained the position of the French government:

> 'Wolfgang Schäuble says that we should go as fast as far as possible without changing the treaty and, if there are any problems which call for a change of treaty, then we will see when that time comes. I agree with that point. Possibly with a slight nuance: we can go very very far with the existing treaties and possibly we also need an integrated authority.' (cit. in Agence Europe, 2013m)

These perspectives were shared by the Commissioner responsible Michel Barnier:

> 'We can't wait for a treaty change to solve our problems. We know what our problems are and we have to tackle them – we found a way to do that in the current treaty.' (cit. in Financial Times, 2013n)

The German legal arguments proved to be indefensible, as a Dutch negotiator laid out very bluntly: 'We were opportunistic and helped the Germans here because they wanted Art. 352, probably to have unanimity [as voting rule] in the Council. But we knew that Art. 114 would work as well' (NT1, 2016). As negotiations dragged on, the German government came under considerable pressure. It eventually gave in on the overall feasibility of a joint European decision-making structure at a meeting of the finance ministers of France, Italy, Spain and the Netherlands in Berlin in December 2013 (Financial Times, 2013a).

The German government did concede on the overall feasibility of a joint authority, but it continued to resist giving up its say over the use of the funds. A senior official in the Finance Ministry explained: 'We have a joint fund and this implies that we need to ensure there is no incentive to circumvent the bail-in rules or to save all banks just because we have this huge fund' (GFM9, 2015). The new strategy consisted of denouncing the European Commission as too politicised to make resolution decisions. Following this argumentative strategy, the Council needed to be involved as well in order to have a counterbalance to the Commission. The former would certainly not have depoliticised the procedure, but it would have constrained the Commission's influence. One official in the German Finance Ministry laid out their thinking as follows:

> 'The Commission put themselves forward to be the resolution authority. This is something we never wanted. The Commission is a political institution and we know on which side they stand. For us it was important that resolution decisions are not based on political considerations.' (GFM1, 2015)

However, involving the Council did not mute the arguments which related to efficiency. An effective mechanism seemed irreconcilable with an involvement of the Council (Financial Times, 2013a). For the vicious circle to be broken, the SRM needed to be effective in the face of the real-life challenges. Thus, the Southern coalition stressed the unsuitability to this goal an unmanageable resolution decision-making process. The majority of Southern governments preferred the Commission as the institution entrusted with rubberstamping the draft decisions by the board of the resolution mechanism (Agence Europe, 2013l; Agence Europe, 2013a). Moscovici insisted that '[t]here has to be a governance process closely tied to the European Commission' (cit. in Financial Times, 2013l). The Italian finance minister Saccomanni discarded the German proposals in a letter to the Council Presidency, by pointing to their complexity:

> 'In order to break the [bank-sovereign] nexus I recalled, we have to establish a system which is effective (…). A credible SRM is first of all a system that is actually able to make quick decisions and to swiftly manage any resolution procedure. The governance arrangements outlined so far should therefore be streamlined, rather than made more complicated.' (Saccomanni, 2013, p. 1)

The Irish finance minister Noonan took the same line:

> 'The proposal on governance looks very complicated. (…) In resolving a bank, one would want to be able to do it over a single weekend at the maximum. So anything that is too cumbersome, with various layers to it, won't be effective.' (cit. in Reuters, 2013d)

He was seconded by Draghi: 'Everybody knows that these decisions must be taken instantly…we can't have hundreds of people debating whether a bank is viable or not' (cit. in EU Observer, 2013a). A similar assessment was put forward by Yves Mersch from the ECB's Executive Board: 'Supervisors cannot give objective verdicts on the viability of banks if banks can only be closed in a disorderly way' (cit. in Financial Times, 2013d). This perspective was also reflected in an ECB opinion on the SRM:

> '[T]he ECB shares the view of the Commission that such a single mechanism is better placed to guarantee optimal resolution action (…), than a network of national resolution authorities. Coordination between national resolution systems has not proved sufficient to achieve the most timely and cost-effective resolution decisions, particularly in a cross-border context.' (European Central Bank, 2013, p. 2)

The European Parliament lobbied decisively for a streamlined procedure. Its president Martin Schulz laid out the need for a quick resolution:

> 'If a bank cannot be wound up within a weekend in order to prevent a run on the banks, the system is too complicated. In other words, the Commission must play a central role here.'
> (cit. in EU Observer, 2013c)

Saccomanni retrospectively stated: 'I indicated that I was willing to work in a spirit of compromise, but not on the existence of an efficient, effective mechanism and a system of effective backstops' (cit. in Bloomberg, 2013d).

The German government saw its stocks tumble. It sought to maintain control of the use of the funds, but the attempt to gain support by blaming the Commission as too politicised to take resolution decisions failed. A German negotiator did not conceal the complicated nature of the German proposal and eventually admitted defeat:

> 'First, there was a legal requirement, and secondly the Commission should under no circumstances be in charge of resolution because the decision to use the funds shall never be taken lightly. There needs to be control. But I admit that it's not ideal to give powers to the Council. It complicates the whole procedure to an extent which is questionable. To say it clearly… it's pretty much nonsense… but it is a question of priorities, and our priority was attaching strings to the mechanism' (GFM9, 2015)

After tense negotiations, the German government conceded and gave way to a more functional system. The Finnish government put forward a compromise acceptable to all involved parties (Reuters, 2013e; Agence Europe, 2014e). A new authority – the Single Resolution Board – was charged with drafting resolution plans and the European Commission merely rubberstamps these plans. The competences of the Council are minimal. If the Commission modifies the resolution proposal by the SRB in a way which increases the amount of funds drawn from the SRF by 5% or more, the Council is authorised to veto this modification – if it manages to make a decision within 12 hours. A second form of Council involvement is subject to approval by the European Commission. The SRB can only resolve a bank if it is deemed to be in the 'public interest' (Art. 32(4), BRRD). If the Commission objects to the SRB's assessment of the public interest, it authorises the Council to veto the resolution decision. Again, both the Commission and the Council have to make these decisions within 12 hours (Agence Europe, 2014d; Howarth and Quaglia, 2014, p. 136). Hence, the intervention powers of the Council are minimal, subject to approval by the European Commission, and highly constrained in terms of time.

The German government first departed from its idea of a network of national authorities. It then gave up on the Council as resolution authority and eventually accepted an important role of the European Commission in resolution decisions. If material bargaining power had been the core determinant, one could have reasonably expected a more favourable outcome, not least because the German government was supported by its triple A alliance consisting of Finland, the Netherlands and Austria as well as (albeit less important) non-eurozone support from Sweden, the United Kingdom and also Romania (Agence Europe, 2013a; Agence Europe, 2013c; Agence Europe, 2013o; Howarth and Quaglia, 2014, p. 133). Instead, the evidence suggests that rhetorical processes became a powerful weapon of the weak. The German government failed to provide a suitable response to the problem frame of the vicious circle and ended up being vulnerable towards calls for a common system without national veto rights.

6.6. Conclusion

When the heads of state or government agreed in June 2012 to ease the market pressure on Italy and Spain with a mechanism for direct bank recapitalisations, only few of them were aware that their decision would eventually lead to a permanent resolution mechanism in the eurozone (Nielsen and Smeets, 2017). The political dynamics and the widely unanticipated intervention of the European Central Bank to do 'whatever it takes' to save the euro eventually resulted in a much more comprehensive overhaul of EMU than initially planned. This chapter analysed the domestic preference formation of governments and the interstate negotiations leading to the establishment of the SRM.

Over the whole SRM negotiations, the German government faced the challenge of balancing efficiency and control. Preferences maximising efficiency would have provided for an effective resolution mechanism, minimising the risks for financial stability, and going a long way towards stabilising EMU. Maximising control would have effectively prevented the use of German money to bail-out the periphery, but conflicted with the functionality of the mechanism, and eventually the sustainability of the currency area. The evidence presented in this chapter suggests that the emphasis on control stems from ordoliberal ideas internalised among German policy-makers. Realigning control and liability is their core claim and this was difficult to reconcile with a mutualised system. Notably, the banks were an insufficient predictor of government preferences. They were either divided as in the case of the bail-in and resolution fund or aligned in their opposition to the government's preferences. The preferences of the Southern coalition were streamlined towards breaking the vicious circle between banks and sovereigns as the overriding macro-economic concern. They strongly advocated a mutualised resolution system providing for an efficient use of the resolution funds. These macro-economic considerations matched the interests of the domestic banking sectors. Given the limited fragmentation, there was no need to resort to post-Keynesian ideas (as suggested by the scope condition).

From a neo-functionalist perspective, the creation of the SRM is puzzling. The crisis pressures diminished in the second half of 2012. By the time the SRM was negotiated, they had disappeared almost completely. If crisis pressures lead to further integration, the SRM would unlikely have happened, as crisis pressures were largely absent. While the analysis has recognised the importance of crisis pressures to bring about the high level agreement at the Euro Summit in June 2012, it also shows that crisis pressures have a rather weak track record to explain the successful negotiations that followed after crisis pressures had diminished.

The preferences of both coalitions were diametrically opposed in the negotiations. Based on the distribution of material bargaining power, one would expect a resolution mechanism that largely corresponds to German preferences. While the German government successfully vetoed a fiscal backstop and delayed the mutualisation of the fund, it made concessions on several other issues. The newly established bail-in rules are subject to a range of exemptions, a single resolution fund is in place, and governments are largely excluded from resolution decision-making. This hardly constitutes a full defeat of the German government, but it exceeds minor concessions that could be expected as part of benign hegemony. The analysis provided only weak evidence for the hypothesis of benign hegemony. Coalition patterns do not rescue the hypothesis either. The German government did have supporters in all three issues. The Northern coalition was even strengthened further by the partial support from the Spanish government. This did not spare the government making concessions of a substantial magnitude. A consistent pattern was the rhetorical action of the Southern coalition. While the German government sought to maintain control over the resolution process, its opponents stressed in all stages of the negotiations that German preferences would risk the effectiveness of the resolution mechanism. This effectiveness, however, was necessary to break the vicious circle between banks and sovereigns, as collectively professed. Governments of the Southern coalition and institutions could show that the German solution frame of structural reforms and bail-ins was no suitable response to solve the problem of the vicious circle.

The German government had started to put more emphasis on bail-ins as a precursor of a comprehensive agenda with so-called risk-reduction measures, but in the absence of a successful case where its new tools had been tried and tested, its adjusted frame failed to gain traction among the negotiators. The German government was forced to acquiesce in Southern arguments about risk-sharing. It gave way to a more effective system and made concessions on core issues. This supports the rhetorical action hypothesis.

When the European Parliament adopted the SRM's legislative package in the very last parliamentary session before the elections in 2015, the banking union was formally put in place. The negotiations to the European Deposit and Insurance Scheme still drag on and a quick conclusion seems unlikely at the time of writing. Despite the absence of this third leg, policy-makers adopted the most fundamental overhaul of EMU's institutional architecture in the short period of two years only. The following chapter summarises and concludes the analysis of the negotiations. It generalises the findings and shows their relevance beyond the case under considerations.

Chapter 7: Conclusion

This concluding chapter serves two purposes. It summarises the results of the analysis of the banking union and makes explicit its wider implications beyond the banking union. While the thesis primarily explained the creation of the EU banking union, it produced several insights, which merit consideration in the broader context of the study of International Relations.

This conclusion takes recourse to the banking union negotiation to show the influence of uncertainty on the formation of actors' preferences. While governments sought to maximise gains, their actions were constrained by incomplete information. As this thesis demonstrated, such an environment makes the impact of ideas likely. They were particularly important for the preferences of the German government. This conclusion draws on these findings to make generalisable claims about how ideas can matter in these situations.

Notably, another finding of this dissertation is the negligible impact of ideas on Southern European preferences. Therefore, the conclusion discusses the conditions under which ideas matter. It underlines that the fragmentation of interests is an important scope condition for ideas to matter. This scope condition also makes an integration of interest-based and ideational approaches possible, which has potentially far-reaching ramifications.

A third key finding of this analysis is the impact of rhetorical action on interstate negotiations. The thesis suggested a framework to show how exactly ideas influence interstate negotiations. The mechanism consists of two steps: Setting favourable terms of a debate makes some arguments appear stronger than others. This enables actors to win the causal argument against their opponents. While the analysis has found this framework to be important for the banking union negotiations, the conclusion generalises it to other cases as well.

Lastly, the banking union in its final form is one of the grand bargains of European integration. Transferring the powers of banking supervision and banking resolution to the European level is an unprecedented shift of sovereignty. Its creation has repercussions for the governance of the single currency. In light of this, a last section of this thesis analyses the policy implications of this shift of sovereignty.

7.1. Research Findings

Based on the theoretical framework, four hypotheses for the domestic preference formation and the interstate negotiations were established. As the thesis was set up in a within-case research design, these hypotheses were tested for seven contentious issues. These seven issues were the following: first, the decision to create a mechanism for direct bank recapitalisations; second, the establishment of a joint eurozone banking supervisor at the Euro Summit in June 2012; third, the role of the ECB in the supervisory mechanism; fourth, the scope of the mechanism; fourth, the bail-in rules; fifth, the creation of a resolution fund, and lastly, the bank resolution decision-making. They provided the basis of the empirical testing of the hypotheses, whose results are summarised in the following sections.

Table 37: Contentious issues: Within-case analysis

	Contentious because…
Creation of joint supervision	delegates sovereignty to the European level; protects against moral hazard
Direct bank recapitalisations	establishes a shared liability for bank debt
ECB as supervisor	possibly triggers moral hazard
Scope of SSM	shapes the conditions under which banks operate
Bail-in rules	serves as an instrument to protect the taxpayer; can be a source of financial instability
Single Resolution Fund	establishes private transfers between banks in the eurozone; important crisis resolution tool
SRM decision-making	affects the sovereignty of national governments

The Domestic Preference Formation

Beginning with domestic preferences, liberal intergovernmentalism predicted that governments follow either the interests of powerful domestic interest groups or macro-economic preferences. The multi-faceted nature of the banking union made it difficult to assign it clearly to either interest-groups or macro-economic preferences, as the scope conditions in liberal intergovernmentalism for both were met. The hypotheses took this complex nature of the project into account and created separate hypotheses for interest groups and macro-economic preferences:

Hypothesis 1a:

The preferences of governments are determined by banks and businesses as the most powerful domestic interest groups.

Hypothesis 1b:

The preferences of governments are determined by the macro-economic preferences of the ruling governmental coalition.

Testing for both interest groups as well as macro-economic preferences brings with it the risk of fragmented interests. Fragmentation is in principle reconcilable with a material interest hypothesis. If there is a most powerful interest, and this interest is shown to have influenced the government decisively, the material interest hypothesis would be confirmed, despite considerable fragmentation. Likewise, if multiple interests suggest the same policy, which is also followed by the government, the material interest hypothesis can be seen as supported (even though a more sophisticated explanation would attempt to show which of the various interests was the decisive one). However, a more difficult situation for the material interest framework comes about when interests are fragmented and at the same time pressure the government in different directions. Thus, the theoretical framework introduced an ideational approach, subject to a scope condition: If there is much fragmentation of (broadly equally powerful) interests, the worldviews of governments tip the balance in favour of the interest which resonates with these worldviews. These worldviews do not trump interests, but tip the balance into a particular direction and settle the argument between competing interests. This led to the following hypothesis:

Hypothesis 2:

In situations with several equally powerful material interests, the preferences of governments are determined by the worldviews held by policy-makers..

A third hypothesis was based on neo-functionalism. It predicted that governments would adjust their stance towards the banking union depending on material crisis pressures. With these pressures occurring, governments would opt for a fully-fledged EMU; without these pressures, they would not move forward and oppose further integration.

Hypothesis 3:

> *Under severe crisis pressures, governments will have a strong preference for a fully-fledged banking union. In the absence of crisis pressures, government will block any steps towards a fully-fledged banking union.*

The test of these hypotheses for the seven contentious issues revealed as a key finding that material interests in Germany were diverse. Furthermore, the analysis showed that, in fact, there was no clearly most powerful interest. The most important private interest was the banking sector, but it was divided between public and private banks. Both groups vary in their business models and degree of internationalisation and they have traditionally been in a rival relationship (Seikel, 2014; Lombardi and Moschella, 2016; Hardie and Howarth, 2013). The public banks enjoyed a number of regulatory and supervisory privileges on the national level, which they were keen to preserve. They rejected the idea of the banking union. The private banks, however, comprised large institutions, such as the Deutsche Bank or Commerzbank. Their main interest was a level-playing field in the euro area, bolstering their international activities and facilitating the internationalisation and expansion of their businesses. They strongly supported the creation of the banking union.

Furthermore, macro-economic preferences provided for more than one rational course of action. From the perspective of the fiscal position, it seemed reasonable to shift the adjustment costs to the periphery. This strategy would be centred on avoiding risk-sharing and mutualisation as a means to preserve the favourable fiscal position. This would result in a form of banking union with no mutualised resources, but with supranational constraints on governments, given that ultimately governments stand in for each other in the euro area via the ESM. If macro-economic preferences were derived from trade patterns, investing into the stabilisation of the crisis-prone currency union would be a rational choice. It was the backbone of the German economy and, thus, fixing the shortcomings of the institutional setting of the currency union would be a priority. The government would advocate a full-fledged banking union, including mutualised resources and common mechanisms to deal with and shoulder bank failures.

Yet, while these various interests provided for different courses of action, uncertainty obscured the expected costs and benefits. A narrow focus on shifting adjustment costs or even rejecting the banking union as such could hypothetically result in high gains (reforms in the periphery without risk-sharing). However, continued asymmetries could also lead to a very costly outcome to materialise: euro break-up. Fixing EMU and introducing more risk-sharing could possibly prevent this outcome, but involve the risk of moral hazard. There was a fine line between both strategies, but a veil of uncertainty obscured the expected consequences.

The fragmentation of interests triggered the scope condition for worldviews to matter. In the case of Germany, ordoliberalism has become an internalised belief in ministries and was proven to be important for previous bargains in EMU (Dyson and Featherstone, 1999; McNamara, 1998). One of its core claim is Walter Eucken's 'principle of liability' *Haftungsprinzip,* which translates to EMU as the need to realign control and liability: no shared liabilities without a sharing of control (Eucken, 1951, pp. 279–285). The framework expected that ordoliberal ideas would tip the balance in favour of one of the competing interests. As the analysis showed, ordoliberal ideas were closer to a policy based on the fiscal positions, than to other interests. Realigning control and liability strongly resonates with a policy that rejects risk-sharing among EMU member states, which could potentially put the German fiscal position at risk. Conversely, ordoliberal ideas did not have much in common with a policy based on trade patterns, as stabilising EMU would hardly be possible without more risk-sharing. This argument received empirical support, as Table 38 demonstrates. The table shows (a) considerable fragmentation of interests across all seven contentious issues and (b) the consistent match between the ordoliberal worldviews and German preferences.
The neo-functional explanation does not produce a convincing result. It has some explanatory power for German preferences, but cannot account why the negotiations were concluded after material crisis pressures had faded.

Table 38: Assessment: Domestic preference formation, German government

	Macro-economic preference: fiscal position	**Macro-economic preference: trade pattern**	**Private material interest: public banks**	**Private material interest: private banks**	**Ideas: ordo-liberalism**	**Neo-functionalism: crisis pressures**	**GERMAN PREFE-RENCES**
Joint supervision	In favour	In favour	Against	In favour	In favour	In favour	In favour
Direct bank recapitalisations	Against	In favour	Against	In favour	Against	In favour	Against
ECB as supervisor	Against	In favour	In favour	In favour	Against	Against	Against
All-encompassing scope of SSM	Against	In favour	Against	In favour	Against	Against	Against
Strong bail-in rules	In favour	Against	Against	In favour	In favour	Against	In favour
Mutualised Single Resolution Fund	Against	In favour	Against	In favour	Against	Against	Against
Veto rights in SRM decision-making	In favour	Against	Against	Against	In favour	In favour	In favour

A last major issue arises: given the consistent match between the fiscal position and German preferences, why is the worldview extension of the framework necessary, after all? Alternatively, one could interpret the congruence between the fiscal position and German preferences as sufficient evidence for the influence of the former. The 'stand-alone' fiscal position explanation would provide a sufficient explanation of the outcome.

The matches of ordoliberal ideas with German preferences would not be decisive factor anymore.

Yet, focusing on the fiscal position alone has three shortcomings. First, it does not exclude alternative explanations. While there is a match between the fiscal position and German preferences, ordoliberal ideas are equally successful in explaining the outcome. Thus, at a minimum, ideas and the fiscal position are indeterminate in this situation. Liberal intergovernmentalism cannot provide a compelling reason why the fiscal position should be more important than the ordoliberal worldviews. Second, while one could argue that the matches of the worldview explanation are incidental and unavoidable in a situation with much fragmentation, it seems equally unlikely that consistent matches of ordoliberal ideas with the government's preferences across all seven contentious issues are coincidence only. The consistency of this match makes it implausible to ignore them completely.

Most importantly, the third reason against a 'stand-alone' fiscal explanation is the evidence that can be derived from process-tracing, which was suggested as complementary method to the method of congruence (see section 1.3). The evidence marshalled with respect to the seven contentious issues suggests that ordoliberal ideas underpinned the choices of policy-makers. For instance, interviewees in the German Finance Ministry and in the Chancellery referred to ordoliberalism as a 'consensus' (GFM7, 2016), a belief 'everyone beliefs in' (GFM5, 2015) and a theory they think of 'when [they] wake up in the morning' (GFM8, 2016). This confirmed the findings from the literature on the internalisation of ordoliberal ideas in German ministries (Nedergaard and Snaith, 2015; Bonatti and Fracasso, 2013). Likewise, the discourse of chancellor Merkel and finance minister Schäuble referred to core ideas of ordoliberalism at a number of occasions. Merkel made clear that '[t]here should never be a misfit between control and liability. Control and liability need to go hand in hand. Joint liabilities require joint control in the first place' (Merkel, 2012a; see also Merkel, 2012c). Schäuble emphasised that '[e]verything revolves around the fundamental ordoliberal question to design the system in a way that it sets the rights incentives and avoids false incentives' (Schäuble, 2014d). For this reason, he explicitly referred to ordoliberalism and ordoliberal principles when creating the banking union (Schäuble, 2014d; see also Schäuble, 2014c; Schäuble, 2014f). Against the background of this evidence, it would be hard to justify excluding any impact of ordoliberal ideas. While it is a common critique of ideas that they serve as camouflage for interests (e.g. Donnelly, 2014), it remains unclear why policy-makers would invest in the ordoliberal frame out of egoistic interest. Public statements emphasising the fiscal position directly or as part of the national 'public interest' as such would also resonate with the electorate and not necessarily be less legitimate than statements underlining ordoliberal ideas. It is difficult to see a need for putting forward ordoliberalism if it only hides equally legitimate interests.

Notably, a different picture emerges in the coalition of Southern European governments. Material interests were aligned towards a full-fledged banking union. The banking sectors in France, Spain and Italy were strongly supportive of the banking union. In the latter two countries, the acute phase of the crisis took its toll and resulted in a preference for European risk-sharing in the financial sector (Howarth and Quaglia, 2013). French banks were more hesitant to endorse the banking union. While they did enjoy cosy links to national supervisors (Véron, 2011b, p. 4), they eventually changed direction in favour of the banking union (De Rynck, 2016). As French banks were highly concentrated, internationalised and competitive, they expected to benefit from a level-playing field in the euro area. The macro-economic preferences were not diverse either. Their fiscal position was weak and, thus, they stood to benefit from risk-sharing with economically more stable countries. A full-fledged banking union would have brought about a shared resolution fund, direct recapitalisations and, in a next step, a mutualised deposit guarantee scheme. Furthermore, their trade patterns were centred on the European market. This interdependence created a rationale for an encompassing banking union as an important stabiliser of the single market. The fragmentation of interests was negligible. It only occurred in some very isolated cases in France, but did not acquire major significance overall. As a result of this constellation of interests, the scope condition for the worldview hypothesis was not met in the Southern coalition. Hence, the theoretical framework expected that their preferences were a consequence of the impact of material interests. This theoretical expectation was confirmed by the empirical evidence. Across the seven contentious issues, the preferences of the governments were consistently matched by material interests. This is strong evidence in support of the hypothesis.

Table 39: Assessment: Domestic preference formation, Southern coalition

	Macro-economic preference: fiscal position and trade patterns	**Private material interest: banking sector**	**Ideas: post-Keynesianism**	**Neo-functionalism: crisis pressures**	**SOUTHERN PREFERENCES**
Joint supervision	In favour	In favour *(France: hesitant)*	In favour	In favour	In favour (*if linked to direct bank recapitalisations*)
Direct bank recapitalisations	In favour	In favour	In favour	In favour	In favour
ECB as supervisor	In favour	In favour	In favour	Against	In favour
All-encompassing scope of SSM	In favour	In favour	In favour	Against	In favour
Strong bail-in rules	Against	Against	Against	Against	Against
Mutualised Single Resolution Fund	In favour	In favour	In favour	Against	In favour
Veto rights in SRM decision-making	Against	Against	In favour	In favour	Against

The fact that ordoliberal worldviews accounts for German preferences, while material interests explain Southern preferences, could lead to the objection that the explanation is actor-specific. It would not be theoretically consistent as the assumptions and logics would be different. Yet, this objection overlooks that the preferences of the German government and the Southern coalition are explained within the same framework, which incorporates a scope condition. The decisive factor, which eventually leads to distinct explanations, is the degree of fragmentation of interests. While German interests were highly fragmented, Southern interests were aligned. This triggered the scope condition in the German case, but not for the governments in the counter-coalition. Thus, while the explanation puts emphasis on different variables for the two main actors, this differentiation is the result of the existence of a scope condition, which applies to all actors equally.

The Interstate Negotiations

The interstate negotiations have taken a large part of the analysis. Two hypothesis guided this analysis and predicted their outcome. If the most powerful member state shapes the outcome of interstate negotiations and imposes its preferences on its counterparts, the power-based hypothesis would be confirmed. In the banking union negotiations, the German government was the actor with the highest material bargaining power, as evidenced by its large financial resources, high credit rating, low public debt and deficit, and a highly competitive economy. From the perspective of this hypothesis, we expected the outcome of the negotiations to broadly reflect German preferences.

Hypothesis 4:

> *The outcome of the negotiations corresponds to the preferences of the government with the highest material bargaining power.*

An alternative hypothesis was based on rhetorical action. It did not neglect the importance of material bargaining power, but predicted rhetorical processes to impact on the outcome. Depending on rhetoric, governments could either punch above or below their (material) weight. All governments agreed collectively to the problem frame of the vicious circle between banks and sovereigns, but invoked two different solution frames. The first solution frame consisted of measures for further risk-sharing. It was predominantly used by the coalition of Southern European governments. Structural reforms and risk-reduction was the second solution frame, invoked by the German government and its allies in the Northern European coalition. If rhetorical action was important, we would expect the outcome of the negotiations to be influenced by the successful solution frame.

Hypothesis 5:

> *The outcome of the negotiations corresponds to the preferences of those governments which can justify their demands with reference to a commonly accepted problem frame.*

Across the seven contentious issues, the power-based hypothesis received only weak support. The German government opposed the very project of banking union, but was forced to accept it at the highly turbulent Euro Summit in June 2012. Several concessions do not match the high material bargaining power of the German government. The first concession was the agreement at the summit to establish a mechanism for direct bank recapitalisations in the euro area. It paved the way for a shared liability for bank debt in the euro area. The German government could subsequently mitigate the impact of direct recapitalisations, as it successfully imposed a joint banking supervisor on its counterparts as a safeguard against moral hazard. Yet, given the long-standing German resistance to a joint supervisor (De Rynck, 2016; Grossman and Leblond, 2011), its establishment is better described as a means of damage control than a genuine German preference or even a success for the government.

In the SSM negotiations in the Council, the German government failed to prevent an agreement that establishes bank supervisory powers for the ECB. Against German preferences, banking supervision and monetary policy are only weakly separated, as in both areas the final decisions are made in the ECB's Governing Council. Furthermore, the established integrated system of supervision gives the supervisor control of the German savings banks and *Landesbanken*, which is likely to increase the pressure on the German government to open their banking market to foreign competitors. In addition, the Germans paid a price for its backtracking from direct recapitalisations (by making the mechanism overly complex): they conceded the creation of a resolution mechanism with a mutualised fund, equalling in size almost exactly the amount of ESM funds earmarked for direct recapitalisations.

The German government could neither prevent a joint and eventually mutualised resolution fund, nor secure veto rights in the resolution decision-making process. While the creation of bail-in rules can reasonably be seen as a success for the German government, a large number of exemptions leave ample room to circumvent them in practice. To be sure, the German government was a powerful actor in the negotiations. It took a central position in the negotiations, which material bargaining power does explain successfully. Yet, given its hegemonic role (Bulmer and Paterson, 2013) and its track record in the crisis management (Schoeller, 2017; Beach, 2013), the analysis suggests that it punched below its weight in the banking union negotiations. Against this backdrop, the outcome of the negotiations does not confirm the power-based hypothesis.

The analysis lent more support to the rhetorical action hypothesis. It showed consistently over the duration of the negotiations that all governments accepted the vicious circle between banks and sovereigns as the problem frame. This agreement on the problem frame implied that proposed solutions had to be suitable to this problem frame in order to be accepted by the audience (i.e. the fellow negotiators). It limited the realm of possibilities. This essentially undermined the German government's advocacy for structural reforms and automatic bail-in rules. Its counterparts disputed these proposals as ill-suited to the agreed problem frame, given their questionable contribution to the shared goal of breaking the circle. Leading representatives of governments and EU institutions fleshed out the weakness of the German proposals in a number of public statements. They showed that neither a limited scope, nor excluding the ECB, a non-mutualised fund, a cumbersome decision-making procedure, or automatic bail-ins would have been conducive to breaking the vicious circle. On the contrary, experts, international institutions and Southern European governments forcefully promoted the solution frame of risk-sharing to break the vicious circle. The suitability of the risk-sharing solution frame to the problem frame of the vicious circle gave the Southern coalition a distinct rhetorical advantage. Eventually, the risk-sharing solution frame provided effective rhetorical ammunition for defending the preferences of the governments in the Southern coalition. It became the decisive device for securing important concessions on key aspects of the negotiations. Across the contentious issues, the risk-sharing solution frame helped efforts by Southern governments. It shifted the outcome in the direction of a more full-fledged banking union, with considerable mutualisation and supranational grip on shared resources.

Table 40: Assessment: Interstate negotiations

	Power: material bargaining power	Rhetorical action: risk-sharing	Rhetorical action: structural reforms/ risk-reduction	OUTCOME
Joint supervision	Part of the agreement	Part of the agreement	Part of the agreement	Agreement on joint supervision
Direct bank recapitalisations	Not part of the agreement	Part of the agreement	Not part of the agreement	Agreement on direct bank recapitalisations
ECB as supervisor	Not part of the agreement	Part of the agreement	Not part of the agreement	ECB as supervisor
All-encompassing scope of SSM	Not part of the agreement	Part of the agreement	Part of the agreement	All-encompassing scope
Strong bail-in rules	Part of the agreement	Not part of the agreement	Part of the agreement	Non-automatic bail-in rules
Mutualised Single Resolution Fund	Not part of the agreement	Part of the agreement	Not part of the agreement	Joint and progressively mutualised fund
Veto rights in SRM decision-making	Part of the agreement	Not part of the agreement	Part of the agreement	Majority voting

7.2. Generalisations

This section puts the findings of the analysis in the broader context of the existing literature. It establishes how the insights gained can underpin the analysis of and knowledge on other subjects in the area of International Relations more generally.

On a broad level, the thesis has shown that ideas influenced both the formation of domestic preferences in some member states as well as the outcome of the interstate negotiations. The impact of ideas on domestic preferences was incorporated in the framework by suggesting an ideational extension of liberal intergovernmentalism (Moravcsik, 1999). The analysis has confirmed the validity of liberal intergovernmentalism as the (self-proclaimed) 'baseline theory' (Moravcsik and Schimmelfennig, 2009, p. 67) for the grand bargains in European integration. However, German preferences remained a puzzle for the framework, and neither could it fully account for German concessions in the negotiations. The ideational extension seeks to fill these gaps of liberal intergovernmentalism. While the approach was generally deemed suitable as a framework for analysis, it required an ideational approach so as to cover situations in which no single rational course of action that can be derived from domestic interest groups or macro-economic preferences of the ruling governmental coalition. Likewise, ideas played an important role to explain the outcome of the interstate negotiations. The actors involved in the negotiations used rhetoric to strategically advance their interests. The literature has shown that rhetoric can influence negotiations through a number of ways and causal mechanisms. These can be arguing and persuasion (Risse, 2000; Niemann, 2006), the strategic use of ideas (Schimmelfennig, 2001; Jabko, 2006; Krebs and Jackson, 2007), or also triggering policy learning and an updating of beliefs in the course of negotiations (Dunlop and Radaelli, 2016). However, even proponents of rhetoric admit that it does not matter in each and every case (Warntjen, 2010; Niemann, 2006).

These findings lead to several generalisable insights into the importance of ideas. The influence of ideas on policies leads to the question which conditions need to be met for ideas to matter. It can plausibly be assumed that the scope conditions that mattered in the case of the banking union are valid in other cases as well. In this regard, the analysis indicated that uncertainty and urgency are important scope conditions for ideas to matter. Informational constraints and an urgency to act were key characteristics of the banking union negotiations. The difficulty to anticipate the reaction of financial markets, the impossibility to control or even predict policies of other member states, or domestic dynamics and changes of governments were only a few of the factors which created a considerable amount of uncertainty during the banking union negotiations. Will structural reforms make the currency union more stable? Will bail-ins work or trigger panic at financial markets? Will risk-sharing lead to moral hazard?

The analysis suggests that uncertainty and urgency are not only scope conditions for a role of ideas in the domestic preference formation, but also in interstate negotiations. A high degree of uncertainty makes it more likely that actors use rhetoric in interstate negotiations. When it is less clear what the facts are, in which situation actors are caught and what consequences their behaviour will have, they seem inclined to exploit the fluidity of the situation and use rhetoric. Uncertainty and informational constraints go hand in hand with less clarity about the circumstances of negotiations. This increases the chances to successfully contest the arguments and preferences of the opponents. Actors are aware of this and more likely to employ rhetoric, which under these circumstances also is more likely to be successful.

Forming preferences and negotiating under uncertainty, however, is no novel setting in International Relations. According to Rathbun's categorisation of uncertainty (Rathbun, 2007), the literature has made sense of the concept in different ways. While some see uncertainty as caused by a lack of information which can only be reduced with power (Lake and Powell, 1999; Mearsheimer, 1994; Grieco, 1988), for others it is not the lack of information, but its ambiguity which causes uncertainty. Cognitive shortcuts and ideas as well as norms and identities mitigate the problem (Jervis, 1997; Tetlock, 1998; Keck and Sikkink, 1998; Schimmelfennig, 2003). The thesis suggests that under the condition of uncertainty, cognitive limits and ambiguous information weigh more heavily on actors. This makes it difficult to anticipate the consequences of policy choices. As a result, actors do take recourse to ideas as shortcuts and to compensate for a lack of knowledge – in line with the latter approach of the existing literature.

While the above reasoning suggests that actors resort to ideas under the condition of uncertainty and urgency, it is the second major contribution of the thesis to lay out how exactly and with which purpose actors use ideas. This relates to an ongoing discussion in the literature. One group of authors considered the constitutive impact of ideas (and norms) (Hall, 1993; Dyson and Featherstone, 1999; Hooghe, 2005; Checkel, 2005). They are constitutive for preferences of governments, leaving aside interests. Thus, ideas trump interests in certain situations (Jupille *et al.*, 2003; Matthijs, 2016). They mitigate the problem of uncertainty by replacing (uncertain) interests with ideational information on objectives and/or instruments. A second group has shed light on the instrumental use of ideas, which provides camouflage to less legitimate interests (e.g. Jabko, 2006; Schimmelfennig, 2001). This is different to another rationalist strand where ideas do not serve to hide less legitimate interests, but help actors to maximise the utility of their preferences, for instance through updating beliefs (Goldstein and Keohane, 1993; Dunlop and Radaelli, 2016; Garrett and Weingast, 1993). Another group emphasised the role of ideas as filters. Accordingly, ideas focus or divert the attention and considerations of policy-makers and thereby shape what they perceive as their interests. This implies the assumption that there are no interests without ideas (e.g. Blyth, 2002; Blyth, 2013). For proponents of this strand, ideas reduce uncertainty by helping actors to interpret their interests.

To do justice to the empirical observations and to understand better the causal chain behind the influence of ideas, the thesis advanced two causal mechanism to theorise their impact on the formation of preferences as well as the course of interstate negotiations. With regard to domestic preferences. This dissertation suggests that ideas are particularly relevant in situations where there is fragmentation of interests. When actors can pursue more than one rational interest, the utility function of a preference does not suggest a particular course of action. Ideas as worldviews are the marginal influence, which decides the course of action. In these situations, ideas do not replace interests, nor do they interpret interests. Instead, in situations with more than one single rational interest, they tip the scale in favour of the one interest which resonates best with the worldviews held by actors.

This finding is relevant as it is potentially applicable to a broad set of cases where actors could pursue more than one rational strategy. One of the more famous instances is the trade policy decisions of Western countries before the Great Depression. In an attempt to maximise gains, several Western government pursued a strategy which consisted of maximising exports while minimising imports. While a gain-maximising strategy, it eventually led to the collapse of the Western trade regime. An alternative rational approach would have been a coordinated policy to maintain open borders (Kindleberger, 1973). Both strategies were rational and the impact of uncertainty obscured which of the two would result in the higher payoff. For these cases, the framework presented in this dissertation could provide a suitable framework for analysis.

The thesis is equally explicit with regard to the causal mechanism behind the impact of rhetorical action. This contributes to our understanding of these processes, notably because seminal studies which have advanced the knowledge on the role of rhetoric have relied on different causal mechanisms. Schimmelfennig's causal mechanism works through standards of legitimacy, which enable actors to name and shame their opponents for being inconsistent with their previous commitments (Schimmelfennig, 2001). For Krebs and Jackson, rhetoric does not work through shaming, but the (coercive) power of the argument (Krebs and Jackson, 2007). Both approaches share in common that actors manipulate normative ideas to extract concessions from their counterparts.

This thesis proposes a two-step framework of the strategic use of rhetoric. In a first step, actors set the terms of the debate, which typically comprise the goal to be achieved, the diagnosis of an underlying problem, or the choice of instruments. These terms narrow the realm of possibilities for the outcome of the negotiations. If governments successfully drag negotiations onto a favourable terrain, their arguments are more likely to corner the opponent. This step offers insights into the framing contests of international negotiations and why governments invest resources into these framing activities. In a second step, the causal argument unfolds on this terrain. Governments present their arguments and attempt to draw support for their arguments from the established frames of reference. They win the causal argument and be able to extract concessions when they silence their opponents and deprive them of effective means of rebuttal.

A suitable example for the applicability of this two-step framework is the negotiations on a public debt relief for Greece, which have started around 2015 but for now been put to a halt by mainly the German government. A sticking point in the negotiations was the question of the sustainability of Greek debt. The Greek government pointed to historically high levels of debt to justify the need for a debt relief. German negotiators, however, emphasised that Greek debt has been sustainable, as its interest-rate payments to the ESM have been significantly below market rates. It contested over-indebtedness as the problem frame and instead sought to replace it with the problem frame of the economy's low competitiveness. Both sides advanced different problem frames and the German government successfully avoided being trapped into accepting that Greek debt is unsustainable. Having failed to shift the negotiations onto a favourable terrain, it is no wonder that subsequently the Greek government did not win the causal argument. Thus, the suggested two-step framework for the use of rhetoric offers some insights into a number of other cases besides the banking union.

To conclude, this thesis has attempted to shed light on the creation of the EU banking union. The banking union is the most recent grand bargain of European integration. It fundamentally transforms the EU's institutional architecture. Almost any economic activity in the euro area is affected by the banking union's inception, despite its technical nature which admittedly makes it a topic difficult to understand. If this thesis made not only the banking union easier to understand, but also informed our understanding of the workings of interstate negotiations, then it surely fulfilled its purpose.

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Annex 1: List of Interviewees

Acronym	***Position***	***Date***	***Place***
European Council			
MEC1	Member of the European Council	January 2016	*Not disclosed*
MEC2	Member of the European Council	September 2015	*Not disclosed*
SEC1	Sherpa of a member of the European Council	June 2015	*Not disclosed*
SEC2	Sherpa of a member of the European Council	January 2016	*Not disclosed*
SEC3	Sherpa of a member of the European Council	September 2015	*Not disclosed*
SEC4	Sherpa of a member of the European Council	June 2016	*Not disclosed*
Cabinet of the President of the European Council			
CPEC1	Senior official	June 2015	*Not disclosed*
CPEC2	Senior official	November 2015	*Not disclosed*
CPEC3	Official	September 2015	*Not disclosed*
European Commission			
COM1	Official	June 2015	Brussels
COM2	Official	August 2015	Brussels
COM3	Official	June 2015	Brussels
COM4	Official	October 2015	Brussels
COM5	Official	June 2015	Brussels
COM6	Official	June 2015	Brussels
COM7	Senior Official	August 2015	Brussels
COM8	Senior Official	June 2015	Brussels
COM9	Senior Official	July 2015	Brussels
COM10	Official	June 2015	Brussels
COM11	Official	June 2015	Brussels
COM12	Official	June 2015	Brussels
European Central Bank			
ECB1	Senior Official	June 2015	Frankfurt
ECB2	Senior Official	June 2015	Frankfurt
ECB3	Senior Official	September 2015	Frankfurt
ECB4	Senior Official	June 2015	Frankfurt
ECB5	Official	August 2015	Frankfurt
ECB6	Senior Official	September 2015	Frankfurt
ECB7	Official	September 2015	Frankfurt
European Parliament			
EP1	Member of Parliament	June 2015	Brussels
Council of the European Union (Legal Service)			
CEU1	Senior Official	November 2015	Brussels
CEU2	Senior Official	September 2016	Brussels

GERMANY			
Chancellery			
GC1	Senior Official	August 2015	Berlin
GC2	Official	August 2015	Berlin
Finance Ministry			
GFM1	Official	June 2015	Berlin
GFM2	Official	August 2015	Berlin
GFM3	Senior Official	October 2015	Berlin
GFM4	Official	June 2015	Berlin
GFM5	Official	June 2015	Berlin
GFM6	Official	June 2015	Berlin
GFM7	Senior Official	January 2016	Berlin
GFM8	Senior Official	January 2016	Berlin
GFM9	Senior Official	October 2015	Berlin
Central Bank			
GCB1	Senior Official	May 2016	Frankfurt
GCB2	Senior Official	May 2016	Frankfurt
FRANCE			
Office of the Prime Minister			
FOPM1	Senior Official	January 2016	Paris
Treasury			
FT1	Official	September 2015	Paris
FT2	Senior Official	September 2015	Paris
FT3	Official	June 2015	Paris
FT4	Senior Official	June 2015	Paris
FT5	Senior Official	September 2015	Paris
Foreign Office			
FFO1	Official	September 2015	Paris
Central Bank/Bank supervisor (ACPR)			
ACPR1	Senior Official	September 2015	Paris
ACPR2	Senior Official	September 2015	Paris
ITALY			
Office of the Prime Minister			
IOPM1	Official	September 2015	Rome
IOPM2	Senior Official	January 2016	Rome
Treasury			
IT1	Official	September 2015	Rome
IT2	Official	June 2015	Rome
IT3	Senior Official	November 2015	Rome
Foreign Ministry			
IFM1	Official	September 2015	Rome
Central Bank			
ICB1	Official	September 2015	Rome
ICB2	Senior Official	September 2015	Rome

ICB3	Senior Official	September 2015	Rome
SPAIN			
Office of the Prime Minister			
SOPM1	Senior Official	September 2015	Madrid
Treasury			
ST1	Official	October 2015	Madrid
ST2	Senior Official	September 2015	Madrid
ST3	Official	June 2015	Madrid
ST4	Senior Official	September 2015	Madrid
ST5	Senior Official	January 2016	Madrid
ST6	Senior Official	September 2015	Madrid
ST7	Senior Official	September 2015	Madrid
ST8	Official	September 2015	Madrid
ST9	Official	June 2015	Madrid
Bank Resolution Fund (FROB)			
FROB1	Official	September 2015	*By phone*
THE NETHERLANDS			
Ministry for General Affairs			
NMGA1	Senior Official	June 2016	The Hague
NMGA2	Senior Official	September 2016	The Hague
Treasury			
NT1	Official	June 2016	The Hague
NT2	Senior Official	September 2016	The Hague
Central Bank			
NCB1	Official	June 2016	Amsterdam
NCB2	Senior Official	June 2016	Amsterdam
NCB3	Official	June 2016	Amsterdam
NCB4	Official	June 2016	Amsterdam
OTHERS			
TT1	Researcher, think tank	September 2015	*By phone*
EBF1	Official at European Banking Federation (EBF)	June 2015	Brussels
BDB1	Official at Bundesverband Deutscher Banken (BDB)	June 2015	Berlin