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An ever closer Economic and Monetary Union?

Integrational dynamics in the Fiscal and Banking Union in a post-crisis era

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Abstract

The study reformulates neofunctionalism as a theory of regional integration by adding insights from liberal intergovernmentalism and the theory of incomplete contracts which has been developed in new institutional economics. This framework is then applied to the integration processes that have been undertaken in the Economic and Monetary Union (EMU) of the European Union (EU) since the outbreak of the financial crisis in 2008. The hypotheses derived are checked for their consistency with the most prominent policy proposals issued by the presidents of the core institutions of the EU and then tested on actual integrational moves in the Fiscal and Banking Union – two policy fields where competences have extensively been transferred since the financial crisis. Integration in fiscal policies has been driven both by the introduction of new enforcement mechanisms as well as a redefinition of the contracts between the member states and the supranational institutions, especially the ECB. In the sphere of the Banking Union, a completely new governance framework has been introduced that shifts competences to the European level. It is shown that despite considerable member state hesitation to deepen EMU, the mechanism of functional spillover is able to explain recent developments.

Key Words: Economic and Monetary Union, European Integration, Neofunctionalism, Contract Theory, Banking Union

Words: 20.000

List of Abbreviations

BRRD	Bank Recovery and Resolution Directive
CRD IV	Capital Requirements Directive IV
CRR	Capital Requirements Regulation
CSR	Country Specific Recommendation
DRI	Direct Recapitalization of Institutions
EBA	European Banking Authority
ECB	European Central Bank
EDIS	European Deposit Insurance Scheme
EDS	Excessive Deficit Procedure
EFSF	European Financial Stability Mechanism
EIOPA	European Insurance and Occupational Pensions Authority
EIP	Excessive Imbalance Procedure
EP	European Parliament
ESIF	European Structural and Investment Funds
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
EU	European Union
GSIB	Global Systematically Important Banks
IGA	Intergovernmental Agreement
IMF	International Monetary Fund
IPS	Institutional Protection Scheme
JST	Joint Supervisory Teams
MIP	Macroeconomic Imbalance Procedure
MTO	Medium-Term Objective
NCA	National Competent Agency
NIE	New Institutional Economics
NRA	National Resolution Agency
NSA	National Supervisory Authorities
NST	National Supervisory Teams
OCA	Optimal Currency Area
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
TSCG	Treaty on Stability, Coordination and Governance in the EMU

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Introduction

After the financial crisis of 2008 spread from the U.S. subprime mortgage market to the European financial system, some European states tumbled to the edge of default. In the EU it became apparent that while economic interdependencies are vast, economic and fiscal policy coordination as well as integration of banking regulation and resolution was insufficient. Enormous efforts have since then been made to tackle the crisis: Legal doctrines have been stretched, competences shifted, institutions build up and titanic resources invested to make the new institutions as credible as possible. The European Union has not only created a permanent crisis management body with paid-in capital of €80 billion, but also institutions overseeing financial institutions (ESM 2016). Therefore this study asks: *What logics drive the recent dynamics in European integration and what mechanisms are employed to pursue it?*

In light of the recent events, this study will review prominent theories of regional integration, namely neofunctionalism and intergovernmentalism. For a long time they seemed to offer contrasting explanations for why and under what conditions the European Union does, or does not, integrate. While neofunctionalism has long been discarded as a theory outmoded and disproven by events, this paper argues that the core logic of regional integration formulated by neofunctionalism is applicable to the recent developments in the Economic and Monetary Union (EMU) of the EU. Neofunctionalism however needs to be enriched by insights offered both by intergovernmentalism and the concept of incomplete contracts, developed in the field of new institutional economics.

Traditionally, neofunctionalism assumes that supranational institutions, such as the European Court of Justice (CJEU), the European Commission or the European Central Bank (ECB) are the main drivers of change. This assumption has been recently challenged as several scholars (e.g. Moravcsik et al.) detect a rise in executive governmentalism, which would be more in line with the theory of intergovernmentalism, which claims that integration is merely a result of the accumulated member states preferences. Not only could we observe a stronger role of national executives in crisis management, but also in the setup of the institutions. Integration now mostly takes place via non-traditional means: Agencies such as the European Stability Mechanism (ESM) instead of the traditional supranational institutions are empowered (i.e. Jabko 2014, p. 137;).

This thesis however argues, that their finding can only be preliminary. A more accurate picture is revealed when interrelated developments in the EMU as a whole are analyzed. The goal of this study is to further the understanding of integrational dynamics in EMU, whereat it fulfills a dual purpose: it is both theory-building and in its empirical section theory-testing. Using neofunctionalism as a theoretical skeleton to be modified by insights from intergovernmentalism and new institutional economics, testable hypotheses are derived in the first chapter.

The second chapter will discuss process-tracing and its purposes as the methodological approach of this thesis. This discussion will be followed by the third chapter that maps out the *dysfunctionalities*[1] that can be detected in the initial structure of the EMU. These dysfunctionalities are the independent variable of the core hypothesis that explicates the central mechanism which drives European integration: Functional spillovers resulting from the integration project itself, spurring further integrational moves.

Finally, the hypotheses are then tested in the empirical section, which is divided into three parts, forming a detailed within-case analysis. Firstly, two central policy proposals for the institutional development in the EMU, issued by the presidents of the most important institutions of the EU, are assessed according to their consistency with the hypotheses formulated above. Then, a reality check is conducted by analyzing the development in the fields of an emerging Fiscal Union and Banking Union.

Tracing the evolution of the EMU in fiscal and economic governance as well as in the field of banking surveillance and resolution, this study will consider both legal documents and scholarly analysis. For this purpose, key documents will be analyzed qualitatively to assess evidence to test the hypotheses according to the process-tracing method as outlined by Starke, Beach and Pedersen. Finally, as neofunctional theory is predictive in nature, the paper will conclude with an outlook on the highly dynamic policy fields of the Economic and Monetary Union.

[1] The term dysfunctionalities refers to the failure of a governance structure (i.e. the Monetary Union) using specific instruments (i.e. the country specific recommendations in the European Semester process, the ECBs monetary policy decisions) to effectively manage a policy area according to certain predefined goals (i.e. financial stability, low unemployment, stable growth).

1. Theorizing European Integration

Theorizing European integration has been a frequent exercise of political science in European Affairs. Integration for the purpose of this study will be defined as "the process whereby nations forego the desire and ability to conduct [foreign and] domestic policies independently of each other, seeking instead to [...] delegate the decision-making process to new central organs (Lindberg, 1963 in Wiener & Diez, p.47). These central organs can both be the grand supranational institutions such as the European Commission or the CJEU as well as highly specialized agencies, such as the Single Supervisory Board, situated at the ECB.

It is often portrayed that supranationalism and intergovernmentalism are the two poles between which integration can be pursued (i.e. Bickerton, Hodson & Puetter 2015b, p. 43;). The two classifications are however ideal types and in practice the institutional landscape becomes more diversified, while institutions with various degrees of institutional autonomy and accountability to various actors, both supranational and intergovernmental, emerge. Part of the descriptive outcome of this thesis will be the classification of the new institutions and mechanisms alongside the blurred traditional categorization.

While supranationalism is a mode of governance, intergovernmentalism is both a mode of governance and a theory of integration. As a theoretical framework intergovernmentalism assumes that member states governments are the central actors that drive and shape integration according to their preferences. On the contrary, neofunctional theory assumes that the integrational process is self-reinforcing and ultimately leads to the empowerment of supranational institutions, such as the European Commission.

The Economic and Monetary Union constitutes an excellent hard case for testing and refining neofunctional theory: If the theory holds even in contexts where fundamental state powers are at stake and reservations of member states to transfer power are to be expected, this would underline it´s explanatory power. The power to determine fiscal policy, a traditional core competence of sovereign states, would constitute such a crucial area for integration.

Though the predictability of institutional development is reduced when major interests are at stake, this study will scrutinize whether the core mechanism of functional spillover can still found

to be applicable in these policy areas. In recent contributions Sandholtz and Sweet argue that empirical work conducted to assess neofunctional theory should not be limited to "technical sectors, [or low politics areas] outside of intergovernmental control", but also include "the extension of new competences to EU organs" (cf. 2013, p. 27;). This analysis will be done in the empirical section of this thesis. It is important to note that the theorizing in this chapter is informed by the empirical material and that the construction of the hypotheses is part of the theory-building ambition of this study, alongside their later application to the empirical material.[2]

This chapter however will introduce the two theories of neofunctionalism and intergovernmentalism by explaining their origin, application, main proponents and critics. Furthermore, the theory of incomplete contracts developed in the field of new institutional economics will be introduced and adapted to the regional integration context as it offers precious insights in the mechanics of enabling integration in an EU where the transfer of competences via a treaty change requires ratification in 28 member states. Finally, hypotheses will be generated that combine elements of all three theoretical approaches, while the outcome is closest to a refined version of neofunctionalism.

1.1 Neofunctionalist Approaches

The aim of neofunctionalist theory is broad in scope: It aims to explain the course of institutional development in the EU. By giving a dynamic account of integrational processes, a general trend of deepening integration is highlighted (Sandholtz & Sweet 2013, p. 28). Originally, the theory has been applied in the area of economic policies stemming from the European Community of Steal and Coal. The application in today's grand economic project, namely the EMU, is thus closely related to the theories roots.

The theory of neofunctionalism was initially developed by Ernst Haas at a time when the Treaty of Rome was signed. His seminal work "The Uniting of Europe: Political, Social and Economic Forces" (1958) outlined the foundations of the theory. While Haas used as empirical reference the European Community of Coal and Steel (ECSC), Lindberg devoted his neofunctionalist work "The Political Dynamics of European Economic Integration" (1963) to the European Economic

[2] The research aim and method is explained in more detail in chapter 2 on process-tracing.

Community (EEC). Both authors highlight the "mechanisms of technocratic decision-making [...] and attach considerable importance to the *autonomous influence of supranational institutions*" (Wiener & Diez 2009, p. 46). But can the concepts of these classics enhance the understanding of recent integrational processes?

There have been periods in the history of European integration theory development where neofunctionalism was discarded as "outmoded and disproven by events", for example during the empty chair crisis steered by de Gaulle or the failure to realize ambitious integration plans in the early 1970s (cf. Sandholtz & Sweet 2013, pp. 18–9;). Even Ernst Haas himself declared it "obsolete and disproven by events" (Haas, cited in Wiener & Diez 2009, p. 53;). Rather, traditional realist theories like liberal intergovernmentalism have been considered more appropriate to explain developments at the European level, with a central focus on sovereign governments and national interest (ibid.).

But is neofunctionalist theory only a footnote in textbooks on European Integration? Wiener and Diez find that some critics overemphasize on the ambition of the theories predictive capacity. The assumption of an evolution from a political community to a superstate as a likely outcome of integration has been softened by the authors already in the sixties (2009, p.51). While nowadays it is widely accepted that integration is no steady or even linear process, the enormous integrative steps taken in the sphere of Economic and Monetary Union suggest that neofunctionalism should be reconsidered to explain regional integration. The following section will introduce the assumptions and mechanisms of neofunctionalism.

Crucial for neofunctionalist analysis is the term *spillover*, which is considered to be the driver of integration processes. Ernst Haas originally noted that spillovers, to be understood as cycles of feedback, occur "when actors realize that the objectives of initial supranational policies cannot be achieved without extending supranational policy-making to additional, functionally related domains" (Sandholtz & Sweet 2013, p. 20). Neofunctionalism distinguishes three types of spillover: cultivated, political and functional.

Cultivated spillovers refer to the dynamics that supranational institutions develop once they entered into existence. This type of spillover is hard to control and predict initially. A recent example

would be the dynamics the European External Action Service environment unfolds among the community of experienced diplomats. Political spillover occur when interest groups shift their loyalties, focus and resources to a new level of governance (cf. Fehlker, Ioannou & Niemann 2013, p. 111;). When political actors and intermediaries shift their efforts to the European stage, this can result in further integrative steps as the importance of the European Union as a bargaining arena is strengthened.

Finally, the core mechanism discussed by neofunctionalism, which I will also use to assess the integration in the EMU domain later on, are *functional spillovers*. These occur when certain goals in a policy area, e.g. financial stability in a monetary union, cannot be achieved without additional integrative steps, i.e. in the field of financial regulation (cf. Fehlker, Ioannou & Niemann 2013, p. 111;). In this case, integrational dynamics would for example spill over from monetary policy to financial regulation policies. In more general terms, functional interdependencies between economies lead, according to a neofunctional logic, to further integration by creating technical pressures that push states to integrate further (Wiener & Diez 2009, p. 49). These functional spill-overs have also been described by former Commission President Walter Hallstein as "Sachzwänge" or functional demands (cf. Heipertz & Verdun 2005, p. 996;). Those demands can be the result of *unintended consequences* of integration (cf. Fehlker, Ioannou & Niemann 2013, p. 111;), implying that member states which transfer competencies to the European level cannot anticipate their long-term consequences.

In this study, only functional spillovers will be employed in the analysis, since both political and cultivated spillovers can only be traced back over an extended period of time, while this analysis focuses on very recent institutional integration processes.[3] Therefore, the term spillover employed in this study is to be understood as functional spillover and will hereinafter be defined as "functional pressure, […] encompassing various endogenous interdependencies", which arise from within the European integration project, and "induce policy makers to take additional integrative steps" (Niemann & Ioannou 2015, p. 198). It is important to note that the endogeneity refers to the interdependencies that arise from institutional construct such as the monetary union

[3] For the analysis of both cultivated and political spillover longitudinal studies must be conducted that allow to make conclusions about shifts in allegiance and perceptions.

or the single market as such[4] – while those endogenous interdependencies can also be facilitated by external factors, as the recent financial crisis has shown.

Neofunctionalism assumes that spillovers occur mainly in the policy fields that are rather technical in nature and less politically contested. The aims in these policy fields, i.e. waste management or financial stability are undisputed, but need to be broken down into detailed technical implementation strategies, usually left for experts to decide. Functional pressure can however also, but is less likely to, trigger integration in sensitive policy areas, where resistance from states can be expected (cf. Tortola 2015, p. 127;).

1.2 Intergovernmentalist approaches

Intergovernmentalism is probably the most widely applied theory to explain European Integration (e.g. Franchino 2013, p. 324;). The roots of intergovernmentalism can be traced back to neorealist theory developed in international relation theory. Neorealism and intergovernmentalism[5] share the same core assumptions: States as the entities of analysis are perceived as unitary actors (i.), they are rational utility maximizers (ii.) and the anarchic nature of the international system (iii.) forces states to pursue strategies that increase their power to achieve relative gains (cf. Pollack 2013, p. 6;). Applied to the European context, European integration is perceived "[…] as a series of rational choices made by national leaders" in response to international interdependence (Moravcsik 1998, p. 18).

Liberal intergovernmentalism has refined some assumptions of traditional variants of intergovernmentalism. Preferences of governments are national and issue-specific and overall directed towards maximizing national welfare (Schimmelfennig 2015, p. 179). While liberal intergovernmentalism assumes that economic interests are primarily shaped by powerful interest groups

[4] One obvious example would be the interdependency a monetary union creates: The ECB adjusts the interest rate on the main refinancing operation according to the overall inflationary tendencies in the Eurozone to fulfill its mandate. Every country is therefore endogenously dependent on economic and financial developments in other euro area members, although the system as such is also exposed to external pressures (such as arising through currency wars in the abovementioned example).

[5] It is important to distinguish between intergovernmentalism as a mode of governance and as a theory of integration (Sandholtz and Sweet (2013, p. 28)). The first is a technical arrangement of rules and decision making-processes while the latter is supposed to offer an explanatory framework for integration. Throughout this thesis, the latter definition of intergovernmentalism will be applicable.

domestically, it assumes alongside the lines of traditional intergovernmentalism, that the state acts as a unitary actor in international negotiations to maximize its own utility (assumptions i. & ii.). In fact, liberal intergovernmentalism sees integration as a three-step process: Firstly the "domestic formation of national preferences", secondly "the intergovernmental bargaining to substantive agreements" and finally the "creation of institutions to secure these agreements" (ibid.). The design of the international institutions that are finally created can therewith be seen as "a function of the kind and size of co-operation problems they are supposed to manage" (Schimmelfennig 2015, p. 178).

In (liberal) intergovernmentalism integration is a means to fulfill the preferences of the member states governments rather than an end in itself. According to liberal intergovernmentalism, it is therewith exogenous to the integration project and cannot be explained endogenously by socialization or institutionalization processes, as the spillover dynamics in neofunctionalism would assume. In contrast to realist intergovernmentalism, states "do not pursue strategic geopolitical interests" but are focused on reaping economic benefits (Schimmelfennig 2015, p. 179), which narrows the state of anarchy that characterizes the international sphere (iii.). This refined version of intergovernmentalism is more applicable to the EMU-case, where certain policy options, such as waging war, are excluded among the community.

Intergovernmentalism as a theory of integration has been criticized for its non-falsifiability, since the concept of "member state preferences" is difficult to measure, while an outcome would need to be judged against the accumulated preferences to confirm or reject the theory. If EU organizations, such as the Commission, are observed to carry out the preferences of powerful member states by pursuing integration, the theory is confirmed. Alternatively, if the agent [such as the Commission] acts in its own self-interest against the will of the principal [the member states], this would lead to the same observations: When the national governments of the EU member states for example transfer power to the Commission and the CJEU to ensure the functioning of the internal market, the interpretation of the supranational institutions action is ambivalent. It might be seen as an action in the interests of the member states that can only achieve a goal such as the creation of a single market by delegating authority, which would underline the importance of national governments.

Alternatively the wide mandate of establishing and ensuring the functioning of the internal market might also be used by the supranational authority to "creep in" to certain areas that have not been considered to be transferred by the principals beforehand. The "vagueness" of the mandate of supranational institutions such as the Commission or the CJEU can be understood as an incomplete contract, in which not all eventualities are accounted for in the initial agreement, which is in this case the Treaty of the Functioning of the European Union (TFEU). The theory of incomplete contracts will be introduced in the following subchapter while its relevancy for political science in general and the case of EMU in particular will be assessed.

1.3 Theory of incomplete contracts

The theory of incomplete contracts has been developed in the field of new institutional economics and has been applied in political sciences. For the purpose of this study, the core concept of incomplete contract theory will be utilized as an analytical tool rather than a self-standing theory of European integration. It aims to facilitate the understanding of different forms of conducting integration rather than to serve as a theoretical framework that seeks to explain the mechanisms of regional integration.

The core idea is that a principal, who wants to exploit efficiency gains via delegation, faces information shortfalls while both the principal and the agent are unable to predict all possible contingencies. Usually, mechanisms of governance are established to control the discretion of the agent to reduce independent and self-interested action by the agent. The spectrum of delegation reaches from an arms-length control of the agent to a comprehensive transfer of authorities (Doleys 2009, p. 487;).

Ideally, contracting parties articulate behavioral expectations and specify appropriate responses across all contingencies that might arise over the lifetime of the arrangement. However, due to information shortfalls and their own limited cognitive capacity (bounded rationality), contracting parties are unable to predict, much less plan for, all possible contingencies (Simon, 1957). The solution to overcome unpredictability would be to agree to a complete contingent contract, where each potential setting is sketched out ahead of time. Complete contingent contracts are however impeded by the transaction costs of contracting, as every possible scenario would need to be accounted for beforehand (Scott & Triantis 2005, pp. 189–90;).

The inability to plan comprehensively however does not prevent contracting. Parties will still endeavor to articulate and cement their expectations (at least up to the point that the transaction costs of doing so exceed the anticipated benefit of the contract). Rather, the combination of irreducible uncertainty and bounded rationality means that all but the simplest contracts will be unavoidably incomplete and expose co-operating parties to certain risks. Chief among these is the risk that a contracting partner may find it beneficial to exploit ambiguous or otherwise underspecified contractual provisions to serve selfish ends. Aware of these risks, contracting parties seek to enhance the credibility of their commitment by *institutionalizing* the terms of their relationship.

They do this by adopting a 'mechanism of governance' (Williamson, 1996). The mechanism assigns authority to take decisions when rules do not apply, to design new rules and to ensure existing rules are enforced. Governance mechanisms may take many discrete organizational forms, but all can be placed on a continuum from 'market' and 'hierarchy' – where the former indicates reliance on de-centralized arms-length interactions and the latter involves a comprehensive transfer of authority (Williamson, 1975; Doleys 2009, p. 487;). Adopted to the context of European governance the continuum can be placed between highly independent supranational institutions and organs which are directly controlled by member states governments.

1.4 Theorizing European Integration: A battle of ideas?

Is the effort to explain European Integration and identify its mechanisms merely an activity of sidelining with a particular school of thought? Certainly this would be both an exaggeration and simplification of the research that has been conducted in the realm of European Integration theory. There is a tendency to overemphasize theoretical differences and streamline theories to make a case. Especially neofunctionalism and intergovernmentalism have often been portrayed as rival alternatives to explain European integration.

The differences between the two theories have been highlighted in the respective section: While neofunctionalism assumes that integration is a self-reinforcing process, where technical spillovers perpetuate integration, intergovernmentalism assumes that the EU is in effect the sum of the preferences of its member states, integration being just one variable that is brought to the negotiation table. Having emphasized on the differences it is worthwhile to also point out their

similarities. While the two theories disagree about the causes of integration, both "converged in their assumption that integration entailed the empowerment of supranational actors" (Bickerton, Hodson & Puetter 2015a, p. 706).

This will be an interesting starting point for analyzing the mechanisms of integration. As the theory of incomplete contracts offers a tool to assess the different configurations of integration, it enables a more nuanced view on whether integration is driven by member state governments playing out their preferences or by functional spillovers inevitably leading to stronger supranational institutions. Whether integration is only pursued by strengthening supranational institutions can at least be questioned and will be scrutinized in the empirical section on the basis of the hypotheses derived in the next section that are mainly motivated by neofunctionalism.

1.5 Deriving hypothesis

To make the theoretical framework testable in the empirical section on the Economic and Monetary Union, this section will derive clear hypothesis that will structure the assessment of the reforms that have taken place in the financial, fiscal and political realm of the EMU. The section furthermore briefly discusses the operationalization of the hypothesis for the empirical section. The basis of formulating the hypothesis in this section is neofunctionalism. Neofunctional elements are included in all six hypotheses and neofunctionalism forms the logical skeleton of all hypotheses.

> *H_1: Dysfunctionalities of a governance framework will lead to further integration in that policy field. This effect is intensified by political pressure caused by the dysfunctionalities.*

Dysfunctionalities typically occur when a governance framework[6] is not able to deliver the desired results. If, for example, financial stability is the main aim of a regulatory framework on the European level, but implementation is pursued by national bodies that have an interest to pursue national ring-fencing that harms the overall financial stability of the Eurozone, the hypothesis would suggest that this will trigger an integrational move towards the European stage. The hypothesis encapsulates the mechanism of functional spillover and supplements it with the condition that the actors who drive the integration process are pressured to act by those very

[6] A governance framework is understood as the set of rules and institutions that are regulating a particular policy area.

dysfunctionalities. Fehlker et. al argue in a neofunctionalist tradition that the multitude of functional spillovers triggered by the crisis worked as a catalyst to transform the preferences of political decision makers towards further integration (2013, p. 115). This is exactly the notion that neofunctionalism is supplemented by political pressure endogenously explained by the dysfunctionality of the governance framework.

Slightly refined this hypothesis could also be formulated on the basis of intergovernmentalism: When the dysfunctionalities inherent to the governance system force member states to change their policy preferences and therewith push for further integration in a specific policy field, integration will ultimately materialize. The dysfunctionality of the governance framework is the independent variable which influences the dependent variable: Further integration in the policy field where the dysfunctionality is detected and causes political pressure. In other words the dysfunctionality is the main independent variable that is mediated by the variable political pressure.

H_2: Integration is most likely to take place in highly technical areas.

Technical	Non-technical
Vague and indirect effect on citizens	Directly recognizable effect on citizens

This hypothesis assumes that the more technical a policy field is, the greater is the chance for further integration. When there is less public contestation of both the aims and measures of reforms, integration is more likely to happen. This is a traditional assumption of neofunctionalism and therefore needs to be included in the catalogue of hypotheses aiming to test neofunctional theory. It is, however, not unproblematic since a convincing and standardized measurement of the degree of "technicality" is not available. This paper assumes that the greater a policy decisions direct effect on citizens is, the less technical a certain field is.[7] The paper will treat "technicality" as a bivariate variable (technical vs. non-technical) and determine on a case-by-case basis whether a certain policy field is to be considered as technical or non-technical.[8]

[7] Obvious examples for a direct effect on citizens would be a change in the income-tax or the decision to wage war, which is likely to be associated with a particular government. On the other hand, a change in the rules governing the risk assessment of a particular financial asset or in the safety requirements of insulating materials for public-housing projects would be considered to be technical.

[8] Further improvements in how to operationalize the concept "technicality of a policy area" would be welcomed by the author in future studies.

H_3: Integration in technical policy areas will increase the power of supranational institutions relatively to intergovernmental arrangements.

This hypothesis suggests that in technical policy areas, supranational institutions, such as the CJEU, the European Commission or the European Central bank will gain power and competences if integration is pursued. Alternatively, new supranational institutions might be created that acquire competences formerly located at the national level. This also indirectly implies, that whereas less technical issues that have a directly recognizable effect on citizens are at stake, influence of intergovernmental arrangements will get considerably stronger. This influence can be asserted directly through individual governments or indirectly through bodies where decisions are being made on an intergovernmental basis, i.e. the Council of Ministers, the European Council or newly created intergovernmental institutions and mechanisms. Determining the power of an institution and the actors involved in a particular governance framework however is not a straightforward exercise. Just looking at the formal set-up might not give a precise picture of how decisions are actually being made.[9] Since the institutions analyzed in the empirical section have come into existence only recently, the analysis nonetheless relies on the legal statutes.

H_4: Integration in technical policy areas will lead to a deepening also in non-technical policy-fields of European integration and eventually to overall stronger political integration.

This hypothesis refers to the spillover-mechanism that has been developed in neofunctional theory. Early predictions on political integration driven by the EMU (i.e. Calmfors 1997) did however not materialize. As this hypothesis is hard to test at the beginning of an integrational move in a rather technical field, it will also be assessed on the basis of the outline important policy proposals provide.[10] This will enable a discussion on prospective changes, bearing in mind that proposals are yet to be implemented or rejected in order to validate or falsify the hypothesis.

[9] If, for example, a governance body is composed of both member states representatives and an independent chair, the strength of the supranational element in that particular set-up is determined by the decision-making culture: If decisions are usually made in a consensus-style with a strong role of the chair that brings up innovative solutions, this is different to a setting, where majority-voting is frequently conducted.

[10] Namely the four- and five-presidents report (2012; 2015)

H_5: Incomplete contracts between the principals (member states) and the agents (supranational institutions) are an essential feature of integrational processes in EMU.

H_6: Incomplete contracts result in the agents filling up the space left undefined by the initial contract.

To reduce the highly complex negotiations between the 28 governments of the EU member states, not every contingency will be covered by the treaties concluded by the respective parties. This is especially likely in cases where a substantial transfer of sovereignty is attached to an agreement. The principals are more willing to transfer sovereignty piece by piece when the need arises. Where the legal situation is blurred, agents can fill up the space and encroach on competences that are not unambiguously assigned to a particular governance level. Incomplete contracts therefore allow transcending the rigidity of a complex governance structure and provide a tool to deepen integration, without incurring the short-run costs imposed by political opposition to further integration. This is completely in line with neofunctional theory and would in intergovernmentalist terms offer a tool to mediate contradicting government preferences.

H_6 encapsulates the tendency observed in new institutional economics: Agents have a self-interest to increase their power and resources and are able to do so when their mandate, which is an incomplete contract, allows them to. Furthermore the hypothesis is in line with the neofunctional logic: Integration is self-perpetuating. Whereas the consequences are the same, the causality is different: While in neofunctionalism the driving factor of integration processes lies in the endogenous functional necessities the integration project itself creates, the abovementioned hypothesis sees integration partly as a result of the agents exploiting the contingencies of the contract between them and the agent.

As mentioned in the beginning of this section, neofunctionalism forms the logical skeleton of all hypotheses. H_1 however qualifies the neofunctional mechanism with the element of political pressure – predominately to be found in traditional intergovernmentalism as outlined above. H_2, H_3 and H_4 are all derived from neofunctional theory. Finally, H_5 and H_6 substantiate the core process of self-reinforcing integration as formulated in neofunctionalism by a tool commonly found in principal-agent theory: incomplete contracts.

	H_1	H_2	H_3	H_4	H_5	H_6
Neofunctionalism	X	X	X	X	(X)	X
Intergovernmentalism	X				(X)	
Incomplete Contracts					X	X

Table 1: Theoretical ingredients of the derived hypotheses

2. Process-Tracing: A multi-purpose method suitable both to build and to test theory

The following section will introduce process-tracing as a qualitative method to both build and test theories and as a technique to analyze causal mechanisms that are either inductively derived or deductively tested. After briefly introducing the origins and purpose of the method, the strengths and weaknesses of process tracing will be highlighted in the context of the case under investigation: Integrational dynamics in the EMU.

Process-tracing was initially developed in the field of psychology in the late 1970 to detect cognitive developments, but has travelled disciplines as George and McKeown have adopted the method for social sciences (Starke 2015, p. 455). Generally, process tracing is a method of causal explanation, which aims to investigate a particular case (within-case analysis) and does not investigate correlations among a set of different cases (cross-case analysis) (cf. ibid). Although mostly only one case is observed, it can be distinguished from historically descriptive studies, as the approach is more theoretical and abstract (Starke 2015, p. 453). Furthermore, while most case studies are focusing on detailed particularities of a single case without the ambition of generalizations, process tracing is more theory-centered and aims to either develop or test generalizable causal mechanisms by conducting a detailed study of a single case (Beach & Pedersen 2013, p. 9).

Realizing that "process-tracing" has often become a buzzword in the scientific community without a clear outline on what the research aim and the method actually is about, Beach and Pedersen develop a typology and differentiate three variants of process-tracing: "theory-testing, theory-building and explaining-outcome" (2013, p. 3;).

In *theory-testing* process-tracing ”a causal mechanism is hypothesized to be present in a population of cases of a phenomenon”, with the goal of evaluating whether the hypothesized causal mechanisms linking independent and dependent variable is actually present and functions as predicted by the theory (Beach & Pedersen 2013, p. 11). As Beach and Pederson put it, “the ambition is to go beyond correlations and associations between X and Y, opening up the black box of causality to study more directly the causal mechanism whereby X contributes to producing Y” (ibid.). Theory-building process-tracing on the other side involves “building a theory about a causal mechanism between X and Y that can be generalized to a population of a given phenomenon”, which usually is applied in cases where there is little previous knowledge about a mechanism (Beach & Pedersen 2013, p. 11). Finally, and according to the authors employed most-commonly, is the explaining-outcome process-tracing that aims to explain particular historical outcome, such as World War I (Beach & Pedersen 2013, p. 11).

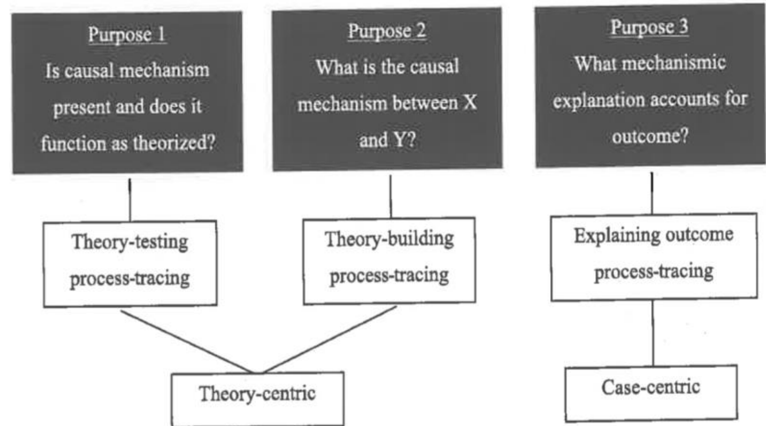

Figure 1: Process-tracing typology outlined by Beach & Pedersen (2013, p.12)

Beach and Pedersen argue that process-tracing methods have three distinct research purposes, the two authors also point out that the theory-generating and theory-testing approaches overlap and interact. While Bennett also distinguishes between inductive theory-generating and deductive theory-testing process-tracing, he however argues that a balance between the two needs to be found in any particular study. This balance would need to “depend on the prior state of development of relevant theories on the phenomenon as well as the researcher's state of knowledge about the phenomenon and the case” (Bennett 2009, p. 704). Therefore, this study has a dual purpose: it is both theory-building and theory testing, while the ambition of both needs to be qualified. A mere theory-building exercise would in the particular case be both unambiguous and ignorant, since there has been a lot of theorizing on European Integration for many decades that would be foolish to discard. We are certainly not left "in the dark" about integration processes as

Beach and Pedersen describe it, though there is a need to improve the theories at hand to be able to understand recent integrational moves.

Therefore this study connects to the existing body of regional integration theory literature to reformulate and refine neofunctionalism as a theory-building exercise, which enables a clearer definition of the causal mechanisms that are at place in the case of European Integration. For that reason, theory-elaboration is a central part of this study. It must be stated that the collection of empirical data and the processes of theorizing are in dialogue and inform each other: Without identifying the mechanics of how authority is delegated in the EU by assessing the relevant legal documents, it would have been impossible to embed the theory of incomplete contracts in a neofunctional framework.

Instead of seeing theory-building process-tracing as "facts before theory" and theory-testing as "theory before facts" (Beach & Pedersen 2013, p. 16) as mutually exclusive, this study takes a different approach: Rather than deductively deriving hypotheses from a coherently and exhaustively formulated theory to test them on a particular case, this study reformulates theory by adding aspects of intergovernmentalism and the incomplete-contract-theory to the neofunctional base frame. While this step can be subsumed under the theory-building block outlined above and is clearly informed by the facts collected before the hypotheses have been constructed, the thesis does not stop at this point. Furthermore it sets out to use the hypotheses as a framework for the analysis in the empirical section. This analysis is clearly oriented along the lines of the theory-testing version of process-tracing. It does however not claim to ultimately validate or falsify the hypotheses that set out the causal mechanisms for integrational moves – since the specific case, the EMU, is in amidst of reform processes that are ongoing and can only be judged retrospectively. The analysis of the recent developments in the EMU according to the hypothesis formulated in the first chapter does however allow for a preliminary assessment of the usefulness of the theoretical compilation developed above.

One of the most obvious advantages of process-tracing as a method is the openness for different sources of data - It can be both public or restricted, qualitative and quantitative. Research on the development of EMU is an excellent example where a variety of sources, depending on the questions asked and the hypotheses generated, could be considered: Interviews with civil servants,

non-paper documents circulated in the Councils working groups, drafts of legal acts, initiatives formulated by the European Commission, statistical data on trade balances, etc. This study relies on academic sources and official documents released by the European Institutions. Central for structuring the data is the dimension of time. Actors, processes and important events, alongside vital decisions for certain policy options have to be selected to detect the mechanisms that drive the development of the specific processes under investigation (Starke 2015, p. 464).

3. The independent variable: Dysfunctionalities and resulting pressures

The following section will present the dysfunctionalities that have become apparent since the outset of the several crises in the European Union that can be traced back to 2007. Starting of as a financial crisis it merged into a sovereign-debt crisis as national governments bailed-out their national banks. Finally it resulted in an economic recession which further reinforced the vicious circle and revealed the institutional design flaws of the EMU. While not all of these shortcomings have been unheard of before and have in some cases even been extensively discussed beforehand, the pressure to solve these dysfunctionalities increased dramatically with the outset of the crisis as the economies shrank, sovereign debt skyrocketed and unemployment soared (i.e. Arestis & Sawyer 2012). In the core hypothesis H_1, as presented in chapter 1.4, the dysfunctionalities are the independent variable that ultimately facilitate integration when the dysfunctionality is accompanied by political pressure. This has been the case in the aftermath of the crisis, as creditors to the struggling European member states demanded austerity measures and structural reforms which traditionally come at considerable political costs. These developments finally led to a reconsidering of the institutional underpinnings of the EMU. Four dysfunctionalities can be made out in the EMU, which will subsequently be addressed. Figure 2[11] depicts the link between the dysfunctionalities presented in this section and the institutional developments to be scrutinized in the next chapter.

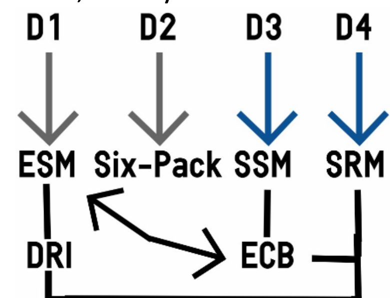

Figure 2: Link between Dysfunctionalities and the institutional landscape

[11] Figure 2 provides an overview of the link between the dysfunctionalities and institutions whereas the governance structure, working methods and legal basis of the latter are further elaborated in the empirical section.

D1 and D2 have triggered integration in the fiscal realm while D3 and D4 have resulted in integration in financial policies.

3.1 D_1: Strict no-bail-out clause was not credible

When financial convergence took place in the first nine years of the Economic and Monetary Union, a general trend of risk-premium convergence on government bonds could be observed. Although states had different economic outlooks and had been to varying degrees indebted, the interest rate paid on riskier government bonds was only marginally higher. Although macroeconomic fundamentals like productivity, trade balance, debt to GDP ratio or trade balance varied considerably, this did not have a great effect on the assessment of a countries risk to default by the financial markets. In fact the convergence trend resulted in almost equal interest rates on government bonds throughout the Eurozone. The assumption that governments would always de-facto be bailed out by other European governments if they are at the edge of default, although the bail-out clause in Article 125 TFEU prohibits this action, was openly challenged in the case of Greece after it became apparent that the budgetary statistics previously published had been incorrect. This lead to huge risk spreads when market actors became uncertain about the debt sustainability (Hadjiemmanuil 2015, p. 9).

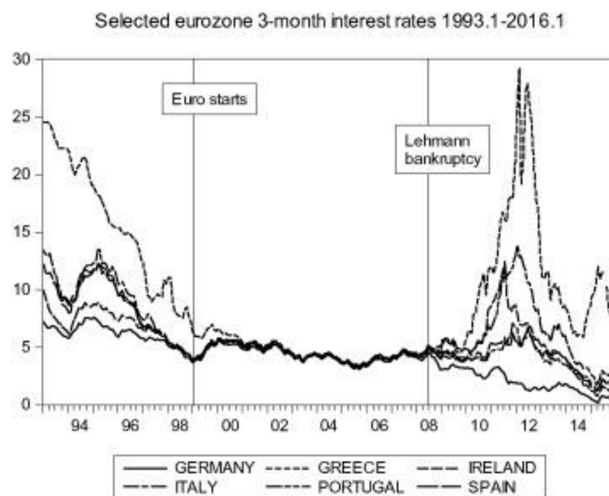

Figure 3: Interest rates on government bonds (Wickens 2016, p. 2)

3.2 D_2: Fiscal Rules laid down initially in the Stability and Growth Pact were not credible

Adopted in Amsterdam in 1997, the SGP represented a rules-based system that limits the scope of fiscal policy rather than a coordinated system of fiscal governance in which budgetary questions are solely a matter of political decision. That rules-based system consisted of a European Council resolution as well as two regulations[12], defining the discretionary powers of both the Commission and the Ecofin Council (Smits 2015, p. 1142). The problem with that rules-based system was that the enforcement of the rules turned out to be not credible. Before reforms have been undertaken, the Ecofin Council had to agree by qualified majority vote on sanctioning a member

[12] Regulation 1466/97 and Regulation 1467/97

state that is in violation of the budgetary stability criteria, defined as a maximum budget deficit of 3% of GDP and a maximum debt to GDP ratio of 60%.[13] The failure of the system became apparent when France and Germany both failed to meet the deficit targets but prevented sanctions by reaching a compromise in the European Council (Collignon 2004).

3.3 D_3: European financial markets but national surveillance

Initially, banking supervision was to be left at the national level, centralization being minimal and limited to the Committee of European Banking Supervisors that had been established in 2004 and only served as an advisory body (Schimmelfennig 2014, p. 325). During the first nine years of the euro, integration indicators showed a steady path to convergence and financial market integration, while in 2007 40% of the euro area´s interbank claims stood against non-domestic banks (Abascal et al. 2015, p. 21). Steadily increasing throughout the early 2000s, the level of financial integration reached its peak around the beginning of the subprime crisis in 2007, which marked a key turning point. Since then, European financial markets have fragmented considerably, spurred by the turmoil surrounding the Lehman Brothers default and the subsequent sovereign debt crisis in the euro area. While in the retail market strong barriers to integration have remained, the financial sector integrated rapidly resulting in a decreased spread of banks funding costs (Ibid.). This could have also lead to a convergence-overshoot in the sovereign bonds market, a trend that has abruptly reversed since the outbreak of the crisis (Abascal et al. 2015, p. 21).

This approach to banking supervision and resolution went fine so long as there were no massive and structural problems of defaulting loans. After the financial crisis however spread from the US housing market to the European financial system, the pressure that build up revealed the dysfunctionalities of the current governance system: The national banking supervisory agencies from the core member states tended to ring fence their banking systems in an effort to prevent contagion from the southern European states, also referred to as "periphery countries" (Abascal et al. 2015, p. 21). This might have made sense from a domestic point of view, but proved to be dramatic for the Eurozone as a whole: Between 2007 and 2011 alone, "the average exposure of core European Union banks to periphery banks dropped by 55% and the percentage of cross-border collateral used for Eurosystem credit operations dropped by one third" (Abascal et al. 2015,

[13] Protocoll Nr. 12 TFEU, Art. 1

p. 21). This meant that capital flowed out of these periphery countries and increased the stress both for the local financial system and the whole economy as sources of financing business dried up.

3.4 D_4: Financial market integration but domestic banking resolution

Ultimately, the banking crisis exacerbated by the national regulatory framework lead to a sovereign debt crisis, for several reasons. Firstly, the crisis initiated a vicious sovereign-bank cycle, in which governments struggled to access primary markets to place government bonds because only few investors would take the risk to buy government bonds of countries that face a significant risk of default. As a consequence, the prices of repurchase-agreements (repos) became dependent on the nationality of the counterparties and their underlying collateral, further exacerbating the problem. The approach by many national governments to bail out domestic banks further increased fragmentation of the banking market while the European Commission, due to special circumstances, authorized 400 decisions on national state aid measures to the financial sector, amounting to the enormous sum of €592bn (Abascal et al. 2015, p. 22).

The problem of both ineffective banking resolution and banking surveillance governance has been theoretically assessed by Schoenmaker with his well-received Financial Trilemma (2013), inspired by Mundell and Flemings model of a monetary trilemma. The Financial Trilemma states that the three goals of “a stable financial system (i), international banking (ii), and national financial policies for supervision and resolution (iii) are incompatible with each other” and cannot be achieved simultaneously: At least one goal needs to be compromised (Schoenmaker 2013, p. 8).

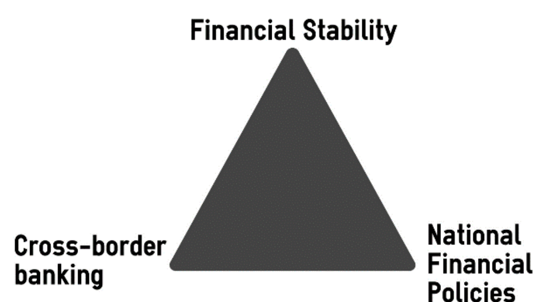

Figure 4: Financial Trilemma

4. The evolving landscape of the Economic and Monetary Union

The crisis triggered enormous integrative steps in the Economic and Monetary Union. Measures taken in different policy areas of EMU are mutually dependent upon each other, which is also expressed by the institutional links between organs that work in these policy fields. This is especially obvious for the areas of fiscal and financial policies: Bank failures and national attempts to safeguard the respective national banking industry led to serious fiscal constraints of certain

member states, e.g. Ireland. While the enhanced framework of fiscal coordination, the European Semester, has a strong focus on reinforcing the formal rules laid down previously in the Stability and Growth Pact (SGP), the grant project of constructing a Banking Union is a consequence of the fiscal constraints governments faced due to the banking crisis. Both insufficient and uncoordinated banking regulation and surveillance as well as the bank-sovereign loop have been identified above as major flaws of the EMU governance architecture.

This chapter is divided in three sections. First, the two prominent policy-proposals, the four and five president's reports, backed by the heads of the most important European institutions, will be analyzed alongside the hypotheses derived in the first chapter. The actual developments after the financial crisis hit in 2008 will then be sketched out both in the realm of fiscal and financial policies.[14] The analytical core subsections are 4.1.3, 4.2.6 and 4.3.3 where the hypotheses are evaluated based on the evidence provided in that section. A final evaluation of the hypotheses will be conducted in chapter 4.4.

4.1 Top-down integration: Towards a stronger Political Union?

The presidents of the most powerful European bodies issued both in 2012 and recently in 2015 their proposals for the institutional development and European integration as a response to the financial crisis that reveal the weaknesses of the EU's economic and financial governance structure. As these proposals are the central documents around which discussions on enhancing EMU have been conducted, it will be assessed whether the steps they outline for the development are consistent with the hypotheses derived above.

4.1.1 The four presidents report

As a reaction to the financial and banking crisis, leading to the fiscal crisis faced by some member states of the European Union, Herman von Rompuy, then president of the European Council, issued, in coordination with the presidents of the Commission, the ECB and the Eurogroup, a report. This report was supposed to serve as a starting point for discussion about further integration in

[14] As for most parts, the institutions just came into existence and only recently started to operate, the following analysis needs to be understood as explorative, while recommendations in how to operationalize future assessments for theory-testing in future studies will be provided throughout this chapter additionally.

the EMU and as a first blueprint for further integrational steps. The following section will scrutinize the arguments and implied logic therein.

The main argument for further integration brought up by the report is the fundamental political pressure that has been exerted during the financial crisis and the weak response of the EU (van Rompuy 2012, p. 2). The report addresses four different areas in which integration would be necessary to achieve the aims of ensuring "economic and social welfare". These areas include financial, budgetary/fiscal and economic policies as well as institutions and mechanisms that ensure the democratic legitimacy of the enhanced competences (van Rompuy 2012, p. 3).[15]

Financial Union

The Authors justify the need for further integration in the financial stability realm with the substantial shortcomings in the regulatory framework. These dysfunctionalities would have materialized during the crisis via tremendous and costly bail-outs. For this reason, the report suggests to "elevate responsibility for supervision to the European level", to provide "common mechanisms to resolve banks and guarantee customer deposits" (Ibid. p.3). The shortcomings of the existing financial regulation framework would ignore the "deep interdependences resulting from the single currency" (Ibid. p.4). Furthermore, certain rules should not only apply where the euro area is concerned, but also where the unity of the single market is endangered in general, which also includes member states whose currency is not (yet) the Euro.

Fiscal Union leading towards a stronger Political Union

While deeper integration in the sphere of fiscal policies is deemed necessary to "ensure sound fiscal policy making at the national and European levels", the report implicitly addresses government defaults and immense risk spreads during the sovereign debt crisis. It remains, however, imprecise about how a post-crisis institutional setup should be designed. Thought is given to "common debt issuance" and "different forms of fiscal solidarity" (Ibid. p.3). Furthermore both an enhanced economic policy framework to promote growth is demanded alongside measures

[15] The second and third section of the empirical chapter follows the distinction that is made by both reports namely financial (i.) and fiscal (ii.) policies while economic policy is understood to be linked with fiscal policy both through the mechanism of economic coordination (the European Semester) and the Structural Funds of the Multiannual Financial Framework. The aspects of political deepening of the EU, which is important to assess H_4, have so far only been outlined in the policy proposals and not been conducted. Therefore, a premature analysis has to be conducted on the basis of the two policy proposals.

that would safeguard the legitimacy of the decisions made, referring to political spillovers that would need to accompany integration in fiscal policies. Stronger fiscal integration would raise institutional questions of democratic legitimacy. Since the sovereignty over the budget has traditionally been the crown jewel of parliamentary democracy in Europe, a move to a more integrated Fiscal Union would require "legitimate and joint decision-making" (van Rompuy 2012, pp. 6–7).

4.1.2 The five presidents report

In the so called five presidents report, the presidents of the European Commission, Jean Claude Juncker, the European Council, Donald Tusk, the European Parliament, Martin Schulz, the European Central Bank, Mario Draghi and the head of the Eurogroup, Jeroen Dijsselbloem lay down their vision for reforming the Economic and Monetary Union. The report is separated in four sections describing the areas of reform, namely financial, economic, fiscal and political Union. The following analysis shows that integration in these areas is described as mutually reinforcing, triggered by dysfunctionalities that have been apparent in the EMU.

The article starts with interlinking the four policy domains of the EMU which would need to "develop in parallel" while "all euro area members" would need to participate in all four Unions (Juncker et al. 2015, p. 5;). The five presidents are clear about the consequences for the member states in that they would need to "accept increasingly joint decision-making on elements of their respective national budgets and economic policies" (Juncker et al. 2015, p. 5). These steps, implying further integration in realm of both fiscal and economic policies, are portrayed as necessary to foster economic convergence (cf. ibid.). Furthermore, the presidents demand that the initial crisis mode, dominated by intergovernmental agreements such as the Treaty for Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), the Euro-Plus Pact or the ESM Treaty, would need to be replaced by supranational solutions, integrated in the EU framework (Juncker et al. 2015, p. 7;).

Though not mentioned explicitly, the report draws on arguments derived from the optimal currency area (OCA) theory[16], which says that in order for establishing a functioning monetary union,

[16] The conditions that characterize an optimal currency area include flexible labor markets (i.), capital mobility (ii.), effective fiscal transfer mechanisms (iii.) and similar business cycles among the regions participating in an OCA (iv.). The theory has been developed in macroeconomics.

flexible labor markets should be encouraged, while they would constitute an "economic necessity" (Juncker et al. 2015, p. 9). The report suggests to strengthen the social dimension of the European Semester and calls for further integration in the area of social policies, traditionally a domain of the member states (Ibid.). While the Economic Union is one component of the EMU, it should be "accompanied by the completion of a Financial Union", since they would be "complementary and mutually reinforcing" (Juncker et al. 2015, p. 11;). That argument implies the logic of a spillover mechanism: Once the Economic Union progresses, integration in financial policies needs to follow suit.

Another spillover triggered by the financial interdependencies in a monetary union would be the establishment of a single banking system. One central element of complementing the Banking Union would be the introduction of a European Deposit Insurance Scheme (EDIS), to ensure confidence in banks regardless of where their headquarters are located. The report sees in the negative "bank-sovereign feedback loop" the reason for the dramatic consequences of the financial crisis and the EDIS as a necessity to finalize the Banking Union. After a single bank supervision and a single bank resolution mechanism have already been introduced after the crisis, national deposit guarantee schemes would always remain vulnerable to asymmetric shocks (Juncker et al. 2015, p. 11;). Another measure of strengthening the Banking Union would be to make the bank rescue mechanism of the ESM more accessible, implying less discretion for individual member states and further integration (Juncker et al. 2015, p. 11).

While during and after the financial crisis companies from southern and northern European countries faced huge risk spreads since banks in the South restrained their lending activities, the report suggests to construct a Capital Markets Union, so as to give companies more diversified access to capital (Juncker et al. 2015, p. 12;). This implies that erecting a single market where companies compete in an economic area which ensures the freedom of goods and services, also needs to ensure the effective freedom of capital, currently restricted by national regulation and the structure of the banking industry. The dysfunctional stress in times of crisis would arise from the dire situation of companies in countries were banks dramatically restrain their borrowing as opposed to states where banks are more free to expand their credit lines. A consequence of the stronger integration of capital markets would be that the "gradual removal of remaining national barriers

could create new risks to financial stability", which is why also the supervisory framework would need to be strengthened, ultimately resulting in a "single European capital markets supervisor" (Juncker et al. 2015, p. 12).

Another necessity of a well-functioning economic and monetary union would be the capacity to have effective macroeconomic stabilization policies in place such as to deal with asymmetric shocks, "that cannot be managed at the national level alone" (Ibid., p.14). This capacity would need to be performed in accordance with a "further pooling of decision-making on national budgets", meaning a shift of decision making power to the European stage. As a short-term solution, the appointment of a European fiscal board as an advisory body on the overall fiscal situation of the euro area is suggested (Juncker et al. 2015, p. 14), which already came into existence in November 2015 (European Commission 2015). Regarding centralization of fiscal competences, the report remains ambiguous: While certain competences should remain at the national level, it suggests that a European treasury could be installed to exert new fiscal competences (Juncker et al. 2015, p. 18).

Finally, the report argues that integration in the economic, financial and fiscal domain would need to be followed by political integration to ensure the democratic legitimacy and accountability of the decision that are shifted to the European level. In fact, the report sees institutional strengthening as "a natural consequence of the increasing interdependence within EMU" (Juncker et al. 2015, p. 17). Another consequence of the strengthened competence in the EMU sphere would be the unified external representation of the Eurozone, especially in the International Monetary Fund (IMF). This idea has been substantialized with a Commission proposal that draws on Article 138(2) TFEU as a legal basis to establish a unified external representation of the Eurozone in international financial institutions, starting with the IMF.

4.1.3 Conclusion on the policy proposals

A preliminary assessment of the abovementioned hypothesis on basis of the central policy proposals put forward by the presidents of the leading European institutions reveals that the reports see dysfunctionalities of a governance framework as a trigger for further integration. This would be in line with the logics outlined in H_1. The reports remain inconclusive about whether integration is more likely to take place in technical policy areas, so no evaluation on H_2 can be conducted

in this section.[17] The proposals specifically advocate the empowerment of supranational institutions instead of the reliance on intergovernmental agreements. This however is hardly surprising, given that most of its authors are heading the European supranational institutions. Nonetheless, a first consistency check reveals that H_3 could possibly be confirmed in the empirical section. According to the outline provided by the reports, integration will spill-over from technical policy fields and should finally lead to a political deepening of integration as H_4 predicts. Since incomplete contracts have only been implicitly referred by stating that the TFEU allows for shifting further competences in financial supervision to the ECB, no qualified statement on H_5 and H_6 can be made.

4.2 The Fiscal Union

This section will outline the integrational steps that have taken place under the "Fiscal Union" heading. It starts with describing the point of departure: The Stability of Growth Pact that was aimed to guarantee stable state finances and has been considerably reformed since the crisis, due to the dysfunctionalities elaborated in chapter 3. The reforms pursued are then explained and it is shown how they affected the institutional balance of power. As the European Semester has been one of the recently introduced novelties, this section also discusses the link between economic coordination via the Semester and the Multiannual Financial Framework, which has only recently been linked to the former via the Structural Funds.

Furthermore, it will be analyzed how the crisis brought about the European Stability Mechanism which finances member states that struggle to emit government bonds at the capital markets and scrutinize its specific institutional setup. Ultimately, it will be assessed how the ECB extended its role by introducing new unconventional monetary measures aimed at preserving financial stability – an explication of an incomplete contract that clearly had not been foreseen by all principals that designed it.

4.2.1 The Stability and Growth Pact (SGP)

The TFEU contains two provisions that govern the coordination of economic policies, namely the Multilateral Surveillance Procedure (MSP), enshrined in Article 121 TFEU and the Excessive Deficit

[17] Integration is outlined both in policy fields that would be considered technical (i.e. financial policies) as well as non-technical (i.e. labor market policies) according to the methodology explained in chapter 1

Procedure (EDP), established by Article 126 TFEU. Just before stage three of EMU started[18], these two primary law provisions have been supplemented by two secondary law provisions that together form the Stability and Growth Pact (SGP), namely the preventive arm of the SGP (also referred to as the Surveillance Regulation), Regulation 1466/1997 and the corrective arm of the SGP (also referred to as the EDP Regulation), Regulation 1467/1997. Even though supplemented by secondary law, early performance of the two mechanisms was poor (Palmstorfer 2014, pp. 189–90). Both regulations have been substantially reformed by the Six-Pack regulations.[19]

4.2.2 The Six-Pack, the Two-Pack and the introduction of the European Semester

The Six-Pack, a collection of five regulations and one directive, has been introduced in 2011 to strengthen and reinforce the fiscal surveillance of the SGP and to embed the process in an annual budgetary framework called the European Semester. The legislative acts form part of a package of provisions which aim at reforming the Stability and Growth Pact[20], at preventing and correcting macroeconomic imbalances[21], at the enforcement of measures that correct excessive macroeconomic imbalances in the euro area[22], at guaranteeing the effective budgetary surveillance in the euro area[23], and at setting the requirements of the budgetary framework of the member states[24] (Fasone 2014, p. 166).

The SGP was strengthened by the Six Pack in that not only government deficit but also excessive public debt can act as a trigger for the excessive deficit procedure implying that countries enter the corrective arm[25] of the SGP (Hinarejos 2015b, pp. 30–1). Apart from strengthening numerical fiscal rules, coordination of economic policies through establishing a procedure for the prevention and correction of macroeconomic policies has been created. Following a recommendation by the Commission, the Council can adopt preventive recommendations addressed to the member

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[18] Stage three of EMU began with the "irrevocable fixing of exchange rates, transfer of monetary competence to the ECB and the introduction of the euro" in 1999 (ECB 2016)
[19] Regulation 1175/2011 and Regulation 1177/2011
[20] Regulation (EU) 1175/2011 and 1177/2011
[21] Regulation 1176/2011
[22] Regulation 1174/2011
[23] Regulation 1173/2011
[24] Directive 2011/85EU
[25] Regulation 1467/1997

states. Additionally, an excessive imbalance procedure has been introduced alongside the possibility to sanction Euro-area countries in case of non-compliance with its corrective action plan. The sanctions include interest-bearing deposits, non-interest-bearing deposits and as a matter of last resort, fines.

The possibility to sanction member states for non-compliance with various rules of the SGP constitutes a main feature of the changes introduced by the Six-Pack. To summarize the triggers for sanctions under the new regulatory regime there are now three key focal points for sanctions: the existence of an excessive deficit in a member state (i.); a significant deviation from a member state's medium-term budgetary objective (MTO) (ii.); and, as abovementioned, the existence of an excessive macroeconomic imbalance in a member state (iii.) (Armstrong 2013, p. 18).

Reverse Qualified Majority Vote (RQMV)

Another essential component of the new laws aimed at strengthening implementation and beefing up enforcement is the introduction of reverse qualified majority rule (RQMV). Whenever the Commission issues a recommendation to a member state in the European Semester process, it takes a qualified majority of the council members to oppose it. An initial failure of the SGP was that a small blocking-minority of member states were able to block sanctions against themselves, as shown initially by France and Germany in 2003 (i.e. Palmstorfer 2014, pp. 190–1;). One of the directives addresses these failures: "mistakes made during the first decade of the economic and monetary union show a *need* for improved economic governance in the Union, which should be built on […] a more robust framework at the level of the Union for the surveillance of national economic policies."[26]

The RQMV method is especially applicable in the cases where the Council might be unwilling to take a decision: Firstly in the monitoring phase of the EDP, the decision stating that no effective action has been taken in the event of a significant observed deviation from the adjustment path towards the MTO[27] and—related to the former—the imposition of sanctions in the form of interest-bearing deposits.[28] Secondly in the EDP, the imposition of sanctions in the form of non-

[26] Regulation 1173/2011, para 3 [emphasis added]
[27] Regulation 1466/1997 Art 6(2), Art. 10(2)
[28] Regulation 1173/2011 Art 4(2)

interest-bearing deposits[29] following the finding of an excessive deficit[30] as well as the imposition of fines following the decision that a member state has not takeeffective action to correct its excessive deficit.[31] And thirdly RQMV applies in the excessive imbalance procedure (EIP) on non-compliance with a corrective action plan to remedy an excessive imbalance[32] for which sanctions in the form of interest-bearing deposits and annual fines[33] are imposed (Palmstorfer 2014, p. 192).

Macroeconomic Imbalance Procedure

Also, the surveillance mechanisms have been broadened by introducing a Macroeconomic Imbalance Procedure (MIP). Due to “spill-over effects of national economic policies on the European Union as a whole”[34], the objective of achieving a stable overall economic development could, according to the regulation, best be achieved at the Union level. This passage anticipates the subsidiarity and proportionality review. As a preparation for the MIP, the commission shall annually report on a set of indicators that aim at identifying eventual macroeconomic imbalances[35], in a so called Alert Mechanism Report (AMR), that encompasses a widespread set of economic figures affected by national policymaking.[36]

The Commission has considerable discretion to evaluate its findings as well as the resulting recommendations as the “conclusions shall not be drawn from a mechanical reading of the scoreboard indicators”.[37] If, after scrutinizing the indicators, the Commission finds that there are specific problems in a member state, this triggers an in-depth review of the developments in this particular member state. Once member states are placed in the EIP, they are obliged to submit a

[29] Regulation 1173/2011 Art 5(2)
[30] Article 126(6) TFEU
[31] Regulation 1173/2011 Art 6(2); Art 126(8) TFEU
[32] Regulation 1176/2011, Art 10(4)(2)
[33] Regulation 1174/2011 Art 3(1)-(3)
[34] Regulation 1176/2011, Art 27
[35] Regulation 1176/2011
[36] The scoreboard of economic indicators includes current account balance, net international investment position, real effective exchange rate, export market shares, nominal unit labor cost, deflated house prices, private sector credit flow, unemployment rate, the consolidated private sector debt, as well as general government sector debt and total financial sector liabilities.
[37] Regulation 1176/2011, Art 2(2)

corrective action plan which sets out their national policy measures (Kment & Lindner 2014, pp. 20–1).

Role of the Commission after the Six-Pack Reforms

With the Six-pack, the Commission's role has generally been strengthened in that it shall (instead of. 'can,' as in the past) give an early warning in case of a significant observed deviation from the adjustment path towards the MTO (Smits 2015, p. 1146). The original formulation in the legislative text on the effective enforcement of budgetary surveillance in the Euro area is clear about the role of the Commission, stating that it "should play a stronger role in the enhanced surveillance procedure as regards assessments that are specific to each member state, monitoring, on-site missions, recommendations and warnings." However with regards to decisions on sanctions RQMV should be used.[38]

Effectiveness of the new rules

A preliminary assessment of the SGP-reforms and the introduction of the European Semester provides reasons for skepticism regarding its efficiency. Implementation rates are generally highest for the SGP which has the greatest sanctioning mechanisms and considerably lower for the MIP. While directly after the introduction of the European Semester the implementation rates of the CSRs in the SGP sphere lay at around 50%, the implementation rates shrank considerably when the economic situation improved and countries moved from the corrective arm to the preventive arm.[39]

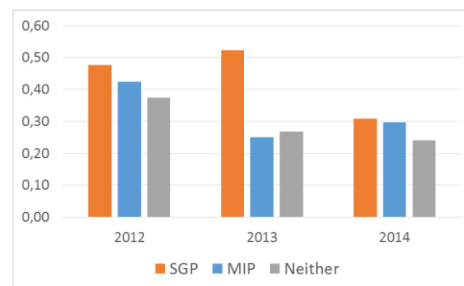

Figure 5: Implementation rate of the CSRs

4.2.3 The Multiannual Financial Framework: Introducing macroeconomic conditionality

Another mechanism strengthening the surveillance power of supranational institutions has been introduced with the recent Multiannual Financial Framework (MFF) 2014-2020. The MFF 2014-2020 has been negotiated during the time when government's budgets were restrained. As a consequence of the costs governments have been bearing to save financial institutions or counter-cyclically stimulating the economy, it became the first budget of the Union that was smaller

[38] Regulation 1173/2011, Art 7

[39] The author would like to thank Prof. Zsolt Darvas, senior scholar at Bruegel for providing the raw data on the CSR implementation index, which has also been published by Bruegel (2015)

than the previous one, reflecting the austerity measures pursued in due course on the national levels in many member states. Besides the big picture, the MFF 2014-2020 also introduced some rather technical novelties. The regulation establishing the MFF 2014-2020[40] now features provisions that link the Country Specific Recommendations (CSR) issued by the Commission in the European Semester cycle to the European Structural and Investment Funds (ESIF).[41]

The regulation states that in order to "support the implementation of a relevant CSR adopted in accordance with Article 121(2) TFEU and of a relevant Council recommendation adopted in accordance with Article 148(4) TFEU", the Commission can propose to review and amend the Partnership Agreement between a member state and the Commission that set out how ESIF can be used.[42] If the member state fails to take action by proposing a change in the Partnership Agreement that reflects the CSRs, the Commission can request the Council to suspend "part or all of the payments for the programs or priorities concerned."[43]

For the suspension of commitments, a modified RQMV procedure applies. According to the regulation, the Commission's proposal to suspend the commitments is adopted unless the Council decides within one month and by qualified majority to reject it.[44] In particularly serious cases, even payments can be suspended, however only in cases where the Council adopts the suspension by means of an implementing act.[45]

As the provision has only been recently introduced, there is no clear evidence about its real implications yet.[46] First evidence suggests that so far only in one case the suspension of ESI-Funds has been considered by the Commission for the case of Hungary, but ultimately not been pursued (Council of the European Union 2012). A formal assessment of the legal framework however suggests that the Commission has been considerably strengthened as an institution that can enforce the recommendations given via the recently strengthened economic coordination mechanisms utilizing the ESI-Funds. Undoubtedly, the link between economic governance in the EU and the

[40] Regulation 1303/2013
[41] Regulation 1303/2013, Art 23
[42] Regulation 1303/2013, Art 23, para 1a)
[43] Regulation 1303/2013, Art 23, para 6
[44] Regulation 1303/2013, Art 23, para 10
[45] Regulation 1303/2013, Art 23, para. 10
[46] The Commission however plans to carry out a review of Article 23, as proposed in para. 16 therein

ESI Funds has been strengthened by the macroeconomic conditionality with the new MFF, as the previous MFF 2007-2013 enabled the Commission to cut funding only in one of the ESI Funds: the Cohesion Fund and only in case a member state was in the EDP (European Commission 2014).

4.2.4 European Stability Mechanism (ESM)

While the European Financial Stability Facility (EFSF) had only been foreseen to operate for three years, it became apparent that a longer-term solution was needed to ensure the access to capital for states facing high risk-premiums. The European Stability Mechanism (ESM) was therefore created as a permanent and separate legal entity. While the capital remains in the hands of the member states of the euro area, not the whole EU, the contribution key is determined by the National Central Banks capital holdings in the ECB (Smits 2015, p. 1180). In December 2010, the ESM was adopted by the European Council, while further details were negotiated by the finance ministers from euro area member states. On July 2011, they agreed on the Treaty Establishing the European Stability Mechanism, which entered into on 27 September 2012 (cf. Ioannou, Leblond & Niemann 2015, p. 160;). While the EFSF had been based on guarantees, the ESM is now based on paid-in capital of €80bn. plus an additional sum of up to €620bn. of callable capital to finance medium- to long-term debt instruments (European Stability Mechanism 2016), further underlining the member's commitments to fiscal stability. The voting rights for both board of governors and board of directors are equal to the share of the paid-in capital of the specific country, making it an exceptional intergovernmental institution in the EU.[47]

4.2.5 The European Central Bank: Fiscal Integration creeping in through the monetary backdoor?

According to the TFEU, the ECB is prohibited from engaging in government-bond purchases. However in the context of the financial crisis, unconventional monetary policy measures have been pursued that include the purchase of government bonds on the secondary market. These measures have been heavily criticized in some northern European countries, Germany being the most vocal critic of the steps the ECB has taken. This section will briefly outline how the ECB has taken up a new role which is not explicitly foreseen in the Treaty, namely fostering overall financial stability by preventing states and their closely entangled national banks from defaulting. In

[47] Treaty Establishing the ESM, Article 4, para 7

fact, some critics have challenged the ECBs action before courts on grounds of breaking EU law (CJEU 2015).

While the TFEU in Article 123 prohibits the ECB from acquiring government bonds directly, the ECB has designed and implemented schemes that enable it to buy government bonds in the secondary market from a financial institutions that acts as an intermediary. This has been conducted for the first time in 2010 with the Securities Market Programme (SMP) when the ECB bought government bonds from Greece, Ireland, Italy, Spain and Portugal (Hinarejos 2015a, p. 21; Rodríguez & Carassco 2014, p. 10;) with the ambition to "[…] ensure depth and liquidity in those market segments that are dysfunctional" while both public as well as private debt securities have been purchased (ECB 2016).

Shortly after Mario Draghi announced in his famous speech at the Global Investment Conference in London that the ECB will do "whatever it takes to preserve the Euro" (ECB 2012a), the ECB decided in September 2012 to announce the so called Outright-Monetary Transactions (OMT) program. Although the program has never been realized, its announcement of unlimited purchases of government bonds on the secondary market had a huge effect and lead to a significant decline in interest rate spreads between government bonds, which was intended by the ECB (Grauwe 2013, p. 520). Although the possible purchases under the OMT program would have been subject to strict conditionality[48], it was challenged in court and led to a complex and unique case before the German Constitutional Court and the CJEU (i.e. Wendel 2014).

According to Schelke, the ECBs actions can be seen as "fiscal redistribution mechanisms that are" in contrast to regular fiscal transfers, "beyond the direct reach of legislatures" (2014, p. 117). The ECB might however itself not be too comfortable with that role, as statements, such as from its former president Trichet suggest.

4.2.6 Fiscal Union: Results

Since the outbreak of the financial crisis, integration in the Fiscal Union has been pursued on different fronts; new institutions have been created, old ones have been further empowered and existing institutions have extended their mandate without a formal change in the underlying legal

[48] The ECB restricted the purchase of government bonds to countries that were receiving aid from the EFSF/ESM-programs and therewith subject to economic conditionality ECB (2012b).

structure. In the following paragraphs, hypotheses H_1, H_3, H_5 and H_6 will be evaluated on the basis of the material presented above.

Many of the integrational steps that have taken place can be directly associated with the dysfunctionalities that have been apparent in the governance framework. This is true both for the introduction of the European Semester and the strengthened SGP as well as the creation of crisis management institutions which lead to the construction of the ESM. As before the crisis, the preferences of the member states were clearly against further transfer of competences, it seems likely that it was ultimately the dysfunctionalities, especially D_1 and D_2 as discovered in section 3, that lead to an overhaul of the fiscal policy governance framework and economic coordination in EMU. As interdependencies of member states' economies are more interwoven in the Eurozone, enforcement rules are stricter for those countries. Furthermore, ESM membership is also limited to Eurozone members, pointing out that the integration in the fiscal policy domain has been pursued in a move to counter the dysfunctionalities, rather than driven by strategic member state general preferences in favor of fiscal integration. The observed differentiated integration is in line with the hypothesis that sees the spillover as endogenous to the integration project, in this case the monetary union.[49] While proponents of liberal intergovernmentalism might argue that government preferences have suddenly shifted, which would imply that a purely intergovernmental model could still explain the integrational move, this is exactly the immunization of the theory against criticism that has been pointed out above.

While the Commission has been considerably strengthened in the European Semester processes, the Council has been relatively weakened with regard to enforcement of the SGP as RQMV has been introduced. Additionally, the stability criteria have also been linked to the MFF, further empowering the Commission as a supranational agency. One however needs to be cautious in interpreting these moves: Although RQMV strengthens the supranational institutions, sanctions ultimately are dependent on government approval and implementation rates during the first years are not overwhelming, while it is crucial whether a member state is placed in the preventive or the corrective arm. Furthermore, the decision to grant financial assistance to a member state is solely dependent on intergovernmental decision making processes in the ESM. On the other

[49] Currently only 18 out of 28 EU member states participate

side, the ECB, by conducting its expansionary monetary policy involving the purchase of government bonds on the secondary market, has taken over responsibilities that some governments assumed to be excluded from its mandate. Overall, H_3 seems to be confirmed by the developments: Supranational institutions have gained considerable competences. Nonetheless, member states have shown to be able to keep in check of major expenses such as government bailouts, highlighted by the intergovernmental governance structure of the ESM.

The institution that impressively expanded the scope of its action in the aftermath of the financial crisis is undoubtedly the ECB. It´s mandate is relatively vague while its primary target is defined as maintaining price stability, while this target must not be compromised by other economic considerations such as stable employment and financial stability, which are only subordinated goals. Although its main objective has not been compromised, the measures taken by the ECB have raised criticism and legal challenge. While opinions on the strategy pursued by the ECB vary, it seems to be a consensual finding that it extended its role considerably since the outset of the crisis, which might also be due to the fact that the governance framework of the EMU lacked a lender of last resort for government bonds.

Article 127(6) TFEU enables the authorization of the ECB, to prudential supervision of banking institutions, given the member states unanimous consent. This provision can be read as an incomplete contract where the space initially left undefined is, according to the policy proposal, to be filled up by the ECB. While imbalances in the financial markets have been a scenario when the Treaty of Amsterdam was negotiated, the principals [the member state governments] preferred to keep the supranational agent, the ECB, at an arms-length by not transferring prudential competences. Nonetheless a back-door has been left open to extend the ECBs power in case evidence suggests that delegation of competences would be necessary for ensuring financial stability. Since the ECB therewith filled up the space that had been left undefined by its initial mandate, H_6 should be accepted.

Evidence however does not suggest that incomplete contracts are a genuine feature that enable integration in the Fiscal Union: The reform of the SGP, the introduction of the European Semester as well as the creation of the ESM were set up either by concluding intergovernmental agreements, amending primary law or extending the body of secondary law rather than by

supranational institutions exploiting the vagueness of contracts between them and their principals. Therefore, H_5 should be rejected for the case of the Fiscal Union.

4.3 The Banking Union

The notorious mismatch in banking supervision and resolution was revealed by the crisis and can be summarized with the adapted words of Sir Mervyn King, the former governor of the Bank of England: "The banks are European in life and national in death." Before the financial crisis, there was strong opposition towards the creation of a common framework for crisis management or banking supervision, since it was seen as too sensitive to member states (Boccuzzi 2016, pp. 14–5). Several scholars have hinted during the time EMU was constructed that this flaw is a dangerous experiment, since banking is the most important channel for the transmission of monetary policy, a task that should have been solely performed by the ECB (i.e. Padoa-Schioppa 1999).

Since these arguments were known, the consensus between member states and the minimum solution of harmonization was to implement an enabling clause in the treaty[50] to entrust the ECB with supervisory tasks without having to amend the treaty if deemed necessary. This is a clear case of an incomplete contract, in which the principals (the member states of the EU), already foresaw the scenario of an insufficient national supervision and opted for this flexible solution to keep the agent (the ECB) at arm's length. Amongst the prime opponents of centralization was Germany (Abascal et al. 2015, p. 26) Ultimately, when the European System of Central Banks (ESCB) was designed in 1998, prudential supervision was only mentioned as a non-basic task of the ECB for the fear that this competence could interfere with the primary mandate of the ECB: To achieve price stability defined as an inflation rate of below, but close to 2%.

Initially, member states had different practices towards banking regulation and supervision while either judicial or administrative entities were solely competent to make and implement decisions about reorganization or liquidation of banks. The decisions being made would then be effective not only in the "home country" of the bank, but in all member states of the European Union. The underlying principle of these procedures was mutual recognition, implying that all subsidiaries

[50] Article 105, para. 6 TFEU

"were considered to be a single entity and were subject to the supervision of the competent authorities of the State in which they had been granted authorization", the so-called Single European Licence (Boccuzzi 2016, p. 15). Boccuzzi identifies three shortcomings of the initial approach: There were different characteristics of legal models for crisis management present in different member states, they operated within a diverse range of tools that were available to them and there was no legislation on banking group crisis in place that would have regulated failure of banks pursuing a truly European or even global business (2016, pp. 13–4;).

A light version of coordination was introduced with the Lamfalussy-process in 2001, with the aim to support the integration of the European financial markets by fostering the convergence of legislation and the consistency of supervisory practices as well as the exchange of information. A four level hierarchical process, consisting of legislation by Council and EP (i), implementing legislation delegated to the Comitology procedure (ii), technical committees composed of national representatives of supervisory agencies (iii), and finally the Commission which controlled whether the measures taken were consistently implemented, had been introduced (Boccuzzi 2016, pp. 24–5). While this initial regulatory cooperation gave member states the final say in all aspects of banking regulation, it proved not to be sufficient to prevent major crisis in the financial sector. Ultimately, further steps to integrate have been taken by setting up the Single Supervisory Mechanism (SSM).

This subchapter will proceed as follows: Section 4.3.1 describes the legal basis, the construction and political controversies, the governance and the broader institutional interplay of the SSM and will be followed by a similar assessment of the Single Resolution Mechanism (SRM) in section 4.3.2. Details are only in so far presented as they are important for analyzing the hypotheses in section 4.3.3. The latter represents the analytical core of the whole subchapter and needs to be read in conjunction with the empirical evidence provided below.

4.3.1 Bank Surveillance: The Single Supervisory Mechanism (SSM)

While there have been suggestions for the introduction of a coherent EU financial supervisory mechanism in academia which also for many years have been promoted by the European Parliament, member states used to reject giving up control of their national banking system that was seen as a core economic infrastructure (ed. Busch 2015, p. 9). The resulting lack of harmonization

lead to considerable possibilities of regulatory arbitrage (ed. Busch 2015, p. 9; Wymeersch 2015, p. 94).

Reviewing the dysfunctionalities

The rationale to create the SSM as the first pillar of banking supervision was to put an end to "national ring-fencing and forbearance in supervisory practices" (Abascal et al. 2015, pp. 25–6). The mission of the SSM is therefore directly linked to D_3 discussed in chapter 3. The general necessity to solve issues at a European level is highlighted in an interview in January 2016 by the Chair of the Supervisory Board of the SSM, Danièle Nouy: "challenges we used to tackle on a single country level can increasingly only be addressed effectively at a European level" (Sueddeutsche Zeitung 2016). Also the SSM regulation, adopted by the European Council, finds that further centralization and integration is indispensable to prevent fragmentation of the financial sector, which would could endanger the "stability of the financial system in the euro area and the Union as a whole and may impose a heavy burden for already strained public finances of the member states concerned" (European Council 2013b).

The regulation goes further by stating that the crisis revealed the dysfunctionality of the current governance system: "the crisis has shown that mere coordination is not enough, in particular in the context of a single currency […] Integration of supervisory responsibilities should therefore be enhanced."[51] (European Council 2013b). In the light of the crisis, the rejection of member states was therewith overcome: The single supervisory mechanisms (SSM) has been developed after the June 2012 European Council on the basis of Article 127(6) TFEU and came into full operation in November 2014.

Due to the short period of existence of the SSM, it remains an open question what influence the introduction of the SSM will have on the institutional balance of the EU. It is too early to assess the recently introduced system on basis of substantial (administrative) decisions made in the field of banking supervision. Rather, this paper will base its findings on legal documents that outline the governance and decision making structure of the new institutions and mechanisms as well as early scholarly assessment of the reforms.

[51] Regulaton 1024/2013, recital 5

Integration dependent on membership of the monetary union

Banking operations typically have many cross-country elements which challenge national supervisors to effectively share their information. Countries outside the Eurozone only accepted some centralized decision making-powers by the European Banking Authority (EBA), but mainly rely on coordination of national supervisors, therefore making the whole European Banking Union a project of Eurozone members only, though other countries are invited to join. For the EU as a whole, the mandate of the EBA is to issue Regulatory and Technical Standards, while the ECB is entrusted to implement and supervise those standards (Boccuzzi 2016, p. 40). Within the Euro area, the ECB now enhanced its portfolio with microprudential supervision of Euro area banks via the SSM. As mentioned above, the SSM regulation also foresees that non-Eurozone member states can join the mechanism (Ioannou, Leblond & Niemann 2015, pp. 162–3; European Council 2013b). In fact, the SSM is a primary example of differentiated integration.

Governance of the SSM

The SSM is headed by the Supervisory Board, which submits draft decisions to the Governing Council of the ECB, which might object the decision of the Supervisory Board. If it does not object, the decision will be implemented, otherwise it will go through a mediation panel to settle the dispute.[52] The SSM encompasses both the ECB and the National Supervisory Authorities of the participating member states. The direct supervision of significant banks is performed through so-called Joint Supervisory Teams (JST) consisting of both the ECB and the National Competent Agencies (NCAs). While an ECB coordinator leads the JSTs, experts from different NCAs are delegated with respect to the proportion of the structure of the cross-border banking group (Abascal et al. 2015, p. 30).

Supervision of significant banks

The ECB in 2016 directly supervises the 129 most significant banking groups (European Central Bank 2015). The decision which banks are included in this framework are made on an annual basis depending on the criteria set out in Article 6(4) of the SSM regulation.[53] Additionally, banking

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[52] SSM Regulation, Art. 25(5)

[53] The criteria for direct supervision include: (i) the entities' total assets at year-end 2014, (ii) their importance for the economy of the country in which they are located or for the EU as a whole, (iii) the scale of their cross-border activities, and (iv) whether they have requested or received public financial assistance from the European Stability Mechanism (ESM) or the European Financial Stability Facility (EFSF) European Central Bank (2015)

groups that own subsidiaries in at least two member states while their cross-border assets and liabilities are significant, and the three most significant banks in every country, regardless of their size, are directly supervised by the ECB (Wymeersch 2015, p.109). For 2015, Boccuzzi finds that the banking groups directly supervised by the ECB account for roughly 85% of the assets of the Eurozone banking system (2016, p. 34). The division of power between ECB and NCAs is relatively clear: The ECB decides and NCAs will have to assist but do not have any explicit power to issue a binding proposal (Wymeersch 2015, p. 104). The JST is then responsible for the day-to-day supervision of the respective bank and is in charge of implementing the ECB and Supervisory Board decisions, while on-site decisions take place on an annual basis by staff from an NCA that is led by a head of mission nominated by the ECB (Ibid.).

Supervision of non-significant banks

Apart from the direct supervision of significant banks, the ECB also has some influence on the supervision of non-significant banks by issuing the ECB´s supervisory manual, which aims to further a unitary approach to bank surveillance. Furthermore, the supervisory decisions of national supervisors are directly reported to the ECB, which can also request further information and reports from the NCAs (European Council 2013b).

The ECB works closely with these National Supervisory Authorities in the surveillance of those credit institutions that don´t qualify for the criteria set out for the significance of a bank. In fact, the ECB can also take the decision to supervise non-significant banks directly if it sees the functioning of the SSM endangered (European Council 2013b). In case a national supervisor is considered to be unable to carry out its supervisory duties, the ECB can directly supervise the banks that fall under the specific jurisdiction to ensure "consistent application of high supervisory standards"[54] (Wymeersch, p.105). Finally, the ultimate decision power remains with the ECB to ensure the "unified interpretation and application of supervisory practices across the EMU (Abascal et al. 2015, pp. 25–6).

Authorization of banking institutions

For the authorization of banks, regardless of their size, a special scheme has been adopted. A request for authorization needs to be submitted to the national supervisor, who assesses it in

[54] SSM Regulation, Art. 70

accordance with national law. In case the legal requirements are fulfilled, the draft decision is filed to the ECB that then grants the authorization except in those cases, where the conditions for authorization in the Union are not met.[55] The withdrawal of the authorization to pursue banking activities, however remains an exclusive competence of the ECB (Wymeersch 2015, pp. 104–5).

Importance of the NCAs

While Tröger (2014, pp. 468–9;) acknowledges that the ECB will have the capacity "to control and influence supervisory practices virtually at the grass-roots level", he also highlights that the ECB is crucially dependent upon the input from NCAs and their day-to-day operations (Ibid. p.464). The NCAs are tightly involved in the supervision of significant banks via the Joint Supervisory Teams. Additionally, they are responsible for providing the factual basis possible sanctions are based upon (Tröger 2014, p. 470). When sanctions are imposed, the ECB relies even more on the national supervisory agencies: It can only impose sanctions itself in case a bank breaches directly applicable EU law, e.g. a regulation according to Article 288 TFEU. If national law is applicable, the NCAs need to implement it. The ECB can, however, require NCAs to open proceedings in case a financial institution breaches harmonized national law, making the NCAs quasi-representatives of the ECB (Tröger 2014, p. 470).

Review of SSM Decisions before the CJEU

When these proceedings against decisions by the Governing Council are initiated, the CJEU enjoys jurisdiction over the process. The procedural guarantees, such as the right to be heard and the access to documents (Article 22 TEU), increase on the spectrum from supervision to sanctions, while the CJEU enjoys full jurisdiction when sanctions are imposed (Boccuzzi 2016, p. 39). This effectively increases the scope for the CJEU to pursue judicial oversight. The CJEU especially needs to safeguard the essential procedural requirements which are the right to be heard, the duty to give reasons and the duty of confidentiality[56] (Arons 2015, pp. 464–5).

4.3.2 Bank Resolution: The Single Resolution Mechanism (SRM)

The second pillar of the Banking Union is the resolution of banks. This has been described by both the European Commission and the European Council as a functional requirement for an effective Banking Union. The IMF in its country report on the Eurozone argues that "leaving resolution

[55] SSM Regulation, Art. 14

[56] SSM Regulation, Art. 27(1); SRM Regulation, Art. 88(1

responsibilities at the national level while supervision is centralized carries significant risks, such as perpetuating bank-sovereign links and creating potential conflict (and deadlock) among national authorities in cross-border resolution" (IMF 2013, p. 17). While the Bank Recovery and Resolution Directive (BRRD) was meant to serve as a basis for coordination between national resolution agencies (NRAs) in the EU as a whole, the degree of centralization was found to be insufficient for countries that share a common currency (European Commission 2013). In its conclusions, the European Council suggested that "a fully effective SSM requires a Single Resolution Mechanism (SRM) for banks covered by the SSM" (2013c). The Commission justified a centralized approach with the "institutional tensions" that could arise when a supranational agency, the ECB via the SSM, is responsible for the surveillance of banks while national institutions would be responsible for the resolution of agencies (2013).

Governance structure of the SRM contested

According to the proposal by the Commission, analysis of banks and the organization for resolution would be conducted by a Single Resolution Board (SRB), consisting of delegates from the ECB, the European Commission and the relevant NRA, depending on where the bank has its headquarters and branches (European Commission 2013). This however did not materialize, as the European Councils proposal stated that the SRB should consist of "an executive director and four full-time appointed members" alongside the representatives of the concerned NRA (European Council 2013a).

The centralized approach however was politically contested by the German government, which initially tried to achieve a two-step solution, according to which a network of resolution agencies funds would have been set up before a centralized SRM could be established after a Treaty revision (Abascal et al. 2015, p. 33). This treaty revision was, however, not considered to be necessary when the SRM regulation would be adopted alongside the Intergovernmental Agreement (IGA) on the SRF by the legal service of the Council, the European Commission and the ECB (European Council 2013d), thereby effectively circumventing the German objections. Abascal et. al find that "the political negotiations to close a deal on the SRM design were particularly tough, given the extremely sensitive nature of cost mutualization" (2015, p. 32). The dividing line ran from the German government and some northern European member states on the one side and the EU

institutions as well as France and euro periphery member states on the other (Howarth & Quaglia 2014, p. 126). Especially contested were the scope and membership of the SRM, the degree of centralization, the sources of funding as well as the abovementioned legal basis (Ibid.). Regarding the degree of centralization, the final agreement departs considerably from a decentralized approach as put forward by Germany. In fact, the division of tasks in the SRM between the SRB and the NRAs is similar to the division of labor between the ECB and the national supervisors in the field of banking supervision, as discussed in the Chapter on the SSM.

The SRM regulation[57] was then finally agreed upon in July 2014. It establishes uniform rules and a procedure for the resolution of credit institutions as well as investment firms. A single resolution fund (SRF), financed by banks contribution is set up and the SRM regulation is furthermore complemented by an IGA that establishes the conditions under which the participating member states levy the financial contributions from banks[58], which are then transferred to the SRF (Hinarejos 2015b, pp. 45–6). This step was necessary since the legal competence of taxation remains with the member states and respective decisions can only be made unanimously, not according to the ordinary legislation procedure, as laid down in Article 294 TFEU. Whereas the legal basis of the SRM regulation is Article 114 TFEU, conferring the competence to take legislative measures to ensure the establishment and functioning of the internal market, levies and taxes cannot be based on that Treaty provision.[59]

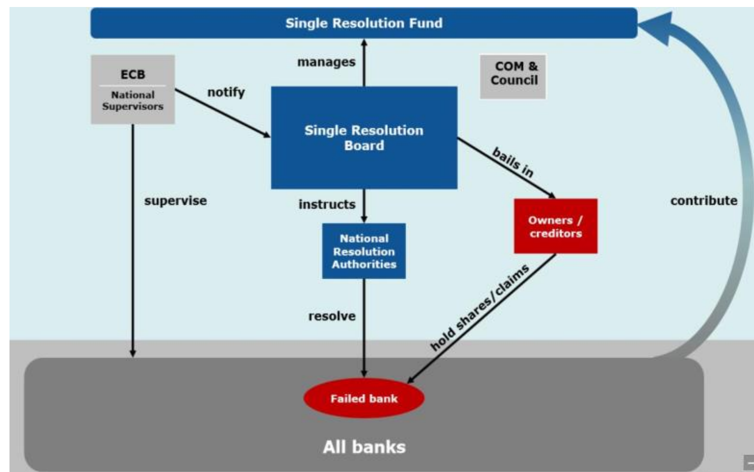

Figure 6: The Single Resolution Mechanism (European Commission 2014, p. 7)

[57] Regulation 806/2014/EU
[58] Agreement on the transfer and mutualization of contributions to the Single Resolution Fund, signed on 21 May 2014 by all member states except Sweden and the UK. Final text: Document 8457/14, ECOFIN 342.
[59] The same dispute currently loomes with regard to whether a deposit insurance scheme can be subsumed under Article 114 TFEU, or whether contributions can be considered as a tax, where an IGA would be necessary

The Single Resolution Board (SRB) and the division of powers

The Single Resolution Board is a Union agency with legal personality[60] and is composed of the chair and four further full-time independent members.[61] The members are supposed to be selected on the basis of merit, skills and knowledge of banking and financial matters and not appointed according to political preferences. Additionally, each NRA of a member state that participates in the SRM, appoints one member to the SRB, while each of the 23 SRB members has a vote (18+5).[62] The SRB gathers either in a plenary or an executive session. In the plenary session, all SRB members participate.

In an executive session, only the Chair and the four full-time members participate.[63] When deliberations on a financial institution that only operates in one participating member state take place, the respective national member appointed to the SRB takes place in the deliberations and the decision-making process.[64] In case a financial institution operates in multiple member states with business being conducted across national borders, all members of those states in which the banking-group has established subsidiaries also participate in the decision-making process.[65] Although not mentioned explicitly in the legislative text, a council representative may also be invited (Busch 2015, p. 290).

The SRM regulation mandates the SRB as well as the NRAs to act independently in the general interest.[66] Additionally the chair as well as the four permanent members are obliged to act in the interest of the Union as a whole. All actors with voting rights in the SRB must not take instructions from any national government or from any of the Unions institutions, making the SRB a strong and independent organization.

When it comes to decision making, in absence of a consensus within the executive session, the NRA loses its voting rights and the decision is made by a simple majority, de facto disempowering the NCAs entirely. This also applies in cross-border situations when multiple NRAs are involved.

[60] SRM regulation, Art. 42(1)
[61] SRM regulation, Art. 43(1)(a)-(b)
[62] Currently, there are 18 national delegates, so the SRB is composed of 23 member
[63] SRM regulation Art. 49
[64] SRM regulation, Art. 53(3)
[65] SRM regulation, Art. 53(3)
[66] SRM regulation, Art. 47(1)

When the SRB meets in a plenary session, votes are usually taken by simple majority. A plenary session meets when decisions on resolution actions are made that surpass the threshold of €5bn.[67]

Although a separation of powers exists between the NRAs and the SRB regarding which level is responsible for the resolution of a particular entity, the SRB can at any time decide to exercise directly all of the relevant powers under the SRM regulation[68]. This especially applies when the NRA fails to properly implement the provisions of the SRM regulation such as adopting resolution plans and carrying out an assessment of resolvability of the financial institutions in its territory. Additionally, member states can also voluntarily decide that the SRB should exercise the relevant powers in banking resolution that are assigned by the SRM regulation to the NRAs.[69]

The Single Resolution Fund (SRF)

The SRF is managed and owned by the SRB[70], and consists initially of national compartments that are over a time period of eight years gradually merged. The use of the Fund is contingent on the intergovernmental agreement, whereby the participating member states agree to transfer to the SRF contributions raised at national level in accordance with Regulation 806/2014 and Directive 2014/59/EU, complying with the principles laid down therein (Boccuzzi 2016, p. 123). The IGA lays down uniform criteria, modalities and conditions for the transfer of resources (ibid.). When the eight-year period ends in 2024, the national compartments will cease to exist and all funds will be gathered at the SRF. Whenever a resolution requires the use of SRF funds, the SRB, not the NRAs, must adopt the resolution scheme.[71] When making a decision on resolution and action, the SRBs permanent members must ensure coherent, appropriate and proportionate decisions across the different formations of the executive sessions.[72]

[67] SRM regulation, Art. 52(2)
[68] SRM regulation, Art. 7(4)(b)
[69] SRM regulation Art. 7(5)
[70] SRM regulation Art. 67(3)
[71] SRM Regulation, Art. 7(3), para.2
[72] SRM Regulation, Art. 53(5) and Recital 34

Cascade for Banking Resolution

As accessibility of funds is a crucial element to evaluate integration, the following section will briefly portray when the European funds can be accessed. The threshold for using public resources via the established European mechanisms and institutions is considerably high. First of all, resolution is, according to the BRRD and the SRM Regulation, only to be considered under "exceptional circumstances" in case the financial stability is endangered.[73] First of all existing stakeholders of a bank, namely shareholders, junior creditors, in some cases senior creditors and even depositors with deposits above 100.000€ have to contribute to the rescue or winding up of an institution, i.e. by writing down their capital to cover losses or by converting debt claims to equity. This is the so called "bail-in tool" with the aim of financing bank rescues by private resources rather than public money. A principle guiding the bail-in tool is that no investor is worse off than he would be under the regular insolvency proceedings.

Usually all the above mentioned private sources, including the national deposit guarantee schemes must be exhausted before the SRF and the Direct Recapitalization Instrument (DRI) can be used. Furthermore, the fiscal backstop introduced with the DRI is not characterized by automaticity, but is dependent upon political discretion, requiring a unanimous agreement of the euro area member states to use it. Prospectively however, Hadjiemmanuil argues that the banking regulation will increasingly dependent upon the ECB, national participation in burden sharing will be harder to justify, while a fully centralized Banking Union would require uniform resolution mechanisms (2015, p. 39).

Conditions for adoption of resolution tools and procedure

A resolution scheme can only be adopted when three conditions are met: a financial entity is failing or likely to fail (i)[74], there is no reasonable prospect that alternative private sector measures can be used (ii)[75] and that resolution action is necessary in the public interest (iii.).[76] The determination whether the latter is applicable is being made by the SRBs executive session, effectively circumventing the case-relevant NRAs in case there is no consensus.

[73] SRM Regulation, Art. (59); BRRD, Art. (45)-(46)
[74] SRM Regulation, Art. 18(1)(a)
[75] SRM Regulation, Art. 3(1)(28)
[76] SRM Regulation, Art. 18(1)(c)

Immediately after the resolution scheme is adopted by the SRB, it must be transmitted to the Commission.[77] The Commission than has only 12 hours, acting by simple majority, to propose to the Council either to object a scheme because the public interest criterion (iii.) is not fulfilled or to approve or object a modification of the amount the Fund provides in the resolution scheme (Busch 2015, p.328). Scrutinizing criteria (i.) and (ii.), the Commission has 24 hours to endorse or object a scheme. These might seem extremely short deadlines, but the fact that the Commission takes part as an observer at the SRB meetings, is aimed to enable the time-efficient decision-making process. The Council then has to act by a simple majority of the member states, including non-participating member states.

Recital 24 of the SRM Regulation establishes the need to involve both the Council and the Commission, as both the fiscal sovereignty of member states and the financial stability of the Union as a whole are concerned. It can also be explained by the Meroni-doctrine, essentially saying that delegation of discretionary powers to EU agencies, such as the SRB, must be limited.[78] Due to this doctrine, the both the Council and the Commission have the right to object the resolution scheme proposed by the SRB, though within a sharp time limit: Overall the procedure must take place within just 24 hours, or, if the SRB modifies the scheme due to objections by the Commission or the Council, 32 hours.[79] If the Council objects the scheme by simple majority, the relevant entity must be wound up in accordance to national law instead[80].

Finally, the resolution scheme is conducted by the NRA, instructed and closely supervised by the SRB. The SRB monitors the resolution process and has, in case the NRA refuses to execute a scheme proposed by the SRB, the SRB can take direct action against the institution under resolution.[81]

[77] SRM Regulation, Art. 18(7)
[78] See Meroni v High Authority [1957/1958] ECR 133 (Cases C-9/67 and C-10/56)
[79] SRM Regulation, Art. 18(7). Within that time-frame it is possible to wind up an institution over the weekend, after the closure of the US stock market and before the opening of the East Asian markets on Monday (Busch 2015, p.330)
[80] SRM Regulation, Art. 18(8)
[81] SRM Regulation, Art. 29(2)-(4)

4.3.3 Banking Union: Results

To conclude the section on the Banking Union, the hypothesis H_1, H_3, H_5 and H_6 will be evaluated on the basis of the material provided above. Overall it can be said that, despite initial resistance by the member states, integration in the field of financial integration took place.

The dysfunctionalities, as stated by the first hypothesis, seem to have been the main driving force of integration, since the integrational moves only took place after the crisis revealed and exacerbated the shortcomings of the financial architecture of the Union. This confirms the notion that the dysfunctionalities are in fact endogenous to the institutions of the integration project as such: The integrational move to shift competences and resources of banking supervision and resolution to the European level has (so far) only been made by members of the monetary union, a project that stimulated more interdependencies among its participants. This observation is in line with the neofunctional assumption that integration is self-perpetuating since it creates functional spillovers that push for further integration in other policy fields, in this particular case monetary policy spills over to financial policies.

Regarding hypothesis three on the empowerment of supranational institutions, a mixed picture emerges: Integration in the field of bank surveillance clearly strengthens the European Central Bank via the Single Supervisory Mechanism. Although the ECB is dependent upon the cooperation with the National Competent Authorities, it has the upper hand not only when it comes to the direct supervision of banks, but also in cases where it controls the implementation of banking supervision for non-significant banks by the NCAs. Additionally, the ECB also acquired the power to check the granting of authorization to banking institutions. Furthermore, the jurisdiction of the CJEU has been broadened by expanding European jurisdiction on banking regulation, especially when it comes to safeguarding procedural requirements, a clear empowerment of a supranational institution.

When it comes to banking resolution, a miscellaneous picture is revealed as well: the governance of the Single Resolution Mechanism is considerably more complex than that of the Single Supervisory Mechanism. The SRB, especially in its executive session is dominated by supranational elements. This concerns both the selection procedure of the staff as well as the voting procedures

where representatives of NCAs can easily be outvoted. On the one hand, the governance structure that has been erected in the field of bank resolution is largely supranational when it comes to the resolution procedures that involve the bail-in of private sources of financing but on the other hand much more intergovernmental when the use of public sources, be it via the SRF or the DRI is concerned, leaving it upon the member states discretion whether the fund can be accessed.

Single Supervisory Mechanism (SSM)	**Single Resolution Mechanism (SRM)**	**Single Resolution Board (SRB)**		**Single Resolution Fund (SRF)**	**Direct Recapitalization Instrument (DRI) via the ESM**
		Executive Session	**Plenary Session**		
SSM Regulation	SRM Regulation	SRM Regulation	SRM Regulation	Inter-governmental Agreement (IGA)	Decision by the ESM board of governors
Supranational	Supranational	Mainly Supranational	Mainly Inter-governmental	Inter-governmental	Inter-governmental

Table 2: Classification of the institutions erected in the financial union since 2008

Overall, it can be stated that integration in the area of financial policies has led to the empowerment of newly erected supranational institutions that exercise their power beyond immediate control by the member states, as H_3 suggests. This finding however needs to be qualified since whenever huge financial transactions are being made, member states governments have reserved themselves the right to make the final decision.

The financial union is a primary example of how incomplete contracts are used to steer integration. Firstly, integration in this area was enabled through a clause in the TFEU that just needed to be activated. The ECB stepped in and filled up the space that had been left undefined by the initial contract [the TFEU] that was agreed between the principals [member-states] and the agents [supranational institutions, here the ECB]. In this case the decision not to specify the competences of the ECB with regards to financial regulation and supervision in the primary law of the union has been made consciously. The principal did not want the agents to directly attain the regulatory power over such an important policy field, but foresaw the possibility to give the agent more leeway in case the need arises.

With regards to the third pillar of the financial union, the European Deposit Insurance Scheme (EDIS), things behave differently: The legal basis of the Commission's proposal is Article 114

TFEU[82], one of the most frequently utilized and least specified articles, which transfers to the European Union the competency to regulate the internal market. If this provision holds even in cases where member states are in strong political opposition and question the applicability of Article 114 TFEU as a legal basis, this would imply that the space initially left undefined by an incomplete contract [in this case the Art. 114 of the TFEU] be filled up by the agent [in this case the European Commission as policy entrepreneur] against the political preferences of its principals [the member states governments] and their interpretation of the incomplete contract.

4.4 Findings on integrational dynamics in EMU

Overall, evidence suggests that the first hypothesis, that is central to neofunctional theory, can be accepted. Integration in EMU after years of stagnation that resulted in the rejection of the constitutional treaty took place only after the dysfunctionalities of its governance framework have been revealed and supplemented by political pressure during the financial crisis, although previously the majority of the member states' government preferences have been opposed to further integration. This is an excellent example of how the EMU created interdependencies that endogenously resulted in spillovers that made more integration necessary. One clear example is supervision in the Banking Union which comes close to the original blueprint laid down in the four presidents report headed by Herman van Rompuy (Hadjiemmanuil 2015, pp. 38–9). This however only regards to the administrative structure of the Supervisory and Resolution Mechanisms, but not to the financing of the resolution actions. While the four president's report foresees the mutualization of resolution costs, the actual system is now based largely on private sources of funds and bail-in mechanisms and only in very exceptional circumstances enables the use of the European funds.

Having assessed the institutional developments both in the Fiscal and Banking union, it seems that H_2 can be accepted: The more technical a specific policy area, and therewith has, according to the definition employed in this study, a more directly recognizable effect on citizens, the deeper the integrational move in a particular policy area: While integration has been considerable

[82] Art. 114, para. 1 states that the Union shall "[…] adopt the measures for the approximation of the provisions laid down by law, regulation or administrative action in member states which have as their object the establishment and functioning of the internal market"

regarding banking supervision, integration has been weaker in fields such as fiscal policy coordination which is easier to grasp and likelier to be communicated in the public debate. Furthermore economic policy coordination, i.e. in the field of labor market policies that clearly have a direct and recognizable effect on citizen, still lack effective enforcement instruments.

	Policy Proposals	Fiscal Union	Banking Union	Overall Assessment
H_1	Accept	Accept	Accept	Accept
H_2				Accept
H_3	Accept	Accept	Accept[83]	Accept
H_4	Accept			
H_5		Reject	Reject	Reject
H_6		Accept	Accept	Accept

Although as a response to the crisis intergovernmental agreements have been concluded that have not been discussed in this study, i.e. the TSCG or the Euro-Plus Pact, it can be stated that integration in technical policy fields has strengthened supranational institutions as H_3 predicts. This has been shown for the European Commission, the CJEU and the ECB. This however needs to be read with care: Whenever the fiscal implications are huge, the member state governments have reserved themselves the right to make the final decision as is shown in the case of the ESM governance structure.

While the four and five president's reports demand a genuinely stronger European Union through political deepening of integration alongside the new technical arrangements, in reality not much has happened on that front. As this is a core assumption of neofunctionalism, an evaluation of the developments in the political sphere would be necessary to make conclusions about the predictive capacity of the theory. However, since EMU is amidst a major institutional overhaul, a final examination will need to be conducted at a later point in time.

Finally it can be said, that incomplete contracts are not an essential feature of integrational processes in EMU. In many cases new institutions have been build up and mandates have been consciously renegotiated between the principals and the agents, which is why H_5 has been rejected. It however can be said that wherever incomplete contracts with room for interpretation of the agents mandate are existent, the agents fill up the space that is left undefined by the initial contract as H_6 predicts.

[83] Accepted, though member states were able to restrict integration where short-term budgetary implications are significant

Conclusion

The Economic and Monetary Union is a highly dynamic institutional arrangement, that ensembles a rich case to study regional integration. While its task of fostering prosperity and financial stability in times of economic globalization and growing interdependencies is enormous, it became obvious that the pre-crisis governance framework was insufficient to effectively mediate the internal and external challenges. As many far-reaching developments have taken place since that time, this study has provided an informed discussion on the logics of integrational dynamics.

Linking the theoretical discussions to traditional European integration literature, this study has suggested that the core mechanism of neofunctionalism is able to explain integration when it is mediated by political pressure ultimately caused by the dysfunctionalities of the governance framework itself. As the purpose of the study is both theory-building and theory testing, the hypothesis derived in the theoretical section have been tested on the current EMU developments.

While liberal intergovernmentalism sees integration only as a possible result when government preferences are summed up, this study has shown that the preferences to not transfer competences to the central level quickly erode when serious dysfunctionalities of the governance framework are revealed and accompanied by political pressure. Furthermore, the fact that agents can extend their influence by exploiting the incomplete contracts concluded with their principals further underlines integration as a self-reinforcing process, since not all long-term consequences can be anticipated by the principals.

Nonetheless, integration is more likely to occur where complex technical issues with a not directly recognizable effect on citizens, such as banking regulation, are concerned and to a lesser extend where the core competences of member states, such as tax and social policies, are challenged. In the institutional overhaul following the financial crisis the member states of the EU have been resilient to keep control over authorizing payments, be it to struggling member states (via the ESM) or to banks (via the DRI). Furthermore, while the power of supranational institutions has been strengthened in the field of fiscal and economic policy coordination, sanctions still need to be concluded by the European Council.

Yet, overall it is apparent that competences have shifted towards Brussels, especially for members of the Eurozone whose economies are more interdependent upon each other. This is most obvious in the case of the Banking Union, a project that is still ongoing. While this study provides an early assessment of the newly emerging structure of EMU, more detailed and in-depth analysis needs to follow. Further studies could for example test whether the institutional culture and decision-making procedures of the SRB that just started operating triggers cultivated spillovers or how the interplay in the JSTs empowers the ECB. These analysis need to be informed by a greater variety of sources, e.g. qualitative-interviews and statistics on bank resolution.

Whether the spillovers from monetary to financial policies will finally trigger a stronger political union, with a greater involvement of the elected EP as the five presidents report demands, remains an open question. One should always retain a healthy skepticism towards a theories predictive capacity, which in the case of neofunctionalism has been greatly overestimated by its founders in the 1950s. While the interdependencies between countries of the monetary union however seem to have been growing in the recent decade, further shifts towards the center seem to be a likely outcome.

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