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Failing Forward? The Euro Crisis and the Incomplete Nature of European Integration

Erik Jones[1], R. Daniel Kelemen[2], and Sophie Meunier[3]

Abstract

The European Union (EU) project of combining a single market with a common currency was incomplete from its inception. This article shows that the incompleteness of the governance architecture of Europe's Economic and Monetary Union (EMU) was both a cause of the euro crisis and a characteristic pattern of the policy responses to the crisis. We develop a "failing forward" argument to explain the dynamics of European integration using recent experience in the eurozone as an illustration: Intergovernmental bargaining leads to incompleteness because it forces states with diverse preferences to settle on lowest common denominator solutions. Incompleteness then unleashes forces that lead to crisis. Member states respond by again agreeing to lowest common denominator solutions, which address the crisis and lead to deeper integration. To date, this sequential cycle of piecemeal reform, followed by policy failure, followed by further reform, has managed to sustain both the European project and the common currency. However, this approach entails clear risks. Economically, the policy failures engendered by this incremental approach to the construction of EMU have been catastrophic for the citizens of many crisis-plagued member states.

[1]Johns Hopkins University, Bologna, Italy
[2]Rutgers University, New Brunswick, NJ, USA
[3]Princeton University, Princeton, NJ, USA

Corresponding Author:
Erik Jones, School of Advanced International Studies, Johns Hopkins University, via Belmeloro 11, Bologna, 40126, Italy.
Email: erik.jones@jhu.edu

Politically, the perception that the EU is constantly in crisis and in need of reforms to salvage the union is undermining popular support for European integration.

Keywords
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The European Union (EU) project of combining a single market with a common currency was incomplete from its inception. The mechanisms designed to limit national deficits lacked credibility. The single market allowed for cross-border trade in financial services and yet relied on national authorities to regulate and backstop cross-border banks. The single currency centralized monetary authority but provided only weak coordination of fiscal policy and no obvious mechanism to facilitate macroeconomic adjustment within the member states.

The incomplete nature of European integration contributed to the eruption of the eurozone crisis. The trigger may have come from abroad as the subprime lending crisis in the United States created trouble for European cross-border banks, but the failures were homegrown. European Central Bank (ECB) President Mario Draghi called this incompleteness Europe's "Achilles Heel" (Draghi, 2014). Because of the gaps in European market structures and governance mechanisms, member state governments could not bail out their "national" banks without risking insolvency. As the financial turmoil spread, capital began to flow from the periphery of the euro area to the core, leaving massive macroeconomic adjustment challenges in those countries that it left behind. The problems were not immediately obvious (Verdun, 2011). Indeed, European governments seemed to weather the first waves of shock emanating from the United States reasonably well. As the crisis unfolded, however, the risks posed by the incomplete governance architecture put in place at Maastricht became evident. Well-placed observers such as European Council President Herman Van Rompuy (2011) viewed the dynamics as an existential threat to the single currency and perhaps even the European project as a whole.

The negative impact of the incomplete nature of European integration on the economic health of the eurozone has confronted policymakers with stark alternatives. EU governments could either cut their losses and unwind their incomplete union, as many pundits suggested they should and would (Feldstein, 2012), or EU leaders could choose to push ahead and deepen the process of economic integration by filling in the gaps in the governance framework. They did not face this choice just once, but repeatedly. At moments when the crisis intensified and the monetary union appeared vulnerable, EU leaders opted to do what they thought necessary to save the euro, but nothing more. Taken together, the series of incremental reforms adopted sequentially in response to the crisis—steps including establishing bailout funds, tightening fiscal surveillance, and moving toward banking union—has led to one of the most rapid periods of deepening of integration in EU history. Yet, even as they took steps toward deeper integration to preserve the euro, EU leaders have acted much as they did at the inception of the common currency: repeatedly putting in place incomplete, unsustainable solutions and rejecting more comprehensive, reform proposals.

The persistence of incomplete measures to address the crisis brings us to a pair of intertwined puzzles. The first, short-term puzzle is why EU leaders have adopted piecemeal, incomplete reforms that only contain the crisis, rather than more comprehensive solutions that might resolve it definitively. This is puzzling because proposals for a more comprehensive response emerged early on, and EU leaders acknowledged the significant risk that piecemeal reforms would eventually prove inadequate. We offer a liberal intergovernmentalist answer to this puzzle, arguing that this incremental and incomplete pattern of response to the crisis can best be explained as a result of interstate bargaining and minimum winning coalitions (Moravcsik, 1998).[1]

And yet, a second longer-term puzzle seems—at first glance—to call into question our answer to the short-term puzzle: Why have piecemeal responses forged by minimum winning coalitions in the heat of crisis consistently moved the EU in the direction of deeper integration over time, rather than toward a dismantling of shared governance institutions and market structures? This tendency to pursue ever deeper integration is a puzzle because it suggests that there is an underlying dynamic connecting iterated intergovernmental bargains. As a result of this dynamic, the EU appears to "fail forward"; again and again responding to the failures of incremental reforms by taking new steps to expand the scope and intensity of integration. But if the actors who oppose deeper integration recognize this pattern, then why do they continue to agree to piecemeal reforms that only set the stage for further deepening down the road?

Providing answers to these intertwined puzzles forces us to revisit fundamental theoretical debates about the nature of European integration. In attempting to explain the repeated incompleteness of Economic and Monetary Union (EMU), this article employs an historical institutionalist approach and makes a temporal argument connecting two theoretical perspectives usually thought to be at odds with one another—intergovernmentalism and neofunctionalism. Intergovernmentalism captures the dynamics at work in critical junctures, whereas neofunctionalism describes the mechanism linking one critical juncture to the next. This combination may lack the theoretical elegance and parsimony of either perspective taken on its own, but it is necessary to capture the dynamics at work in the development of both the single currency and the EU as a whole. To date, this cycle of piecemeal reform, followed by policy failure, followed by further reform, has managed to sustain the euro. However, this approach entails clear risks. Economically, the policy failures engendered by this incremental approach to the construction of EMU have been catastrophic for the citizens of many crisis-plagued member states. Politically, the perception that the EU is constantly in crisis is undermining popular support for European integration and the credibility of the EU on the world stage.

This article is divided into five sections. The first section reviews existing explanations for the pattern of incomplete policy response to the eurozone crisis and develops our theoretical argument. Using historical process tracing, the rest of the article compares the actual pattern of policy response to the patterns expected from the alternative theoretical perspectives. Although the failing forward dynamic can be observed in all major aspects of response to the Eurozone crisis, due to space constraints, we focus on tracing these patterns in just one crucial dimension of the crisis: banking regulation. The second section examines the ways in which the initial design of eurozone financial governance was incomplete. The third section explores how this incompleteness contributed to the eurozone crisis. The fourth section demonstrates that the adoption of measures in response to the crisis also reflected a failing forward dynamic. The fifth section concludes and highlights the dangers inherent to a pattern of integration driven by this dynamic.

Why Governments Pick Incomplete Solutions: Theorizing "Failing Forward"

Why do governments repeatedly select incomplete policy solutions both in the initial design of eurozone governance arrangements and in the pattern of response to crises, rather than either going all the way or rejecting the policy altogether? Why have these incomplete solutions led to deeper European integration over time? We begin by reviewing two theoretical perspectives that offer potential explanations for our central puzzle and then present our own historical institutionalist synthesis blending international and domestic politics.

Intergovernmentalism and Neofunctionalism

For decades, much of the scholarship on European integration focused on a meta-theoretical debate about its underlying causes. The two schools of thought in this debate—intergovernmentalism and neofunctionalism—suggest contrasting explanations for the design and reform of eurozone governance.[2] On one side, the intergovernmentalist perspective holds that bargaining among powerful national governments determines the scope and pace of integration (Moravcsik, 1998). From this perspective, important steps in the deepening of European integration—such as transferring new policy competences to the EU or delegating new powers to EU institutions in existing areas of competence—occur only as a result of lowest common denominator bargaining among powerful member states, each pursuing its domestically determined economic self-interest (Moravcsik, 1993). With regard to the euro crisis, a standard liberal intergovernmentalist account would suggest that the EU's responses to the crisis would have been the product of a series of intergovernmental bargains, driven by the domestic economic preferences of national governments at the time. Thus, if the EU has taken piecemeal, incomplete reforms rather than comprehensive ones, this is because at least one or more powerful member states saw more comprehensive reform as inimical to their economic self-interests and blocked it (Germain & Schwartz, 2014).

On the other side of the debate, the neofunctionalist perspective suggests that initial steps toward economic and monetary integration generate functional spillovers into adjacent fields of policy-making (spillovers unanticipated by at least some decision-makers), which later produce incentives to strengthen cooperation in those adjacent fields.[3] Neofunctionalism also suggests that the activities of non-state actors (EU officials, pan-European economic interests, and other non-governmental organizations) who favor deeper integration generate additional pressures to increase integration over time. This perspective recognizes the central role played by national governments in EU decision-making, but it emphasizes that governments are not the only consequential actors and that government preferences are themselves gradually transformed as a result of the consequences of earlier steps toward integration.

With regard to EMU, a standard neofunctionalist account would suggest that functional spillovers from monetary union into adjacent fields such as fiscal policy and banking regulation have created incentives for member states to pursue deepening, and that supranational entrepreneurs and interest groups have added pressure for such moves (Schimmelfennig, 2014). If neofunctional dynamics were at play in creating and responding to the crisis, then we would expect Europe to be moving incrementally toward a comprehensive solution within the constraints implied by its own history.[4] We would observe choices made during critical junctures early in the process to have enduring consequences and expect functional spillovers to generate pressure to extend integration to new areas.[5] Also, skilled political entrepreneurs could manipulate these spillovers and path dependencies strategically to promote deeper integration (Jabko, 2006). They may agree to incomplete institutional designs anticipating that these designs will generate functional pressures to strengthen cooperation in the future. Finally, according to neofunctionalist predictions, societal actors would increasingly shift their expectations and allegiances to the supranational level, resulting in further economic and monetary integration.

Each of these theoretical traditions offers part of the explanation to the two linked puzzles we posed above. Intergovernmentalism explains why, in moments of crisis, negotiations between EU leaders produce lowest common denominator bargains that yield only incremental reforms rather than comprehensive ones. But for all its strengths in explaining key moments of decision, intergovernmentalism is less well equipped to explain gradual patterns of change over time. Meanwhile, the neofunctional perspective does not explain the outcomes of particular bargains but does offer a plausible explanation of why a series of piecemeal reforms have produced a pattern of sustained deepening over time.

"Failing Forward": Toward a Fusion of Intergovernmentalism and Neofunctionalism

We propose an explanation of the EU's response to the eurozone crisis that fuses together these two theories, despite their seemingly distinct ontologies and epistemologies.[6] We show that processes associated with liberal intergovernmentalism and neofunctionalism are connected over time to produce the "fail forward" pattern so characteristic of European integration.[7] While negotiations between member states determine outcomes in the short term, policy outcomes over the longer term reflect what one might expect to result from the forces of neofunctionalist spillover and supranational activism. Building on recent scholarship on European integration that employs insights from historical institutionalism (Fioretos, 2007; Pierson, 1996; Posner, 2007; Verdun, 2007), our fusion of liberal intergovernmentalism and neofunctionalism offers a convincing explanation of the dynamics of the euro crisis that yields broader implications for study of European integration.[8] The strand of historical institutionalism we embrace treats path dependency as contingent and not deterministic. Choices that are made at critical junctures can sink costs and create feedback mechanisms that influence the trajectory of future events, but they do not override political will entirely, and they can be reversed or diverted at future points (Bulmer, 2009).

Hence, our explanation focuses on intergovernmental bargaining, while recognizing the influence of neofunctionalist forces over time. Both the causes of the crisis and the piecemeal responses to it resulted in part from the fact that eurozone governance institutions were not designed by a single political principal who set out to create an efficient institutional arrangement to pursue a particular objective. Rather, they have been designed as a result of political compromises involving multiple governments with heterogeneous preferences, some of whom are unwilling, for domestic political reasons, to delegate to EU institutions the powers they would need to govern effectively. This type of political compromise will be familiar to students of EU politics as a reflection of the lowest common denominator bargaining anticipated by liberal intergovernmentalist theory (Moravcsik, 1998). Such a compromise also reflects the political dynamics anticipated in other theories of institution building, distributive bargaining, and two-level games (i.e., Evans, Jacobson, & Putnam, 1993; Moe, 1990; Putnam, 1988).

Whatever their regrets about how the euro was constructed or their decision to join it, eurozone member state governments see the survival of the euro as crucial to the survival of the EU as a whole—which they view as vital to their economic and geostrategic interests. As a result, they are unwilling to allow the common currency to fail. Yet, many of the reforms that would be necessary parts of a comprehensive solution to stabilize the euro are deeply unpopular domestically in some member states. In this context, because leaders discount future costs, as scholarship on historical institutionalism demonstrates (Pierson, 1996, 2004), they make intertemporal bargains. Governments refuse to agree to domestically unpopular reforms until they are convinced by further eruptions of the crisis that it is absolutely necessary to do so to save the euro (Bernhard & Leblang, in press).

The reluctance to embrace comprehensive reform is grounded first and foremost in national preferences, the formation of which has been subject to long-standing and widespread exploration by scholars of liberal intergovernmentalism and more generally international relations.[9] Even if we assume that the member states have a common interest in preserving the euro, there is still room for divergences in preferences that will lead to lowest common denominator agreements. Some national leaders may believe that limited reforms may prove sufficient; others may recognize their inadequacy but simply prefer to postpone deeper, more unpopular reforms as long as possible—potentially to be dealt with by future governments. The point here is not that national leaders are in principle opposed to delegating to European institutions; that may be the case but does not have to be. Rather the argument is that some national leaders are reluctant to delegate authority or undertake other necessary reforms in the (for them) present and would rather leave that task to their successors. Putting off more comprehensive reforms may ultimately prove more costly, because incomplete institutions are self-undermining: They stimulate further functional spillovers that perpetuate the cycle of crises.[10] Nevertheless because leaders discount future costs, they may nevertheless prefer this approach to a comprehensive one with higher up-front costs. In this context, advocates of more comprehensive solutions may have little choice but to embrace the piecemeal reforms that reluctant states are willing to accept.[11]

Our "failing forward" argument—based on a fusion of liberal intergovernmentalism and neofunctionalism—has a number of observable implications. If this dynamic is at work, we should observe the following: (a) member governments should introduce incomplete governance structures as a result of lowest common denominator bargains, (b) at least some national leaders involved in these bargains should indicate that they believe the incomplete governance structures are likely to prove inadequate, (c) the incomplete governance structures should generate functional spillovers that help spark future crises, and (d) the cycle should repeat itself.

Failing Forward Toward EMU

At the time of their launch in the 1990s, the governance structures of the eurozone were incomplete in at least three crucial respects: fiscal policy, macroeconomic adjustment policies, and banking regulation (Copelovitch, Frieden, & Walter, in press). First, when the euro was created, a political compromise was struck not to increase the EU's modest budget significantly, nor to establish a new supranational fiscal mechanism to allow countercyclical redistribution from booming to depressed regions in the eurozone. Information about the potential dangers of having monetary union without fiscal integration was readily available.[12] Nevertheless, significant strengthening of fiscal union was rejected by representatives of virtually all member state governments as politically too sensitive.[13] Instead, they introduced deficit and debt limits in the Maastricht Treaty and the 1997 Stability and Growth Pact requiring member states to maintain sound fiscal policies on the assumption that this would prepare states to respond to asymmetric shocks.[14] Second, European leaders sought to avoid large-scale cross-border labor mobility and yet failed to put in place adequate mechanisms for macroeconomic adjustment in the event of asymmetric aggregate demand shocks.[15] Europe's leaders recognized this problem but chose the lowest common denominator adjustment mechanism—market-structural reform—emphasizing that factor markets must be made more efficient locally, so that unemployed workers could find new jobs without having to move from one place to the next. [16] And they pursued this lowest common denominator mechanism half-heartedly, relying on the so-called "open method of coordination," which encouraged governments to share best practices but did not force them to implement reforms or to establish common priorities (Kok, 2004). Third, as we discuss in detail below, while financial markets were being integrated, the oversight of banking and cross-border financial services was not. The grave risks posed by integrating financial markets while leaving regulatory oversight in national hands were well known, but nevertheless national governments were unwilling to transfer regulatory authority to the supranational level.

In short, leading policymakers recognized the shortcomings of eurozone governance and understood that these shortcomings might provoke serious crises in the future. But European leaders proceeded with monetary union nonetheless. As European Commission President Romano Prodi explained to the *Financial Times* in December 2001, on the eve of the launch of euro banknotes, "I am sure the euro will oblige us to introduce a new set of economic policy instruments. It is politically impossible to propose that now. But some day there will be a crisis and new instruments will be created" (Barber & Norman, 2001). Prodi was prophetic. As suggested by our "failing forward argument," each aspect of eurozone governance's initial incompleteness—with regard to fiscal policy, macroeconomic adjustment, and financial regulation—helped generate crisis, and in each instance member states responded with minimal incomplete reforms that merely set the stage for another cycle of crises in the future. Due to space constraints, we can trace these dynamics in only one policy area. We focus on the governance of financial markets and banking, which provides a clear and powerful illustration of how the eurozone has failed forward toward deeper integration.

Weak and Fragmented Banking Regulations

This section explores the first stage of the "failing forward" dynamic, explaining why European leaders initially opted for incomplete regulation and oversight of banking, despite the fact that warnings were raised at the time. Perhaps some policymakers in the 1990s did not fully recognize or understand the risks involved in liberalizing capital flows across borders and fostering free trade in financial services within Europe's internal market (Goodhart, 2014; Obstfeld, 2013), but many clearly did. Scholars familiar with sovereign debt crises in emerging market economies highlighted the dangers implicit in capital market integration (Chinn & Frieden, 2011;

Frieden 1992). The experience of the Bretton Woods system was also replete with examples of the danger of cross-border capital flows (Gowa, 1983). Nevertheless, European leaders chose to view their own project as somehow different and liberalized financial markets (including for banks) without putting in place an EU-level system of banking regulation.

European policymakers briefly considered building a Europe-wide system for financial market regulation and yet quickly rejected that in favor of "mutual recognition" and national responsibility (Vipond, 1991). They decided that the financial institutions responsible for actually engaging in these cross-border financial flows would be governed by market forces. The problem with this approach was that market integration led financial institutions to become ever more tightly interconnected—such that eventually the failure of any major bank in one member state could jeopardize banks in other states.

This interdependence raises two questions: First, how effective will national regulatory authorities be in overseeing the activities of the banks under their supervision operating in other countries? Second, how willing or able will national authorities be to absorb losses and protect depositors beyond their national boundaries? These questions were easily ignored during the early to mid-1990s, as increased competition across the single market stimulated banking consolidation within countries (Story & Walter, 1997). They became harder to ignore once newly consolidated national champions expanded into foreign markets (Mügge, 2010). Soon, European banking institutions began to rival national economies in terms of the scale of assets under management.

By the end of the 1990s, European policymakers recognized that they had a problem and yet, once again, the lowest common denominator solution prevailed (Posner & Véron, 2010). The Maastricht Treaty contained a provision (Art. 105(6)) that allowed the member states, acting unanimously, to confer on the ECB a leading role in financial supervision. But when national leaders in the Council of Ministers worked to revamp EU banking and financial market regulation in the early 2000s, they rejected the idea of centralizing regulatory authority in the hands of the ECB or another EU level regulator as a step too far toward regulatory integration (Alford, 2006). Instead, they chose to combine corporate self-regulation with the maintenance of national sovereignty through a multi-stage "Lamfalussy" process of European financial market regulation (Lamfalussy, 2001). Advocates of this process recognized the threats posed by adverse incentives and moral hazard in Europe's liberalized financial markets but assumed that the combination of self-policing by the financial services industry and coordination of national regulators supervisory practices through bodies such as the Committee of European

Banking Supervisors (CEBS) constituted an adequate governance framework.[17] Even at the time, skeptics of the Lamfalussy process suggested that its reliance on self-regulation and soft law would prove inadequate and that greater centralization of regulatory power at the EU level would be necessary to make banking regulation effective.[18] Nevertheless, such warnings were ignored, and EU leaders agreed to a decentralized and ineffectual regulatory regime for banking that left national regulators and European monetary authorities dangerously exposed to the threat of financial instability—as the crisis would soon reveal.

So, why did European leaders agree to such an incomplete structure in the first place? Although some national leaders may have overestimated the effectiveness of their incomplete solutions, it was mostly domestic political conditions that forced a lowest common denominator compromise. Europe's policymakers knew that they were running risks with their incomplete construction. Asserting that the original design of EMU was "incomplete" is not simply an ex post assessment made with the benefit of hindsight; rather, the shortcomings of the initial design had been highlighted and forewarned by contemporary analysts in real time, but these warnings were discounted (Giavazzi & Wyplosz, 2015). Greater centralization of banking regulation was rejected by national governments who resisted the deepening of European integration. As many observers and participants noted, there was a widespread belief that what had been agreed to would be sufficient for now and that any shortcomings might be addressed down the road.[19]

From Incompleteness to Crisis in Banking Regulation

The events that sparked the crisis in Europe emanated from the financial meltdown in U.S. subprime mortgage markets and related instruments, but these sparks were only able to ignite a profound crisis in the eurozone because of deeper forces linked to the incompleteness of EMU. This section traces how the policies included in the initial EMU design—such as the common currency and monetary policy, the free movement of capital, and the single market in financial services—interacted in devastating ways with the incomplete features of eurozone banking governance highlighted above. The eurozone's incomplete architecture generated functional spillovers that both contributed to the crisis and pressured for new steps to deepen integration.

As part of its broader single market project, the EU promoted free movement of capital and a single European market in financial services, including banking. While the operations of many banks had become pan-European and national banking systems had become tightly interconnected, supervision and regulation remained national. Beginning in 2004, national banking regulators had cooperated through the CEBS. But like most other networks of national regulatory authorities, CEBS remained an advisory body, and real regulatory power continued to lie firmly in the hands of national regulators—as was the preference of governments in Britain, Germany, and France (Grossman & LeBlond, 2011).

Two dangers arose from the disconnect between the increased integration of banking and financial services across borders and the resolutely national character of regulation. First, regulatory failures in any member state posed a greater risk of contagion. If lax supervision by any national regulatory led to a banking crisis, this posed risks for other states across the EU whose banking systems were increasingly exposed to one another through the activities of cross-border banks and through the free movement of capital. Second, market integration allowed gaps in regulatory control to emerge. Banks that operated in jurisdictions across the single market were subject to a mix of controls by their home country bank regulator and their host country regulator, which were supposed to coordinate. However, such coordination was often ineffectual and many cross-border banks were able to take on excessive risk in foreign markets where regulation was lax. Peripheral eurozone states saw massive inflows of capital from the core seeking higher returns (Zahariadis, 2013). These inflows generated several destabilizing dynamics: They released the pressure on public finances, they encouraged excessive private sector borrowing, and they increased the vulnerability of peripheral economies to a "sudden stop" in cross-border capital flows.[20]

The dangers posed by combining a single market in financial services with national supervision and regulation of banks became evident in late 2007. At first, the structural links between the initial banking failures went unnoticed. The initial banks in Europe to suffer losses in the wake of the U.S. financial crisis were French (BNP Paribas) and German (IKB Deutsche Industriebank). Before long, the damage spread to other parts of the single market and affected countries both outside the euro and even outside the EU. The British regional bank, Northern Rock, was the first highly public victim. Swiss banking giants Union Bank of Switzerland (UBS) and Credit Suisse took major losses, even as banks in the Baltic States, Iceland, Ireland, and Hungary came under pressure (Walter, in press).

The tension continued to mount during the summer of 2008, only to burst open following the collapse of U.S. investment bank Lehman Brothers. The introduction of the euro had seen interest rates drop significantly in Ireland, fueling a wave of borrowing by Irish banks throughout the 2000s from the United Kingdom and euro area markets—largely to make loans to finance investments in Ireland's booming property market. Ireland's banking regulations were lax, encouraging banks to use loose lending standards and make risky loans. But as the U.S. financial crisis raised concerns about the stability of Irish banks, lending dried up and depositors began to flee by September 2008 (Sharma, 2011).

European policymakers began to fear a run on Irish banks. When initial steps taken by the Irish government failed to reassure depositors, ECB President Jean Claude Trichet told Irish Finance Minister Brian Lenihan, "You must save your banks at all costs" (Irwin, 2013). On September 30, 2008, the Irish government announced that it would offer a blanket guarantee to all bank deposits in Irish banks and all bond-holders in the six main domestic banks (Murray-Brown & Dennis, 2008). This guarantee stopped the run on Irish banks and indeed caused an inflow of saving into Ireland from other EU countries. The outflow of deposits to Ireland quickly posed risks to other European banking systems and set off a wave of reassurances from other national governments, including Germany and the United Kingdom, that deposits in their countries would be backed to an equal extent (Benoit & Wilson 2008; Elliott, Brignall, & McDonald, 2008; Summers, 2008).

The see-saw of bank runs out and back into Ireland and the series of countermoves by other national bank regulators underlined the fact that combining a monetary union, free movement of capital, and a single market in financial services with national-level banking regulation was a recipe for instability and contagion. EU member state governments responded collectively within days of the Irish bank bailout by agreeing to raise minimum levels of bank deposit insurance across all EU member states from €20,000 to €50,000 (Teather, 2008) and jointly declaring that "each of them will take whatever measures are necessary to maintain the stability of the financial system."[21] Later in October 2008, the European Commission charged former International Monetary Fund (IMF) Managing Director Jacques de Larosière to head a high-level working group to recommend improvements in governance of European financial markets. When it issued its report 4 months later, the group recommended that policymakers focus more on the systemic risks that large interconnected banks posed for the European economy (de Larosière, 2009). The report stopped short of calling for a Europe-wide regulator, but it did note the importance of having sufficient resources to reassure depositors and to wind up failing institutions.

One can view the initial increase in minimal standards for deposit insurance, the joint statement of resolve by national leaders, and the commissioning of the de Larosière report as the first tentative steps toward banking union (Grossman & LeBlond, 2011). Member states were unwilling to allow the interconnected EU banking system to collapse, but at this stage they were only willing to do the minimum they viewed necessary to prevent this outcome. Even the agreement on the €50,000 minimum deposit guarantee was a compromise, down from the €100,000 that states with stronger reserves had favored (Teather, 2008). As we will see below, it took a further spiraling of the crisis before member states were willing to take more decisive steps toward banking union.

Finally, before we turn from the consequences of weak and fragmented banking regulation to examine Europe's partial response, we must highlight the connections between limited banking regulation and limited fiscal integration. The Irish bank bailout eventually shifted more than €62 billion bank liabilities onto the shoulders of Irish taxpayers, turning a state that had been a model of fiscal rectitude into a massive debtor that had to turn to the EU and IMF for a bailout. The connection between private sector involvement and the Irish bailout was ironic. When the Irish government acted to underwrite the liabilities of its domestic banking system in October 2008, the ECB refused to allow the Irish government to impose losses on bank bond-holders. The concern was to avoid sparking an institutional "run" on Irish banks that could quickly spread across the euro area. Hence, the Irish government was not allowed to insist on "private sector involvement" and instead was forced to keep the bond-holders "whole" (Thorhallsson & Kirby, 2012; Whelan, 2012).[22] The result was a dramatic increase in Irish public debt. The socialization of banking losses in Ireland highlights the interconnection between the eurozone's banking crisis and its sovereign debt crisis. In short, lax banking regulation allowed for an unsustainable build-up of private sector debt which—it eventually turned out—would be foisted on the back of the public sector (Mabbett & Schelkle, 2014). Thus, the Irish crisis underscored the fact that even tighter fiscal union might have proven futile if it were not coupled with tighter supranational banking regulation.

Europe's Partial Response: Toward a Banking Union

The political implications of the European crisis were immediately apparent in public opinion, with public trust in EU institutions hitting an all-time low (European Commission, 2013). Europe's heads of state and government were quick to acknowledge that they needed to forge a coherent response. Despite a record number of crisis-related meetings, however, they were accused of being behind the pace of events and adopting only partial responses. By contrast, the ECB was more activist. We explain this incomplete action, once again, by the Council of Ministers' inability to move beyond the pace determined by the lowest common denominator. European integration managed to move forward nonetheless.

First the crisis in Ireland and later the crisis in Spain demonstrated that there was little point in controlling member state fiscal policy in the absence of a banking union. The Irish case has already been mentioned. The Spanish case was subtly different. The country's largest banks were renowned for their stability. The smaller regional savings banks (*cajas*) were another matter. Within Europe's liberalized capital markets, they borrowed aggressively and invested poorly. The Spanish government tried to rescue the smaller banks by cobbling them together. All it succeeded in doing was creating a mammoth financial institution, called Bankia, that threatened to bankrupt the Spanish state in the absence of European support. Banking union was the solution to this Spanish problem (Royo, 2013).

Yet if banking was regulated nationally and governments could feel compelled to socialize banking losses, then even the most fiscally prudent states could quickly find themselves insolvent. The challenge was to come up with a mechanism to sever the link between sovereign finances and banking solvency without explicitly bailing out excessive government debts and deficits. There were a number of different options on the table. The EU could deploy its temporary bailout fund European Financial Stability Facility (EFSF) or its permanent successor the European Stability Mechanism (ESM) more broadly and so bring both Spain and Italy into a fiscal consolidation program.[23] The EU could also give the ESM a "banking license," so that it could leverage its working capital more aggressively to bail out larger member states. Alternatively, the EU could allow both the EFSF and the ESM to inject capital directly into troubled banking institutions to avoid placing pressure on sovereign borrowing.

Neither the Spanish nor the Italian governments were willing to accept the constraints on national sovereignty implied by a full bailout.[24] By the same token, European Commission officials worried quietly that any attempt to rely on EFSF or ESM financing would soon reach the limits of resources available and so lack credibility in the markets. And the German government was unwilling to allow the ESM to obtain a banking license because any increase in leverage would impose unacceptable risk on ESM capital and because having the ECB as a liquidity backstop looked too much like the monetary financing of governments.

The lowest common denominator solution was to allow for direct capital injections by the ESM. Before the German government could accept this notion, however, the EU had to come up with some mechanism for the shared ("single") supervision of European banks. The Euro Area Summit declaration of June 29, 2012 announced this compromise arrangement (Howarth & Quaglia, 2013; Véron, 2013). In turn, this announcement triggered three unintended consequences. First, the construction of a single supervisory mechanism had implications for other areas in banking policy, from the creation of a single regulatory rulebook to common banking resolution mechanisms, resolution funding, and deposit insurance. Second, the single supervisory mechanism required an institutional home. The experience of the crisis suggested that this home should be co-located with lender of last resort facilities in the ECB. Third, the plan to inject capital directly into Spanish banks was too slow and too contingent on future institutional innovations to reassure the markets. Hence, soon after the announcement of the Euro Area Summit declaration, Spanish and Italian sovereign debt markets threatened to go into a rout.

The panic only subsided in the markets once ECB President Mario Draghi famously promised to do "whatever it takes" to safeguard the euro (Wolf, 2014). His solution was to put a floor under sovereign bond prices by promising to make "unlimited" purchases of obligations with short residual maturities on behalf of governments that agreed to participate in a fiscal consolidation program under the guidance of the Troika. Draghi called these purchases "outright monetary transactions," and he explained that they were necessary to preserve the monetary policy transmission mechanism; hence, they should not count as a form of monetary financing or sovereign bailout in violation of EU treaty requirements.

"Whatever it takes" produced immediate and dramatic results (Genovese, Wassmann, & Schneider, in press). Soon after Draghi's speech, the spread between Spanish or Italian and German sovereign debt yields diminished. Within weeks, the threat of a full-blown sovereign debt crisis has vanished. As the crisis abated, however, the plans for a fully fledged reform of the European banking system quickly came off the table. Europe's heads of state and government were able to agree on the creation of a single supervisory mechanism located within the ECB, but the deadline for doing so was allowed to slip and the urgency to complete the project gave way to more careful deliberation. Proposals to develop a single resolution mechanism with common funding moved forward even more slowly. Talk of common deposit insurance shifted to having different national deposit insurance systems adhere to common standards of performance.[25]

The banking crisis in Cyprus helped consolidate this reversal in European attitudes toward what came to be called collectively as the "banking union" proposals. Cyprus was a small island with oversized banks that got into trouble much like Ireland (and a little like Spain). However, rather than trigger a sense of solidarity, Cyprus underscored that each country would face a banking crisis on its own. European negotiators pushed the Cypriot government to impose losses on bank depositors. Ultimately, the Cypriot government was able to contain the crisis only through the imposition of capital controls. The Dutch Finance Minister and Euro Area President Jeroen Dijsselbloem heralded the Cypriot experience as a model for all future bailouts. He even insisted that the goal is to avoid any direct recapitalization of banks with European resources (Spiegel, 2013). Dijsselbloem quickly recanted these remarks when they provoked turmoil in the markets. It was clear nonetheless that he meant what he said. So did many others on the European Council, including not just the Germans but also the Finns and the Slovaks.

The alternative of sharing responsibility for bailing out illiquid or insolvent banks implied a greater implicit transfer of resources and greater political solidarity than some member governments were ready to offer. Hence, Europe's leaders were willing to accept a suboptimal solution. They were also unwilling to adopt other reforms that might have severed the relationship between sovereign finances and bank solvency. A European Commission green paper on the mutualization of a limited volume of sovereign debt issues across countries through the creation of "eurobonds" was quietly dropped due to German, Dutch, and Finnish opposition. The only progress made was in terms of the elaboration of the single supervisory mechanism as preceded by a comprehensive assessment of the balance sheets of systemically important financial institutions. By contrast, the single resolution mechanism they agreed upon relied on overly complicated decision-making procedures, and the supply of resolution funding was inadequate to bailout anything larger than a mid-sized bank.[26]

Nevertheless, it is too soon to say whether this minimal response to the Spanish crisis constitutes a stable equilibrium (Howarth & Quaglia, 2013). Now that the ECB is in charge of banking supervision, it will have to prove its ability to resolve or restructure insolvent institutions. This places the ECB on a collision course with national authorities who are reluctant to agree to an expensive resolution and yet unwilling to face the market fallout from failing to support the single supervisor. This became apparent when the Greek government was forced to impose capital controls to stop a run on its banks in June 2015. The ECB also has to struggle to maintain its promise to purchase significant volumes of sovereign debt instruments either to support the functioning of the monetary transmission mechanism or as a form of quantitative easing. So far, the ECB has won legal support for its efforts. Whether it retains sufficient political support is as yet unknown. What is clear is that a large expansion of the ECB's balance sheet will push the member states to reconsider the virtues of sovereign debt mutualization—ultimately, if not immediately—because significant exposure to such instruments through the ECB's balance sheet is a form of mutualization through the back door. Hence, even a minimal acceptance of responsibility for national banking systems could lead over time to much deeper European integration than Europe's heads of state and government ever imagined in the heat of the crisis. Europe's solution is still piecemeal, and yet the direction it points to is clear.

Conclusion

This article has shown that the incompleteness of EMU was both a cause of the euro crisis and a characteristic pattern of the policy responses to the crisis. Even though the flaws and gaping holes in the initial EMU governance architecture had been pointed out by prominent analysts at the time, member states with diverse preferences could only agree on the lowest common denominator. European leaders took a leap of faith that their partial solutions would be adequate or that problems could be worked out later. After the crisis hit and policymakers were forced to react in urgency, they could, again, only agree to partial incomplete measures to patch some holes in the EMU architecture.

We call this sequential dynamic typical of European integration "failing forward." Intergovernmental bargaining involving states with divergent preferences leads to institutional incompleteness because it forces settlement on lowest common denominator solutions. Incompleteness then unleashes neofunctionalist forces that lead to crisis. Member states respond to this crisis by again settling on lowest common denominator solutions. Each individual bargain is partial and inadequate. As these negotiated solutions accumulate over time, they lay the foundations for further integration. Like in Zeno's proverbial dichotomy paradox, however, European leaders always travel only half the distance between the problem they face and a workable solution; integration progresses, but a "complete" EMU always remains beyond reach.

Recognizing and understanding this pattern of "failing forward" has two important implications. First, it helps us reconcile the tension between the main theoretical explanations for Europe integration—liberal intergovernmentalism and neofunctionalism. Both processes are apparent, and they operate in tandem—but they unfold at different paces. Liberal intergovernmentalism explains short-term outcomes; neofunctionalism offers a longer-term perspective. By combining the two explanations, we are able to show how European integration progresses in the field of EMU. We expect that "failing forward" can be used to explain political development in many other areas of European integration, such as immigration policy, and we hope that future studies will explore whether and to what extent such dynamics are at work in other fields.

Second, the account of the development of eurozone governance presented above reminds us that "failing forward" may be highly dangerous. The practice of advancing integration through cycles of incomplete reforms followed by more crisis may be politically expedient in the short term, but it undermines public support for the EU over the long term. This pattern gives the public the impression that the EU is rudderless and in a perpetual state of crisis. Hence, while "failing forward" may have advanced European integration to date, as a mode of institutional development, it is self-undermining (Greif & Laitin, 2004) and may eventually prove unsustainable.

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Notes

1. The importance of interstate bargaining and domestic politics is also highlighted in the introduction to this Special Issue by Copelovitch, Frieden, and Walter. Liberal intergovernmentalism combines both factors in that domestic politics is taken to shape government preferences which inform national positions in interstate bargaining.
2. Ideational factors and conflicts certainly had an influence on the design and reform of Economic and Monetary Union (EMU; Jabko, 2006; McNamara, 1998). However, an ideational perspective alone cannot explain the compromises reached between policymakers, nor can it alone explain the longer-term pattern we observe, whereby policymakers move incrementally to deepening economic and monetary union.
3. Classical neofunctionalist accounts include Haas (1958), Lindberg (1963), Lindberg and Scheingold (1970), and Schmitter (1970). Updated neofunctionalist accounts include, for instance, Pierson (1996), Stone Sweet and Sandholtz (1997), and Schmitter (2004). From the late 1980s, many scholars in this camp (whom we discuss below) avoided the label neofunctionalist—preferring labels such as institutionalist or supranationalist—but nevertheless made arguments based on premises that were neofunctionalist in nature.
4. Already in 1970, Schmitter (1970) offered a neofunctionalist perspective on the role of crises in European integration (see also Lefkofridi & Schmitter, 2014; Parsons & Matthijs, 2015 for recent treatments of the role of crises in the process of integration). Our approach differs from Schmitter's in several respects, including our emphasis on endogenizing crises as byproducts of incomplete governance institutions and our focus on fusing intergovernmentalism and neofunctionalism.

5. In this respect, the argument parallels more general claims made in the literature on critical junctures (Capoccia & Kelemen, 2007) and punctuated equilibrium in the policy process (Baumgartner & Jones, 1993).
6. Other scholars have attempted to bridge the two theories by arguing that the degree to which either theory will explain outcomes will vary depending on the institutional rules that apply in particular policy areas or periods of time. See Tsebelis and Garrett (2001). This approach cannot explain the puzzle of eurozone governance reform, which has been subject, at most key moments of decision, to unanimity voting.
7. This pattern is similar to that described by Posner (2007) and builds on his insights about the halting pace of progress in institutional development over time.
8. For a review of institutionalist analysis in European Union (EU) studies, see Pollack (2009). See also Meunier and McNamara (2007) for a collection of historical institutionalist analyses of European integration.
9. See, for instance, Moravcsik (1993, 1997), Frieden (1999), Fioretos (2001), Farrell and Newman (2010) discussing the origins of national preferences in the field of international political economy. The "failing forward" argument presented here focuses on how divergences in national preferences concerning economic governance lead to lowest common denominator bargains, but it does not offer a detailed treatment of the origins of national preferences.
10. In this respect, our argument builds on Greif and Laitin's (2004) insights concerning self-undermining and self-reinforcing institutions. The argument also complements Dyson's (2009) more general discussion of time inconsistency in EU macroeconomic governance.
11. Proponents of deeper integration may recognize that these incomplete institutions are unstable but agree to them anticipating that when these institutions prove inadequate and the next crisis strikes, reluctant states will then agree to deepen cooperation.
12. Some prominent economists—and even EU-sponsored studies—had long warned that it was necessary to establish some form of compensation for the asymmetric effects of monetary union. See Kenen (1969), Commission of the European Communities (1977), Commission of the European Communities (1993b).
13. On the political sensitivity surrounding fiscal transfers, see Beramendi (in press).
14. Baerg and Hallerberg (in press) discuss key provisions of the Stability and Growth Pact. In the 1990s, those who argued that the eurozone would not require a centralized fiscal capacity claimed that compensation for shocks could be done within countries rather than between them. See Commission of the European Communities (1993b).
15. The lack of an adjustment mechanism is a problem because if adjustment to asymmetric aggregate demand shocks hitting countries within the monetary union does not take place smoothly, then short-term unemployment becomes structural and capital is wasted. See Mundell (1961) and Kenen (1969).

16. See Commission of the European Communities (1993a). Bernhard and Leblang (in press) argue that concern about cross-border migration remains a potent constraint on policy choice.
17. The Committee of European Banking Supervisors (CEBS) was established on the basis of Commission Decision 2004/5/EC.
18. On critiques of the Lamfalussy process, see Kelemen (2011).
19. Discussion with Herman Van Rompuy, Princeton University, September 23, 2014.
20. The liberalization of capital markets and the growth of cross-border banking promoted an influx of capital investment in the peripheral countries, which made it possible for firms there to pay increasing real wages. As long as interest rates remained low and capital plentiful, these countries would prosper, but if that capital were to disappear suddenly, and thus spark a rapid rise in interest rates, the result would be disaster.
21. See Statement by the EU Heads of State and Heads of Government, October 6, 2008. Available through the Office of the Swedish Prime Minister at http://www.regeringen.se/sb/d/10889/a/112895
22. The Greek situation was different because it was the insolvency of the Greek government that threatened the liquidity of the banks rather than the insolvency of the banks threatening government finances.
23. Member state governments had agreed to establish the European Financial Stability Facility (EFSF) in June 2010 to address the problem of wider contagion of the sovereign debt crisis from Greece to other member states and replaced it with an expanded permanent bailout fund, the European Stability Mechanism (ESM), in September 2012. See Gocaj and Meunier (2013) and Jones (2015).
24. The Spanish were willing to accept unpopular policies when necessary, but they were unwilling to accept the symbolic loss of status that bailout conditionality would imply. See Fernandez-Albertos and Kuo (in press).
25. This shift was institutionalized in Directive 2014/49/EU on Deposit Guarantee Schemes (April 16, 2014).
26. See Council Implementing Regulation (EU) 2015/81 of December 19, 2014.

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Author Biographies

Erik Jones is professor of European studies and international political economy at the Johns Hopkins University SAIS and senior research fellow at Nuffield College, Oxford.

R. Daniel Kelemen is professor of political science and Jean Monnet Chair in European Union Politics at Rutgers University.

Sophie Meunier is research scholar in the Woodrow Wilson School of Public and International Affairs and co-director of the EU Program at Princeton University.