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Integration and Disintegration: Two-level games in the EU*

Waltraud Schelkle (European Institute, LSE)

Abstract: The centrifugal tendencies of the EU make us aware that our theories of European integration were not formulated to explain disintegration. Furthermore, attempts to explain disintegration, notably the new intergovernmentalism, portray these tendencies as idiosyncratically European and dysfunctional. But we can observe disintegration and collective action failure elsewhere, and not all new institution-building is dysfunctional. This paper interprets recent EU institution-building and its limits in light of the concept of two-level games, both in its classic instrumental version of Putnam (1988) and in a more recent normative version developed by Bellamy and Weale (2015). Framing the new economic governance of the EU as the result of two-level games can help us see the specific collective action problems of an incomplete union and the general problems of international cooperation.

Integration and disintegration in post-crisis Europe

The prolonged crisis of the euro area has strengthened centrifugal forces in the EU. For the first time in the union's history, a member state has decided to leave the EU, following an in-out referendum. EU-sceptic parties have become a vocal presence and have taken about a third of all seats in the European Parliament, although their ideological differences and/or nationalistic stance make them an ineffective opposition to further integration. Governments in Greece and Hungary have used referenda to challenge collective decisions of the EU, challenging the norm that the EU is a union of representative democracies. Inside the euro area, a perception has taken hold, supported by academic research, that Southern and Northern European political economies cannot co-exist using the same currency. Johnston and Regan (2016: 333) argue that even permanent fiscal transfers from the North to the South would not change this verdict. The Balkanisation of financial markets, in particular for government bonds, has become a manifest legacy of the crisis that undermines the traction of monetary policy in stimulating the economy (ECB 2015).

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But this is not the whole story. At the same time, we have witnessed a series of sovereign bailouts in the EU that make all IMF bailouts pale in comparison, among them the biggest in history for Greece. The emergency funds, above all the permanent European Stability Mechanism (ESM) but also the European Financial Stabilisation Mechanism (ESFM) operated by the Commission, have generated a lending capacity of the EU that surpasses that of the IMF. The banking union, created within a few years, made the ECB then the world's biggest financial supervisor and prudential authority in terms of bank assets under its purview.

Hence, the story is one of astonishingly rapid and far-reaching steps of institutional integration, at the same time as centrifugal political-economic forces are on the rise. Still, most observers either stress the centrifugal tendencies and the incompleteness of the steps towards integration that were taken (De Grauwe 2013, Stiglitz 2016), or they revive the Whig history of European integration that, according to one of its founding fathers, Jean Monnet, will be forged in crises, so every crisis is good news of further progress[1].

This paper suggests that integration and disintegration tend to be the outcome of the same process. Integration is always subject to limits and boundaries; disintegration is never complete but leaves elements of integration in place. To study this simultaneity, I choose the most extreme case of a country apparently promoting disintegration and seeking deliberate outsider status, the UK, on the one hand, and the country with an unwanted leadership role in the EU, Germany, on the other.

Our theories of integration were not formulated to analyse processes of disintegration. The main post-war theory of European integration, supranationalism, predicts ratchet effects that make every step of integration to some degree irreversible. In its *neo*-functionalist guise, supranationalism allows for more contestation and agency in bringing ever closer union about but this does not change the fundamental claim that European integration is a one-way street (Rosamund 2000: 65, 72).

Intergovernmentalism can provide a more plausible account of the reverse of ever closer union: it can explain why certain steps toward integration may come to a halt or even go backwards, if they do not suit a sufficiently large or influential number of member states. But its liberal version, formulated by Moravcsik (1998), has opened the black box of member state interests and would predict that the main sources of such a backlash should be particular economic interests (Rosamund 2000: 138-139). This is at odds with the overwhelming impression that the opposition to further integration has electoral, ideological and outright populist origins.

The new intergovernmentalism responded to precisely this state of affairs (Bickerton, Hodson and Puetter 2015a, 2015b). Contributors to this literature observe a fundamental

[1] For references and a critique of this Whig history, see Parsons and Matthijs (2015).

"integration paradox: Member States pursue more integration but stubbornly resist further supranationalism" (Bickerton et al 2015a: 705). Their argument expresses a kind of disappointed supranationalism because they demonstrate how dysfunctional this paradoxical integration is. For instance, the emergence of a Fiscal Compact outside the Treaty framework is taken as evidence for politically counter-productive intergovernmentalism, because it circumvents the Commission as guardian of the Treaty and conforms only with the priorities of more powerful member states (read: Germany).

This is a timely update of intergovernmentalism and can make sense of manifestations of differentiated integration instead of merely elaborating various descriptive metaphors (variable geometry, concentric circles, integration à la carte, etc). It synthesises an impressive number of insights about the malaise of capitalist democracies in Europe. But like all integration theories, the new intergovernmentalism treats these manifestations of power asymmetry and collective action failure as an idiosyncratic European problem.[2] Yet, the populist backlash against integration and the difficulties of inter-state cooperation can be seen elsewhere. The antagonistic politics of the United States is a prime example: none of the mainstream presidential candidates has been supported by grass-root movements and the eventual Republican nominee excelled in insults against immigrants and Mexico, a NAFTA member state. The long-awaited bilateral trade agreement between the EU and the U.S., TTIP, has stalled just like previous attempts at reviving multilateral trade negotiations. An even more important example is the utter failure of leading nations to cooperate on the restoration of some kind of order in failed states in the Middle East and Africa, notwithstanding their shared interest in containing the associated refugee flows.

This paper analyses recent EU institution-building amidst signs of re-nationalisation and EU-scepticism by applying the concept of two-level games, both in the classic instrumental version of Putnam (1988) and in a more recent normative version developed by Bellamy and Weale (2015). Understanding the new economic governance of the EU, in particular fiscal governance, as the result of two-level games can grasp both the specific collective action problems of an incomplete and diverse union as well as the general problems of inter-state cooperation. It also allows us to see the dilemma of EU-ins and euro area-outs more sharply: choosing to be in or out is a way of dealing with the inherent tensions between honouring international commitments and responding to demands of domestic constituencies. The two-level game concept highlights not only this political dilemma but also the strategic opportunities open to policymakers.

The next section spells out the conceptual basis of the paper in more detail. It then proceeds to analyse the new economic governance of the EU, which saw a shift from the sole emphasis on fiscal surveillance to emergency lending and financial supervision; the

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[2] Although, to be fair, neo-functionalism has tried to overcome this theorising of one case early on (Rosamund 2000: 68-72).

latter two have an important fiscal component. The paper tries to make sense of the impression that the EU has become politically extremely divided, while relentless institution-building nonetheless progresses. The outs of the euro area, in particular the UK, are taken as a suitable lens to capture the tensions underlying this contradictory impression. The conclusions summarise.

Instrumental and normative two-level games

The original concept of two level games is based on an instrumental understanding of international agreements between nationally accountable administrations (Putnam 1988). It starts from the simple fact that all international agreements between democracies have to be ratified at home. From this flows a powerful hypothesis about the distribution of gains and losses whenever international cooperation is successful (Putnam 1988: 452-3): governments that face strong domestic opposition to an international agreement have a strong position in getting their way when negotiating this agreement with other governments. The other parties know that the international agreement will not be ratified in this member state unless they make considerable concessions. This is a variant of the paradox of weakness (Schelling 1960). The keenest supporters of an international agreement, with large win-sets, typically get a raw deal while those not particularly interested in cooperation (small win-sets) will reap the gains.

In contrast to integration theories, the framing of integration as a series of two-level games is not biased towards assuming that international agreements and cooperation will always succeed. Even when there is room for agreement (overlapping win-sets), the paradox of weakness gives each party an incentive to exaggerate domestic constraints to get an upper hand at the international level. This strategic behaviour can easily lead to collective action failure if too many participants pretend that their hands are tied. Negotiations break down because everybody bluffed, foregoing the benefits from finding a solution.

Anticipating this strategic behaviour, those with a strong interest in an agreement may think of devices that deter it. For instance, they may allow for degrees of membership or ratification by a qualified majority, calling the bluff of those who merely pretend to be weak. This is a central element in explaining the byzantine institution-building that has been going on in the EU regardless of growing resistance, in particular the abandonment of the Community method noted by the new intergovernmentalism in favour of "de novo institutions" (Bickerton *et al.* 2015a: 705).

The game can also be played the other way round or "vice versa" (Putnam 1988: 460). Administrations involved in international negotiations may collude with other governments to achieve a reform that they could not achieve at home without the international hands-tying. This is using the international agreement as a lever to overcome the domestic constraint. Obviously, this works only if opposing domestic interests can be

disciplined by the prospect of not being party to the international agreement. Sectoral interests, such as a financial industry interested in cross-border business, can be more easily disciplined in this way than the sceptical electorate at large.

The instrumental version of two-level games grasps the rise in Euro-scepticism at the member state level only as a constraint on negotiating executives. Bellamy and Weale (2015) have recently presented a normative variant of the two-level game logic, so as to bring the political crisis of the EU into much sharper focus. Their starting point is the irreducible diversity of sovereign peoples (*demoi*) represented in international negotiations. This diversity must be respected and reflected in any legitimate agreement. Instead of analysing the strategic interaction and instrumentalisation of each level for the negotiator's own purposes, they stress the political constraint that the two levels impose: "when governments make commitments to one another about their future behaviour, they simultaneously need to be responsible and accountable to their domestic populations in order to retain their political legitimacy" (Bellamy and Weale 2015: 259). This normative logic of two-level games resonates with Mair (2009) who saw an increasing tension between responsible and responsive government. The "republican intergovernmentalism" of Bellamy and Weale (2015) explores what is required to observe this dual duty and proposes a stronger role for national parliaments in EU policymaking. In terms of the instrumental two-level game, this forecloses the use of the international level to achieve domestic reform leverage.

The positions of Germany and the UK in the recent reforms of economic governance will be used in the following to illustrate – and hopefully illuminate – the usefulness of the two-level game framework in both versions. It is incumbent upon any German government to ensure European integration, which is a tenet of its post-war constitution. The win-set in this respect is large for Germany, which is the set of all international agreements that stand a good chance of being ratified domestically (Putnam 1988: 437) This has not prevented German governments from exploiting their veto-player position in monetary integration and insisting on a policy framework which both in substance (to ensure above all price stability) and in form (rule-based) suits German interests. The imperative of this stance is to preserve its strong export position, and avoid possible fiscal exposure through instability.

UK governments have always had an ostentatiously utilitarian view of European integration, and, until recently, they played the two-level game competently in the original sense of Putnam (Hancké 2016). The UK's small win-set tended to give its diplomats the upper hand in negotiations, and both the Blair and the Cameron administrations underscored that with the threat of referenda. But the peculiar situation that the UK is the financial centre of a monetary union to which it does not belong also made its win-set large in specific reforms to solve the euro area crisis (Schelkle 2016). It agreed to a banking

union that split the Single Market, indicating that it had a large win-set, thanks to a political system in which the government has clear majorities and the opposition exercises only weak control. The executive is more constrained by internal party conflict that did not materialise on this occasion.

The two countries therefore had diametrically opposed positions in the two-level game of European integration in general, and reforms of euro area economic governance in particular.

Table 1: Stylised two-level game representations of German and UK positions

	Germany	United Kingdom
Closer European integration	Big win-set due to normative obligation to support European integration	Small win-set due to Euro-sceptic public opinion made politically binding with announced referendum
Euro area governance reforms	Small win-set whenever solutions lead to fiscal exposure	Big win-set due to unique position of being the euro area's financial centre

For Germany, this constellation raised the question of whether it would manage to give up the fiscal taboo when the euro area was confronted with an existential crisis that arguably asked for some fiscal integration. For the UK, the puzzle is why the Cameron government could not exploit its small win-set to its own advantage when it had done so successfully for over 40 years.

The ins and outs of two-level games

This section sketches three significant innovations that characterise the new economic governance of the EU: the Fiscal Compact, the ESM, and the banking union.[3] A remarkable feature of all three is how fiscal governance, in particular, is quietly shifting while many observers still accuse the EU of being stuck with the same old Stability and Growth Pact. The analysis focuses on whether we can understand these innovations as the outcome of a two-level game with participants who had different preferences and different stakes in achieving collective EU action. For each innovation, the analysis zooms in on Germany, because this indispensable insider was involved in initiating but also limiting integration, and on the UK as the critical case of an explicit outsider that still had a part in these integration efforts.

[3] For details on the latter see Lucia Quaglia's chapter.

The Fiscal Compact

The Fiscal Compact was initiated by French President Sarkozy and German Chancellor Merkel in a letter to Herman van Rompuy in August 2011. The timing of this Compact as well as its motivation are rather obscure. The letter was sent one and a half years after the Council President had been asked to convene a task force that would come up with fundamental reforms to economic governance.[4] The Compact is the fiscal section of a contract between signatory states, an intergovernmental "Treaty on Stability, Coordination and Governance in the Economic and Monetary Union". All EU member states could sign up although it was initially meant to include countries in the euro area only. It came into force when at least twelve member states had signed which was the case by 1 January 2013. In the meantime, all EU members except the UK and Croatia have signed it. The Czech government decided in March 2014 to join.

The timing is odd because the Commission had already presented legislative proposals for the reform of fiscal surveillance almost a year earlier, in September 2010 (Beach 2013: 114). The five Directives and one Regulation, known as the 'Six Pack', contain a "muscular" package of reforms that was in crucial respects plagiarised by the Fiscal Compact. The Six-Pack contains an extension of the Excessive Deficit Procedure to debt above 60% and, in case of violation, foresees an obligation to bring this debt down by a prescribed amount (a twentieth of the difference between the actual debt ratio and a 60% debt-to-GDP ratio). A qualified majority is now required to reject (rather than endorse) a Commission proposal for opening an Excessive Deficit (and Debt) Procedure. This 'reverse' QMV (qualified majority voting) was meant to make for quasi-automatic sanctions, as Christian-Democratic German finance ministers had demanded for some time. Member states were also obliged to introduce independent Fiscal Councils, which would assess the budgetary plans of the government.

Only two features distinguished the original Compact from provisions in the Six Pack: the Compact requested that an automatic debt brake should be written into each signatory's constitution. And it envisaged giving the Court of Justice (CJEU) powers to sanction a non-compliant state, which would align sanctions in fiscal surveillance with the normal legal infringement procedures of the Court (Dehousse 2012: 1), thus replacing this role of the Council of Economic and Finance ministers (Ecofin). However, both stipulations were watered down considerably (Burret and Schnellenbach 2013: 9): constitutional implementation became an equivalent hard law implementation (Article 3) and the powers of the Court were confined to overseeing the balanced budget rule (Article 8). These two amendments spared willing signatories the trouble of finding super-majorities for

[4] It was published as the Four Presidents report (van Rompuy 2012) and quickly shelved by the European Council; its successor, the Five Presidents report (Juncker et al 2015), fared no better.

constitutional changes and/or holding referenda because of the fundamental Treaty changes that would otherwise have been necessary.

The Treaty asked the Commission to provide a Communication and a report about the Compact's transposition in signatory states. This request was made in early 2014 but the report was not forthcoming until 22 February 2017, so deficiencies that the Commission had found (EPSR 2016: 8) earlier did not have to be corrected. The Communication is lukewarm and notes a lot of 'heterogeneity' in the transposition of the new rules; it also announced incorporation into EU law by early 2018 as the Compact itself foresaw (European Commission 2017: 4).

It is arguable that the Compact has been in abeyance ever since it was ratified. Independent evaluations about its implementation come to rather mixed conclusions (Burret and Schnellenbach 2013, EPRS 2016): member states use its flexibility to the maximum and often follow more the letter than the spirit of the Compact. The strictest implementation can be observed in Spain and Portugal while Germany and the Netherlands have opted for weaker rules, for instance as regards correction mechanisms (Burret and Schnellenbach 2013: 9-10). Last but not least, despite all the talk about tougher rules, the sanctions envisaged by the Compact have not been applied as of December 2017. The thresholds for admissible deficit and debt ratios have been exceeded by several member states, among them Spain, Portugal and the Netherlands (EPRS 2016: 9-10). The Compact shares this fate with the Six Pack as far as sanctions are concerned: even the German finance minister Schäuble shied away from endorsing them when they jeopardized a cooperative administration belonging to his own party family in Spain (Eder 2016).

One might thus conclude that the Fiscal Compact was manifestly redundant and, for better or worse, has not achieved its goal of making the new economic governance more disciplinarian. It was also not very helpful in easing negotiations with the UK ahead of the Brexit referendum (Beach 2013: 118). In preparation for the summit in December 2011, the French and German governments reiterated their commitment to the proposal for a Compact and called for amendments of the TFEU. Prime Minister Cameron expressed willingness to go along with Treaty changes but combined this with a list of demands for concessions, especially regarding financial regulation.[5] German politicians, including Chancellor Merkel, rejected any such *quid pro quo*; a member of her CDU called it "a massive attempt at blackmail" (quoted in Beach 2013: 118). When Cameron presented his wish-list at the Council, at 2 am in the morning, Council President van Rompuy cut short any discussion and closed the proceedings. In the end, only the Czech government joined

[5] The key word for these demands was "flexibility", meaning that Cameron wanted the freedom to both slap higher (sic) capital requirements on UK-resident banks and to exempt banks from tighter bonus rules of the EU (see below on the banking union).

David Cameron in not signing the Fiscal Compact. President Sarkozy blamed the British Prime Minister for the fact that the Compact had to remain an intergovernmental treaty outside the EU framework (BBC 2011).

The mystery of Cameron's blunder can be dispelled with the help of the concept of a two-level game. At a time when the euro area crisis was still escalating, Cameron's negotiation tactics were seen as shamelessly exploiting the fact that the rest of the union was desperate to get a deal on the Fiscal Compact. Support for the Fiscal Compact by other member states was not for reasons of substance; they recognised the constraints faced by Germany. Angela Merkel was involved in a precarious two-level game of her own. Other member states urged the German Chancellor to agree to bring forward the implementation of the permanent ESM, scheduled for 2013, to calm down panicking markets in Italian and Spanish government bonds (Beach 2013: 126). Domestic opposition made it imperative for Merkel to have some assurances that member states would change their ways and exercise preventive fiscal discipline. This domestic constraint allowed her to dictate the terms of the Fiscal Compact, making her domestic weakness international strength.

A German Chancellor could not, however, let the euro area implode, especially after Italy had got Mario Monti as a prudent technocratic leader. With respect to this bigger game, Merkel was vulnerable to getting a raw deal. Other governments seem to have understood the Chancellor's predicament, even though most had as little stake in the Compact as the British. Cameron's blunt strategy jeopardized the entire plot. He treated the Fiscal Compact as a bargaining chip when Merkel wanted it to be seen as the sea change that would make the required massive support for Italy and Spain acceptable. It was particularly sensitive that Cameron pretended to need special treatment for the UK financial sector while the euro area went through another episode of financial market panic. Cameron's demand was also far from the truth – he had not consulted the City on this, representatives of which were actually quite taken aback by his tactics (Schelkle and Lokdam 2015: 15). Cameron's bluff was called by van Rompuy's short shrift. The UK's leader had not recognised the bigger game, presumably because Cameron was notoriously disinterested in policy detail. He and his administration assessed the payoffs incorrectly: the other member states did not need UK agreement for the Fiscal Compact to fulfil its function. Or put the other way round: they would only have to respond to the UK's other small win-set if it was essential to have the UK on board.

From the UK's point of view, its failure in the two-level game meant the beginning of the end of British EU membership.[6] Cameron had to return empty-handed which was grist to

[6] Thompson (2017) argues that, in a longer time horizon, the beginning of the end for British membership came with the creation of the euro. This conclusion does not necessarily contradict my analysis although the two-level game framework has inherently more space for contingencies than her structural analysis.

the mill of Eurosceptics. In the EU, his ill-judged tactics had destroyed trust in his ability and willingness to navigate the difficult terrain of honouring international commitments and representing domestic constituencies. From the German point of view, the double two-level game it was involved in was a success. The tightened rules could be used to soften domestic opposition against more taboo breaks to come (see next two sections).

For the EU, we can see how a step toward closer integration had disintegration in its wake: the attempt at closer fiscal coordination created an institution outside the EU's treaty framework and exposed the alienation of one member state from its partners. Ironically, the Compact outside the Treaties was arguably more in line with the normative logic of the two-level game than if all had gone according to the Franco-German plan. The Fiscal Compact is not part of the legal constitution of the EU, so the Commission does not have to cooperate in the implementation of it; it promptly dragged its feet and did not publish its implementation report in a timely fashion. The competence of the CJEU is equally ambiguous with respect to an institution outside the Treaty and it is doubtful that fiscal disciplinarians will want to test the robustness of its role in the Compact. This has helped to let governments off the hook exactly when implementing the fiscal rules would be counterproductive economically. In this, the implementation of the Fiscal Compact arguably conforms the normative logic of two-level games, even though Bellamy and Weale (2015: 262, 271) seem to have a different empirical interpretation: they take the legal phrasing for political reality. The evidence suggests that the Fiscal Compact became a dead letter as soon as it had fulfilled its role in the instrumental and normative two-level game that the Franco-German initiative had set up. This interpretation can also explain why the French President went along with it.

The European Stability Mechanism

The ESM was indeed brought forward by a few months (September 2012), thanks to the introduction of the Fiscal Compact. Access to its funding was made conditional on signing the Fiscal Compact. This condition is obviously meant to be a preventive mechanism against moral hazard: countries must be deterred from behaving recklessly in fiscal terms, knowing that there is an emergency fund that can bail them out when investors turn away. The problem with this explanation is that the intrusive and harsh conditionality imposed on distressed countries before this stipulation was added should have been sufficient deterrent, if deterrents work at all.[7]

[7] One can legitimately doubt that deterrence in fiscal surveillance works, not because incentives for moral hazard are so powerful, but because a fiscally unsustainable situation may not be due to reckless behaviour of governments. When a private sector boom ends, no democratically elected government can let households, firms and banks simply go bust; it will have to come to their rescue, irrespective of who is to blame (Rodrik and Zeckhauser 1988).

The two-level game framework provides a more convincing answer than the pervasive moral hazard explanation. In order to be able to bail out Greece in May 2010, governments had to circumvent the 'no bailout' clause that they had so publicly proclaimed to be the bulwark against fiscal excess. This was particularly difficult because Greece was the disciplinarians' showcase of fiscally unsustainable government policy. The first temporary emergency fund was based on voluntary bilateral guarantees of bond issues that would finance the Greek loan, so as to be compatible with Article 125(1) TFEU: "The Union [..] [or a] Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project." This bailout clause still had its uses, even though it had to be bent. It allowed guarantor countries to exploit the paradox of weakness in conditional lending.

This weakness (small win-sets) was not self-evident. The guarantors had enormous interest in avoiding another Lehman moment in general and in the rescue of domestic banks exposed to Greece in particular. At the end of 2009, when the Greek budget data began to unsettle markets and officials, banks in the euro area held claims to the tune of around €1,100bn that is 62% of all foreign bank claims on Greece, Ireland, Portugal and Spain. This figure related to claims consolidated on an ultimate risk basis; in other words, if those countries defaulted, losses would have to be borne by these euro area banks. French and German banks were particularly exposed, holding more than half of the combined exposure (€345bn and €325bn, respectively).[8] Thus, it was not so much Greece as financial panic that forced a bailout. The systemic crisis made everybody's win-set large. But the guarantors could claim that having to break a very public political commitment that exercises national voters made them domestically constrained. They could thus impose one-sided and harsh adjustment on Greece, in return for unprecedented bailouts that were simultaneously bailouts for the guarantors' banks.[9]

The voluntary nature of strictly bilateral guarantees meant, however, that small member states could refuse to participate. This was the choice of Slovakia. Its right-of-center government pointed out that it could not ask domestic voters for fiscal restraint while helping to rescue a profligate richer member state like Greece (Economist 2010). The bigger guarantor countries thus felt acutely that their bigger win-sets made them bear the brunt of the responsibilities. They had to ensure that a permanent solution would make

[8] There was also the real threat of a domino effect among vulnerable economies: for instance Spanish banks were the largest creditors of Portugal (€77 bn). Data is from BIS (2010: 18-19), US $ amounts converted at a historical (interbank) exchange rate of 0.7 $/€.

[9] It stands to reason whether the guarantors could have asked banks to share more in the pain, given that domestic opinion was favourably disposed toward seeing bankers 'bashed'. While even the Obama administration urged the Council of heads of state to bail out Greece (Barber 2010), an orderly write-down of Greek debt, as the IMF recommended, could have bailed-in banks earlier (Mabbett and Schelkle 2015: 524-8).

them less vulnerable. This was soon in the offing: the ESM is based on callable capital to the tune of €80bn, to which member states must commit when they become a member of the emergency fund. While the guarantees are still bilateral, members cannot simply refuse to pledge them, so if the guarantee of the bond issue becomes necessary (because the borrowing country cannot pay back), the capital is called from member states according to a key that is based on the share in the paid-in capital of the ECB.

The ESM provides a stark example for the simultaneity of disintegration and integration. Its conditional lending is politically extremely divisive (disintegrating) while the fund also represents a significant step towards integration and solidarity at the same time. This new fiscal capacity has been used in historically unprecedented amounts of actual sovereign lending. This becomes clear if we compare EU lending to IMF credit outstanding. At its peak, IMF lending amounted to €112bn, at the end of December 2012.[10] The Spanish bank restructuring programme alone, which proceeded without the involvement of the IMF, had an envelope of €100bn, of which €41bn was used. The Greek rescue was the biggest in the history of sovereign lending, amounting to €289.6bn (the disbursed credit of the first two programmes plus committed sum of the third programme). In return, the guarantor countries used their leverage to reign deeply into the policies of a distressed country. Fiscal governance thus exercised is effective and has led to a turnaround of budget balances at the most difficult of economic times. But it raises serious concerns about the legitimacy of such outside interventions in sovereign democracies.

One might expect the UK to be a complete outsider to this evolution of emergency funding, officially so when Cameron did not sign the Fiscal Compact. But HM Government did take part in the Irish bailout programme. Banks headquartered in the UK were the largest creditors of Ireland (€160bn) on an ultimate risk basis and held large claims on Spain (€98bn) (BIS 2010: 18-19). According to a Treasury insider at the time, the department was very happy to pay a "small insurance premium" for its banks by contributing €3.8bn to the Irish bailout programme of €85bn.[11] This was admission that every bailout of euro area members is also a bailout of UK's financial system, a gesture of goodwill that came with a conveniently low price tag.

The two-level game has thus worked well for the UK in the case of emergency funding. There was never any discussion that the voluntary contribution to the Irish bailout programme could be formalised in the set-up of the ESM and made a regular feature if the UK had a large stake in a rescue. This is less absurd than such a request would surely have been portrayed by British Eurosceptics: the City of London is the euro area's financial center and has fought hard to remain so. It thus has a vital self-interest in its preservation

[10] Source: IMF data on total credit outstanding and on historical SDR rates, accessed 15 October 2016.
[11] The Commission fund EFSM contributed €22.5 bn, the IMF €22.5 bn; the predecessor to the ESM, the EFSF €17.7 bn; the Irish Treasury and Pension Fund €17.5 bn; UK €3.8 bn, Sweden €0.6 bn, Denmark €0.4 bn.

(and we will see below that the Chancellor at the time admitted this). But its hands were tied so tightly by domestic hostility to the euro experiment that it could not even enter the game. This is in line with playing a normative two-level game: the UK could not have entered an international commitment in good faith because it would have gone so much against the mainstream voter sentiment. This was also instrumentally what worked for the apparent outsider in the sense that its financial system got the insurance: the "voluntary nature" of the ex-post insurance gave the UK the upper hand, as the guarantors had to bail out Ireland anyhow. Outsider status inside the EU was actually advantageous and made Chancellor Osborne an ardent defender of continued membership, in line with the utilitarian tradition of Britain's attitude towards the EU.

The banking union

In the context of this paper, the banking union is remarkable for the attempt to resist further fiscal integration when this clearly diminishes its benefits. This resistance defies the most immediate goal of the banking union, namely to break the negative feedback loop between weak bank balance sheets and weak fiscal positions, transmitted through banks' holdings of government bonds. The diabolic loop jeopardizes the neat separation of a single monetary policy from national fiscal policies that so many elements of the euro area's economic governance try to ensure.

For the same reason, namely jeopardizing the separation of monetary and fiscal policy, financial supervision was a known problem area of economic governance before the crisis. Member state authorities were responsible for the prudential supervision of banks, for resolution of insolvent banks and for deposit insurance schemes. They conducted these tasks in accordance with EU rules and regulations, but without any shared fiscal resources. Each of these responsibilities may require fiscal backing. In a systemic crisis, accumulated resolution and deposit insurance funds, typically financed by industry levies, may be too small to deal with the fallout and governments have to make up the balance, at least in the first instance. When supervisors order a bank to close, savers may have to be compensated for their losses – in fact, protection of small depositors is typically the main reason why governments across the party-political spectrum come so readily to the rescue of banks (Brunnermeier et al 2009: 68).

But keeping supervision, resolution and deposit insurance as national responsibilities contributed directly to the fragmentation of banking during the crisis as well as to the negative feedback loop between banks and sovereigns (ECB 2015: 88-90). This fragmentation can be seen in the differentiation of interest rates on new loans to non-financial firms in "peripheral countries"[12] compared to non-distressed EA members, as well as shrinking credit to the distressed economies since 2008 (ECB 2015: charts S32 and S34). Banks posted much less cross-border collateral in liquidity operations with the ECB after

[12] The ECB (2015: 88) includes in this category the five programme countries, Italy and Slovenia.

the crisis, again a tendency driven by distressed countries (ECB 2015: 127). The home bias in banks' holdings of government bonds had fallen before the financial crisis, but, by 2015, it had returned to the levels of the early 2000s (ECB 2015: 89).

The June 2012 European Council decided to introduce a banking union, in the context of dangerously rising risk premia on Italian and Spanish bonds. In a backroom deal, the heads of the four biggest euro area member states also gave ECB President Draghi the green light for his "Do whatever it takes" speech (Draghi 2012) before he proposed this to the ECB Governing Board, notably his internal opponent Bundesbank President Weidmann. Draghi's speech at an investment bankers' forum in London announced Outright Monetary Transactions (OMT): the promise to buy government bonds in secondary markets in unlimited amounts, provided the bonds were issued by a government with an ESM programme; the ECB would not claim senior status among creditors. This speech marked a watershed that turned a virulent into a latent crisis. It supposedly shows the ECB at the height of its power, having silenced Bundesbank opposition by going directly to the top, i.e. Chancellor Merkel.

This coincidence - of an agreement on the banking union with the announcement that the ECB could act, if necessary, as an indirect Lender-of-Last-Resort to sovereigns – was enough to calm down markets. These were undoubtedly two significant steps of integration and the setting up of the Single Supervisory Mechanism as the world's largest financial supervisor and regulator within two years is an extraordinary achievement. But the sudden stop of financial panic also allowed Germany to backtrack on promises to agree to a deposit insurance guarantee and some fiscal backstop at the height of the crisis. The "Do whatever it takes" speech worked too well. Inadvertently and unintentionally, ECB President Draghi reduced the win-set of the German government, leading it to block all immediate moves to a European Deposit Insurance Scheme (FAZ 2015). Reassuring steps toward more integration helped to sustain disintegration in fiscal terms.

Somewhat surprisingly, the British government did not stop the move towards banking union. In the most basic sense, it encouraged the banking union, hence Quaglia's verdict of "constructive fence-sitting". The UK wanted to see the troubled currency union stabilised and accepted "the remorseless logic" towards closer integration, as finance minister Osborne put it (Giles and Parker 2011). Contrary to earlier German wishes, the ECB was put at the helm of the SSM and created a two-tier Single Market. While open to all EU members, nine non-euro countries stayed out of the SSM, including its financial center, the UK. Supervision of its banking system by a supranational authority was unacceptable even though the UK had just abolished its own pre-crisis supervisor. More astonishingly still, the UK government asked for remarkably little in return for the two-tier Single Market in financial services that the banking union implied (Schelkle and Lokdam 2016: 3-4). The only concession it requested concerned the voting rules for decisions by

the European Banking Authority (Quaglia 2016: 9-10). The escalation of the euro area crisis made even a hard-nosed British government concede, as it feared for its own stability. There were apparently no domestic constraints, from organised banking interests, on this accommodating stance (Quaglia 2016: 9).

But the permanent split also deprived the UK government of a lever vis-à-vis its own financial system. Banks are domestically unpopular and able to create huge costs for the government but are too important for the UK economy, as a major source of employment, income and tax revenue, to be abandoned. Sharon Bowles, the influential chair of the European Parliament's economic and financial committee until 2014, said at an LSE hearing that Cameron's demand for "flexibility" from the EU meant protection of the taxpayers from the City, not of the City from Europe; evidence for this is that the UK government lobbied hard to be allowed to impose higher capital requirements than the EU Directive foresaw (Schelkle 2016: 160). Losing the protection of the EU creates a problem for the new government in regulating the City. Against this background, it is noticeable how the new Prime minister, Theresa May, signalled early on to the City that she will not fight its corner in the Brexit negotiations. Her pledges to care more about "ordinary, working-class families" than the "wealthy" is an act of public hands-tying, telling the financial service industry that the constraint from "Brussels" had been replaced by the constraint that popular opinion represents to her government. Her government tried to sideline Parliament as both Houses have too many pro-integrationist members which would get in the way of a shift to compassionate nationalist Conservatism. [13]

Her re-positioning was a transparent attempt to replace the two-level game when it can no longer be played in reverse by using restrictive "Brussels" to rein in domestic opposition. For the normative two-level game, this contains the important qualification that supranational agreements are not always in a normative tension with domestic democracy. In the presence of unduly powerful special interests at home, supranational commitments may strengthen democracy by tying the hands of the executive. No member state has a fully functioning representative democracy, immune from special interests, as the theory so far seems to assume.

Concluding remarks

This chapter started out with a criticism of the existing integration literature, especially the neo-functionalist supranational strand. It cannot coherently explain processes of integration and disintegration. Realist intergovernmentalism does better and it is no wonder that it was intergovernmentalism - both new and Republican, as advanced by Bickerton, Hodson and Puetter (2015a, 2015b) and Bellamy and Weale (2015), respectively

[13] This strategy floundered when Theresa May lost her majority in the House of Parliament after the June 2017 elections.

– that has grasped the centrifugal tendencies within a theory of European integration. This paper takes cues from this recent literature but focuses on the notion of two-level games that revolve around the interaction of supra-/international level and the domestic level of inter-state cooperation. It provides the analytics that makes us see the twists and turns of recent institution-building, in particular the strategies of the indispensable insider, Germany, and the deliberate outsider, the UK.

Another conceptual advantage of the two-level game is arguably that it does not pre-dispose the analysis toward finding integration. New intergovernmentalists tend to be dismayed when integration does not occur, ignoring all we know about the likelihood of collective action failure. By contrast, two-level game analysis alerts us to the astonishing amount of cooperation and institution-building that has taken place over recent years, under the most difficult of circumstances (Moravcsik 2012). This is easily forgotten given the limitations and deficiencies of each reform of economic governance recently agreed upon.

The three case studies – Fiscal Compact, ESM and banking union – were chosen because they are significant innovations in economic governance. They illustrate a shift away from the emphasis on fiscal surveillance (for which the Fiscal Compact still stands) to fiscal capacity building (ESM) and monetary-fiscal interfaces (banking union). To summarize briefly what the two-level game analysis of each showed:

- The Fiscal Compact became a dead letter as soon as it had served its role of bringing forward the creation of a permanent fiscal capacity. David Cameron, who had not cared to understand the game that was going on, came back empty-handed from his first attempt at invoking the UK's small win-set to bargain over signing up to the Fiscal Compact. While the Fiscal Compact represents a "de novo institution" (Bickerton et al 2015a: 705) created by inter-state cooperation, it was also a further step towards ending UK membership.
- The ESM had to be built in open breach of the no-bailout clause. It managed to become an intergovernmental emergency fund that, in terms of actual sovereign lending, surpasses the IMF. The *quid pro quo* was intrusive and harsh conditionality on lending to distressed countries, and this divides the euro area deeply. The UK's domestic opposition to European integration could only grow in light of these interventions. This allowed the UK Treasury to exploit the paradox of weakness and even combine it with a gesture of goodwill at its discretion by contributing voluntarily to the Irish bailout, which benefitted UK banks disproportionately.
- The banking union was a major step toward further integration but as such a classic example of Monnet's curse that Europe will be forged in crisis. As soon as this crisis receded, Germany backtracked on promises of targeted joint liability and a common deposit insurance fund, regressing to its original position that the single

monetary policy should be isolated from national fiscal policies. The UK was surprisingly adamant in letting a banking union come about, even though it split the Single Market, under the pressure of an escalating euro area crisis. Being no longer part of an integration project that is of such vital interest to the UK economy would have raised in any case the issue with which the new administration under Prime Minister May is confronted acutely: how to impose constraints on special interests at home when domestic democracy has proven too weak in the past.

The two-level game analysis of the UK brings into sharp focus how membership in the EU extends the policy space of national executives. Compared to full members of EMU, the UK after Brexit can no longer exploit the instrumental logic of two-level games to the same extent. Its outsider position will mean that its win-set is always larger than that of a diverse union of 27 other countries. The UK will lose more from the more constrained access to the Single Market than any other member state, with the exception of Ireland that therefore proves to be the most difficult veto-player in the Brexit negotiations. Hancké (2016) argues that the referendum destroyed the basis on which the two-level game worked so well for the UK while the country was in the EU. Others had to accommodate the 'recalcitrant member' to preserve the union. When the UK referendum called off this union, its recalcitrance became an empty threat.

At the same time, two-level games of inter-state cooperation will have to be played still, especially if an economy houses one of the world's financial centres. Policymaking is then still subject to normative tensions inherent in such games. But Theresa May's initial strategy gave us a glimpse of the new dilemma: it will no longer be about fighting "flexibly" the corner of Britain (read: the City and/or the taxpayers), but about pitching an international elite (read: banks) against the people (read: a mix of losers from open borders and right-wing internal opposition). Future British governments will find that the two-level games inside the EU were actually fun to play once one mastered the rules, while nobody knows yet how to play the anarchic games ahead.

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