Europe's quest to ensure the euro's long-term survival by forging a deeper political union out of crisis is fizzling out.

A European Union summit, starting Thursday, was originally intended to pave the way for tighter coordination of economic policies, but now is expected to make little progress. Many European officials say they are losing hope of reaching a deal in the next year to build elements of a common government for the 17 countries that use the euro, including shared spending, borrowing and support for banks and depositors.
Germany is leading the resistance. In Vilnius, Lithuania, last month, German Finance Minister Wolfgang Schäuble orchestrated a revolt against a proposal to let EU officials decide when euro-zone banks should be wound down or restructured.

The proposal was part of a so-called banking union in which Europe as a whole would stand behind its lenders. Many countries favor the concept because it would take pressure off weaker countries to support their banks alone. But German officials see parts of it as a green light for EU bureaucrats in Brussels to spend Germany's money to rescue banks in Ireland or Spain. Mr. Schäuble mustered a coalition in Vilnius to block the proposal, recruiting EU members such as the U.K. that don't use the euro and don't want more powers for Brussels.

The quest for a deeper union was born last year at the height of financial-market panic in Europe, when fear was widespread that the euro might collapse. The crisis showed that sharing one currency among 17 countries with separate policies is an unstable formula. Although financial markets have calmed since then, the euro zone still is struggling with debt, unemployment and impaired banks, especially in Southern Europe.

Herman Van Rompuy presides over EU summits. Zuma Press

European countries already have taken many steps to bolster their currency union, establishing a permanent bailout fund, new rules to prevent fiscal profligacy and a stronger European Central Bank that can stabilize bond markets and will soon supervise big banks across the bloc.

But advocates of tighter integration believe that the euro zone needs to go further by borrowing elements from the American system of federalism. Many proposals reflect a belief that the euro zone needs to partially mimic the U.S., where the dollar works well across all states partly because of budgets, bonds, financial oversight and depositor protection at the national level.

Jörg Asmussen, a German executive-board member at the European Central Bank, says the debt crisis showed the monetary union wasn't finished. "If we don't complete it, we will remain vulnerable to shocks," he says.
Over the past year, however, the political winds have shifted. Interviews with more than a
dozen officials across Europe reveal how plans for deeper integration have run aground as
financial markets have calmed and mistrust has simmered between power centers
including Berlin, Brussels and Paris.

The push to build a more stable currency union arose from a May 2012 dinner, when
Europe's leaders charged top EU officials with figuring out a plan. Herman Van Rompuy, a
conservative Belgian politician who presides over EU summits and who writes haiku in his
spare time, led the effort.

At the time, massive capital flight from Italy and Spain was threatening to unravel the euro.
Observers on both sides of the Atlantic were saying the euro zone needed an "Alexander
Hamilton moment," akin to the 1790 move by the U.S. treasury secretary to take over
states' debts, which made the U.S. a deeper economic and political union.

During the summer of 2012, Mr. Van Rompuy and his colleagues worked on proposals
that echoed the view of many economists in the U.S. and Europe: The euro zone needed
to become a little more like America by replicating some of the functions of U.S. federal
authorities.

To work properly, the EU officials believed, the euro zone needed a central budget, or
"fiscal capacity," which would help cushion crisis-hit countries, for example, by funding
some of the rising cost of unemployment benefits in a slump. The budget would eventually
be financed through bonds guaranteed by the euro zone collectively.

In a written report, the group led by Mr. Van Rompuy also proposed a banking union, with
a common safety net for stricken banks, and federal deposit insurance. It called for closely
aligning euro members' economic policies and said Europe's strengthened central
authorities should be either elected or accountable to elected officials.

Enlarge Image
In late June, the European federalists won their first big victory: German Chancellor Angela Merkel agreed to deploy the bloc's collective financial strength to save ailing banks, relieving pressure on cash-strapped nations facing a banking crisis. In return, the bloc agreed to unify supervision of the region's lenders.

By fall, the European Central Bank's promise to intervene massively in bond markets had calmed the financial-market panic. The move bought time for governments to address the euro's flaws. But it also reduced the pressure to take politically unpopular steps.

Mr. Schäuble, the German finance minister, fought to water down the banking union that Ms. Merkel had assented to in June under pressure from France, Italy and Spain. Those three countries saw their "victory in battle" undone by German-led "guerrilla attacks," says a senior Italian official.

One such incident occurred that September, when Mr. Schäuble met with his Finnish and Dutch counterparts at a country mansion outside Helsinki. Without consulting other euro members, the three finance ministers issued a statement that said: "Legacy assets should be under the responsibility of national authorities." It was a refusal to pay for cleaning up Southern European banks.

A summit meeting last December in Brussels proved a turning-point for the proposed fiscal union. Before flying to the gathering, Ms. Merkel described Mr. Van Rompuy's report—supposedly the blueprint for the euro's future—as merely a "background document."

When she arrived, Ms. Merkel rejected Mr. Van Rompuy's euro-zone budget. She said she was prepared to offer small-scale funding for economic reforms—but not for Europe-wide unemployment insurance or stimulus spending to fight recessions, according to people who were there. Germany had already shown enough "solidarity" by supporting the bloc's bailout fund, she told her counterparts over dinner.
Advocates of tighter integration believe that the euro zone needs to go further by borrowing elements from the American system of federalism. Agence France-Presse/Getty Images

Mr. Van Rompuy thought he could count on French support. Signals from Paris had led him to believe that President François Hollande would help push Ms. Merkel to soften her stance, say people familiar with the matter.

But when Mr. Van Rompuy sought the Frenchman's backing, Mr. Hollande kept quiet, officials familiar with the discussion say. Other EU officials were left scratching their heads. French officials say their leader had concluded that fiscal union was only realistic as a long-term aspiration.

This year, Ms. Merkel changed her tone on the "political union" she had called for in 2012. The lingering economic crisis had turned public opinion against EU institutions such as the European Commission, the bloc’s executive arm. Germany, the most powerful euro member, saw the Commission as too eager to spend Germany’s money and too soft on indebted Southern European countries.

Ms. Merkel backed away from a major rewrite of EU treaties, instead pushing for a limited change only to allow more economic-policy controls. This summer, she said she opposes more rights for the Commission or the European Parliament. German officials have begun talking about taking some powers back from the EU.

The split between Berlin and the euro-zone majority was readily apparent in Brussels on the morning of Oct. 3, when top aides to European leaders, known as "Sherpas," gathered to prepare this week’s EU summit.

Ms. Merkel's adviser on Europe, Nikolaus Meyer-Landrut, argued that further integration should focus on a limited goal: enforcing stiffer discipline in the economic policies of member countries to improve their competitiveness. He proposed that EU leaders attending the meeting agree on a set of indicators, such as rising labor costs, that would signal when a country's economy is veering off course. He also said national governments should sign binding promises on economic overhauls that EU leaders would monitor.

The German proposal found no takers. French presidential aide Philippe Leglise-Costa argued that the focus shouldn't only be on competitiveness, and that monitoring of countries' performances should also include "social cohesion." Other countries, meanwhile, insisted that any further handover of economic control would have to come with financial incentives.
Southern European countries were only interested in Germany's money, one Northern European delegate said after the Oct. 3 meeting. "They had dollar signs in their eyes," he said. A delegate from Southern Europe, meanwhile, said Berlin wants European unity based only on discipline and controls, which the official called "politically and economically unsustainable."

Guntram Wolff, director of Brussels think tank Bruegel, says that across a range of issues, "Germany thinks more and more that we should move back to a model where countries are responsible on their own." Without a fiscal, political and banking union, he argues, "we will have a euro that just survives, but not one that functions well."

—Gabriele Parussini and William Horobin in Paris contributed to this article.

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