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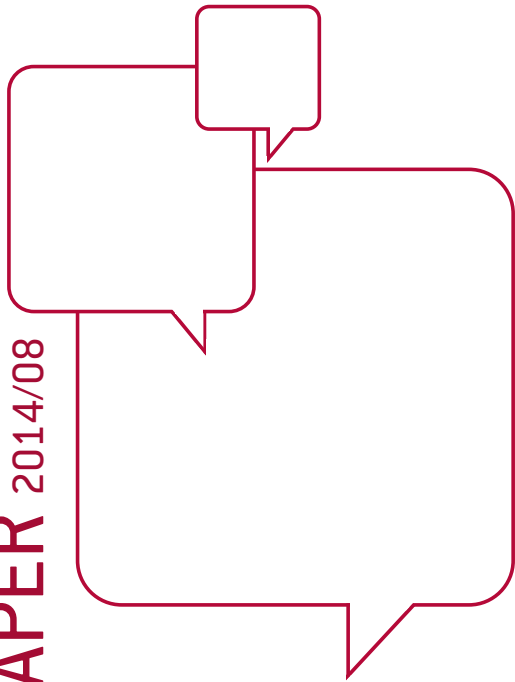
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EUROPE BETWEEN FINANCIAL REPRESSION AND REGULATORY CAPTURE

ERIC MONNET, STEFANO PAGLIARI AND SHAHIN VALLÉE

Highlights

- The financial crisis modified drastically and rapidly the European financial system's political economy, with the emergence of two competing narratives. First, government agencies are frequently described as being at the mercy of the financial sector, routinely hijacking political, regulatory and supervisory processes, a trend often referred to as "capture". But alternatively, governments are portrayed as subverting markets and abusing the financial system to their benefit, mainly to secure better financing conditions and allocate credit to the economy on preferential terms, referred to as "financial repression".
- We take a critical look at this debate in the European context. First, we argue that the relationship between governments and financial systems in Europe cannot be reduced to polar notions of "capture" and "repression", but that channels of pressure and influence between governments and their financial systems have frequently run both ways and fed from each other. Second, we put these issues into an historical perspective and show that the current reconfiguration of Europe's national financial systems is influenced by history but is not a return to past interventionist policies. We conclude by analysing the impact of the reform of the European financial architecture and the design of a European banking union on the configuration of national financial ecosystems.

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1. INTRODUCTION

In the long shadow of the euro-area crisis, the relationship between governments and their banks has been brought to the centre of the policy debate in Europe by the implementation of regulatory reforms, the risks associated with financial fragmentation, and the fight to sustain the flow of credit to governments and corporates. The attempt to interpret the patterns of pressure and influence running between governments and their financial system has led commentators to rediscover and give new life to concepts originating from academic debates of the 1970s such as “regulatory capture” and “financial repression”. Government agencies have been frequently described as being at the mercy of the financial sector, often allowing financial interests to hijack political, regulatory and supervisory processes in order to favouring their own private interests over the public good¹. An opposite view has instead pointed the finger at governments, which have often been portrayed as subverting markets and abusing the financial system to their benefit, either in order to secure better financing conditions to overcome their own financial difficulties, or with the objective of directing credit to certain sectors of the economy, “repressing” the free functioning of financial markets and potentially the private interests of some of its participants².

But a closer look at the experience of European countries suggests that both the notion of “capture” and “repression” are too narrow to describe the complex relationship between financial stakeholders and their national governments. Instead, the history of European financial systems reveals how governments, central banks, public sector banks and financial institutions have historically been part of deeply interconnected European financial ecosystems bound both by political and financial relations. Patterns of pressures and influence within these financial ecosystems have always run in both directions and have been mutually reinforcing.

As Andrew Shonfield argued in 1965 in one of the first detailed analyses of the role of governments and

¹ Baxter has defined capture as occurring “*whenever a particular sector of the industry, subject to the regulatory regime, has acquired persistent influence disproportionate to the balance of interests envisaged when the regulatory system was established*”. Lawrence G. Baxter (2011) ‘Capture in Financial Regulation: Can We Redirect It Toward the Common Good?’ *Cornell Journal of Law & Public Policy* 175-200. The origins of the concept: see George J. Stigler (1971) ‘The Theory of Economic Regulation’, *The Bell Journal of Economics and Management Science*, Vol. 2, No. 1. See also Dal Bó, Ernesto (2006) ‘Regulatory Capture: A Review’, *Oxford Review of Economic Policy*, 22(2), 203–225. For a recent discussion of the problem of capture in the context of the financial crisis see Carpenter, Daniel and David A. Moss (eds) (2013) *Preventing Regulatory Capture: Special Interest Influence and How to Limit it*, Cambridge University Press; Johnson, Simon (2009) ‘The Quiet Coup’, *Atlantic Monthly*, May; and Daron Acemoglu and Simon Johnson (2012) ‘Captured Europe’, *Project Syndicate*, May, available at <http://www.project-syndicate.org/commentary/captured-europe>.

² Reinhart, Carmen M. (2012) ‘The return of financial repression’, *Financial Stability Review*, 16, 37-48; Kirkegaard, Jacob F. and Carmen M Reinhart (2012) ‘Financial repression, then and now’, *VoxEU.org*, May; Allianz Global Investors (2013) *Financial Repression. It Is Happening Already*, available at: <https://www.allianzglobalinvestors.de/cms-out/kapitalmarktanalyse/docs/pdf-eng/analysis-and-trends-financial-repression-it-is-happening-already.pdf>.

of the “*balance of public and private power*” in western capitalism after WWII, these different financial ecosystems in Europe varied across countries because of different histories and institutions that framed such relationships³. These national differences have frequently been presented as declining with time and in response to deeper financial integration. The breakdown of the Bretton Woods system in the early 1970s, the removal of restrictions to the circulation of capital within Europe following the 1986 Single European Act, the creation of the single currency, and the process initiated in 2001 by the European Commission with the Lamfalussy Report to extend the single market to financial services have fostered a greater integration of banking and financial activities across national borders that have profoundly altered existing national ecosystems⁴. The response to the euro-area crisis seems to have further encouraged this trend, and new institutional mechanisms, in particular the creation of a European banking union, typically aims at Europeanising further banking supervision and resolution thereby potentially reducing further the weight of national historical and institutional idiosyncrasies.

However, claims suggesting the end of national financial ecosystems in Europe are at best premature. This paper discusses how national financial ecosystems in Europe continue in fact to exercise a significant influence over financial policy-making and how the transition towards a more integrated financial framework (ie banking union) influences these relations. Our conjecture is that the rapid reversal of financial integration and a re-domestication of financial flows and financial risks triggered by the crisis⁵ have built on practices, ties and institutions that have deep historical roots. Meanwhile, the European policy response, which intended to repair financial fragmentation and recreate a more integrated financial sector has attempted to Europeanise the regulation, supervision, resolution of the financial sector thereby trying to break historical ties within national financial ecosystems. It is therefore important to take a critical look at these opposite movements and the way they affect not

³ Andrew Schonfield (1965) *Modern capitalism: The changing balance of public and private power*, Oxford University Press. A subsequent literature in political sciences has coined the term “*varieties of capitalism*” to study these differences and their institutional roots: Colin Crouch and Wolfgang Streeck (eds) (1997) *The Political Economy of Modern Capitalism: Mapping Convergence and Diversity*, London: Sage; Peter A. Hall, David Soskice (eds) (2001) *Varieties of Capitalism. The Institutional Foundations of Comparative Advantage*, Oxford University Press.

⁴ De Larosière Jacques (2009) *Report on financial supervision to the European Commission*; Mügge, Daniel (2006) 'Reordering the Marketplace: Competition Politics in European Finance', *Journal of Common Market Studies*, 44(5), 991–1022.

⁵ For the literature on financial retrenchment globally see for example Lund, Susan *et al* (2013) *Financial globalization: retreat or reset?* McKinsey, available at http://www.mckinsey.com/insights/global_capital_markets/financial_globalization; Milesi-Ferretti, Gian Maria and Cedric Tille (2011) 'The Great Retrenchment: International Capital Flows during the Global Financial Crisis', *Economic Policy* vol. 26(4), pp. 285-342. Re-nationalisation of financial intermediation and financial policy has emerged as a response to the contradiction between international market integration and spatially limited political mandates, as highlighted in the political science literature: Pontusson, J. and Raess, D. (2012) 'How (and Why) Is This Time Different? The Politics of Economic Crisis in Western Europe and the United States', *Annual Review of Political Science*, 15, 13-33; Clift, B. and Woll, C. (2012) 'Economic patriotism: reinventing control over open markets', *Journal of European Public Policy*, 19(3), 307-323; Schmidt, V. A. and Thatcher, M. (eds) (2013) *Resilient liberalism in Europe's political economy*, Cambridge University Press.

only the efficacy of capital allocation and credit intermediation at the national level, but also the policy-making process at the European level.

2. BANKS AND GOVERNMENTS: COMPETING NARRATIVES ACROSS THE ATLANTIC

Attitudes towards the relationship between governments and national financial institutions have historically varied significantly across the United States and Europe. Suspicions over the involvement of politically powerful banks in the political system have been an integral part of the US political debate. These can be traced as far back as the controversy between Alexander Hamilton and Thomas Jefferson about the establishment of the First Bank of the United States in 1791⁶. More recently, many commentators seeking to explain the regulatory failures at the origin of the financial crisis have repeatedly pointed the finger towards the political clout of financial lobbies. The Report by the Financial Crisis Inquiry Commission established by the US Congress to investigate the roots of the crisis found that: “*the financial industry itself played a key role in weakening regulatory constraints on institutions, markets, and products*”. The Commission explained this influence by making reference to the \$2.7 billion in federal lobbying expenses and \$1 billion in campaign contributions spent by the financial sector between 1999 and 2008⁷. Others have highlighted how the role of the preferential access allowed by the “revolving doors” between Wall Street and US regulatory agencies⁸.

The perception of financial industry groups capable to often act as rule-makers has brought a number of commentators to analyse the relationship between US financial firms and the political system through the lenses of “regulatory capture”. The origins of the term are usually attributed to the work of George Stigler in the early 1970s but this concept has been brought to the fore by Simon Johnson, former IMF chief economist, and other commentators during the recent financial crisis⁹.

This description of the financial industry as systematically “capturing” the design and implementation financial regulatory reforms has however resonated more broadly in the US than across the Atlantic. This is in part the result of the fact that the focus of most US-centric analyses on financial resources, campaign contributions and revolving doors as means through which the financial industry is capable

⁶ Goldstein, Morris and Veron, Nicolas (2011) 'Too Big to Fail: The Transatlantic Debate', *Working Paper* No. 11-2, Peterson Institute for International Economics; Johnson, Simon and Kwak, James (2011) *13 bankers: the Wall Street takeover and the next financial meltdown*, Vintage.

⁷ FCIC (2011) *The Financial Crisis Inquiry Report. Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*. Washington, DC: The Financial Crisis Inquiry Commission. See also Johnson, Simon (2009) 'The Quiet Coup', *Atlantic Monthly*, May.

⁸ US GAO (2011) 'Securities and Exchange Commission. Existing Post-Employment Controls Could be Further Strengthened', Government Accountability Office, GAO-11-654 Report, Washington DC.

⁹ Stigler (1971). See footnote 1.

to routinely “buy” regulatory policies does not sit comfortably with the experience of most European countries, where political party financing and electoral rules limit the importance of financial resources in buying political support, while bureaucrats in financial regulatory agencies and central banks are more likely to spend most of their career in the public sector.

Campaign contributions and revolving doors are not the only channels through which the interest groups are capable to capture the policy-making process. On the contrary, while theories of regulatory capture developed from the US experience have focused on the resources that different financial groups are capable of deploying in the lobbying of the US Congress or federal regulatory authorities, the European experience is illustrative of the wider and often less visible channels through financial which banks often influence the design of financial policies. A number of structural characteristics of different financial ecosystems in Europe have bolstered the influence of European banks over the design of financial policies. These include for instance the formal and informal links between the political system and the banking system. For instance, German public saving banks (Sparkassen and Landesbanken) that held some 33 percent of the assets of the German Banking sector in 2009 remain owned and controlled by regional governments¹⁰, which naturally create a peculiar relationship. In Italy, state-owned banks have been privatised over the last few decades, but many of these institutions remain still today under the influence or control of foundations (“*fondazioni bancarie*”) that maintain close ties with the political system and in some cases are directly appointed by political parties¹¹. In Spain, small and medium size *Cajas* remained partly owned by the public and largely under the influence and control of regional officials and religious leaders, thus weakening the hand of the central government in supervising and regulating them and favouring undue forbearance by the central authorities. These formal ties are frequently reinforced by informal ties, such as the social networks embedded in the French *Grandes écoles* where future civil servants, politicians and bankers are trained together and come to form networks of influence organises around the *Grands Corps*¹². These formal and informal ties between the political system and the banking system make banks particularly receptive to political guidance at the local, state and federal level but also allow these institutions to exercise a significant

¹⁰ The Landesbanken are themselves partly owned by regional confederations of Sparkassen (saving banks) and respective federal states. See also Grossman Emiliano (2006) 'Europeanisation as an interactive process: German public banks meet EU competition policy', *Journal of Common Market Studies*, vol. 44, n°2, p. 325-347.

¹¹ Giani, Leonardo (2008) 'Ownership and Control of Italian Banks: A Short Inquiry into the Roots of the Current Context', *Corporate Ownership & Control*, Vol. 6, No. 1, pp. 87-98.

¹² On the role of these networks for banking reforms, see Butzbach Olivier, Grossman Emiliano (2004) 'La réforme de la politique bancaire en France et en Italie : le rôle ambigu de l'instrumentation de l'action publique', in *L'instrumentation de l'action publique* (sous la dir. de Pierre Lascoumes et Patrick Le Galès), Presses de Sciences Po, Paris, pp. 301-330. More general references are Swartz, David (1985) 'French Interlocking Directorships: Financial and Industrial Groups', in Stokman, Ziegler and Scott (eds) *Networks of Corporate Powers: A Comparative Analysis of Ten Countries*; Kadushin, Charles (1995) 'Friendship Among the French Financial Elite', *American Sociological Review*, Vol 60, N_2, pp 202-221. For a quantitative approach highlighting the role of networks of former high ranking civil servants in shaping board composition of banks and other corporations, see Kramarz, Francis and Thesmar, David (2013) 'Social networks in the boardroom', *Journal of the European Economic Association*, 11:780–807.

influence over the regulatory process through their political connections.

Another characteristic of the European financial systems that is often ignored by US-centric analysis of regulatory capture is the greater reliance of European countries on bank credit for financing the real economy as well as sovereign debt. This structural feature of European financial systems, gives to banks rather than other financial intermediaries a particular importance and creates channels through which national financial institutions are likely to gain leverage over policy makers. As Cornelia Woll argues, “*decision-makers will act in favour of the industry because they need finance for funding the so-called real economy, for funding the government and as a motor for growth*”¹³. These kinds of relations also explain why even without strong pressures by the financial industry, governments feel compelled to consider that the interest of the financial sector are aligned with those of the economy and the country as a whole. For example, Sir Howard Davies, the first Chair of the UK Financial Services Authority explained how during the pre crisis period “*on the whole, banks [in the UK] did not have to lobby politicians, largely because politicians argued the case for them without obvious inducement*”¹⁴.

Indeed, some of the same dynamics have been fully in display during the response to the global financial crisis when concerns about the potential impact of regulation on banks balance sheets and possible consequences on the extension of credit to the economy have brought politicians in a number of European countries to support the demands from their financial industry to water down these regulatory measures. The greater success of European banking lobbies in having their demands met during the implementation of Basel III at the European level has clearly been influenced by the link with the real economy that the financial industry was able to establish¹⁵. Indeed, financial industry lobbies seem to have achieved concessions conditional on their capacity to highlight the impact of different pieces of regulation over their capacity to provide credit to the broader economy¹⁶. At the same time, the watering down of key regulatory requirements has been accompanied by repeated calls from European politicians towards banks which were asked to commit to increase credit to the domestic economy.

Overall, the experience of recent banking regulatory reforms in Europe are indicative not only of the fact that the significant political influence of banks is not uniquely a US phenomena. On the contrary, the

¹³ Woll, Cornelia (2013) 'The power of banks', *Speri*, University of Sheffield, July.

¹⁴ Davies, Howard (2010) 'Comments on Ross Levine's paper "The governance of financial regulation: reform lessons from the recent crisis"', Bank for International Settlements; see also The Warwick Commission on International Financial Reform (2009) *In Praise of Uneven Playing Fields*, University of Warwick.

¹⁵ Howarth, David and Quaglia, Lucia (2013) 'Banking on Stability: The Political Economy of New Capital Requirements in the European Union', *Journal of European Integration* (May), 37–41.

¹⁶ Pagliari, Stefano and Young, Kevin L. (2014) 'Leveraged interests: Financial industry power and the role of private sector coalitions', *Review of International Political Economy*, 21(3), 575–610.

influence of European banks over the design of financial policies frequently arises from a number of structural characteristics of the different financial ecosystems in which they find themselves operating. But shifting the focus from the direct lobbying of financial institutions towards the characteristics of different financial ecosystems in Europe also reveals a further corrective to notion of 'capture' that has frequently been used to interpret the relationship between banks and government agencies. While many US-centric have focused on the influence of financial actors and other interest groups over the state, channels of pressure and influence between European governments and their banking system within distinct European financial ecosystems have frequently been presented as running both ways and feeding from each other. These reciprocal channels of influence between European governments and their banking systems will be explored in the next section by looking at modern European history.

3. HISTORICAL PERSPECTIVES ON FINANCIAL ECOSYSTEMS

Examples of this symbiotic relationship between European governments and their financial system abound throughout modern European history. European governments have indeed frequently used banks to expand and broaden their reach over the economy either domestically or internationally. The creation of Deutsche Bank in 1870 in the context of the formation of the German Empire and the need to challenge the leadership of British banks in the global markets, as well as the creation of public credit institutions in Italy and France to support national financial development or postwar reconstructions are only some of the many examples throughout modern European history of the way through which financial nationalism and The promotion of "national banking champions" was also often intended to allow competition with European neighbours and the projection of power internationally to accompany the internationalisation of domestic firms¹⁷.

The involvement of the State in financial developments in the nineteenth century went beyond the promotion of international champions. During this period, financial liberalisation went hand in hand with the promotion of national credit and state intervention. Governments were indeed keen on rescuing banks in order to save bankers interests as well as the financing of the economy, and personal connections between politicians and bankers were crucial to this process¹⁸. Central banks – which were still at the time institutions with private shareholders granted with a monopoly on the right

¹⁷ Morris and Veron (2011), see footnote 6. Gerschenkron, A. (1962) *Economic backwardness in historical perspective. Economic backwardness in historical perspective*, Harvard University Press.

¹⁸ Hautcoeur, Pierre Cyrille, Riva Angelo, and White Eugene N. (2013) 'Can Moral Hazard Be Avoided? The Banque de France and the Crisis of 1889', paper presented at the 82nd Meeting of the Carnegie-Rochester-NYU Conference on Public Policy; Caroline Fohlin (2012) *Mobilizing Money: How the World's Richest Nations Financed Industrial Growth*, New York: Cambridge University Press.

to issue – were perfect examples of these connections between governments and financial capitalism that developed throughout the nineteenth century. European governments or monarchs also exerted controls on some large credit institutions that were crucial for the financing needs and debt repayments of local authorities, as the Caisse des Dépôts and Crédit Foncier in France and the Cassa Depositi e Prestiti in Italy.

For a long period, the collusion between State and banks went hand in hand with significant government interference in the activities of financial firms in order to channel and allocate credit in a non-competitive way. But the controls of the State over financial systems strongly increased after the Great Crash throughout the 1930s in democratic and dictatorships alike, and were reinforced after the second world war with bank nationalisations and the increasing role given to public credit institutions.

Also in the years following the end of the second world war, western European governments continued to strategically direct their domestic banking system towards the achievement of specific public policy objectives. The term “financial repression” – coined in the early 1970s to describe developing economies in Asia and Latin America¹⁹ – has been used retrospectively to indicate a wide range of targeted prudential controls and requirements such as capital controls, reserve requirements, capital requirements, and various taxes and levies to favour – directly or indirectly – the holding of government debt. In addition, over the same period, interventionist credit policies were developed to influence the allocation of credit through price or quantity rules so as to offer a competitive advantage to certain economic sectors. A key feature of these interactions during this period was to force financial institutions to extend credit that would otherwise have to be funded by government deficits expenditures²⁰. This alternative financing of state intervention contained public debt while introducing political pressures and “distortions” of competition in the financial sector. Banks were sometimes requested to hold a certain amount of government bonds and of claims on certain sectors as a percentage of their total asset. The same outcomes could also be pursued indirectly by central banks in their design of monetary policy operations (reserve requirements, credit ceilings, liquidity ratios) and through collateral policy facilitating banks access to the discount window for certain categories of claims. The intervention of governments in the working of their respective domestic markets also frequently occurred through the development of public credit institutions as substitutes to banks and

¹⁹ McKinnon, Ronald (1973) *Money and capital in economic development*, Brookings Institution Press.

²⁰ Hodgman Battilossi, Stefano (2005) 'The Second Reversal: The ebb and flow of financial repression in Western Europe, 1960-91', Open Access publications from Universidad Carlos III de Madrid; Monnet, Eric (2014) 'The diversity in national monetary and credit policies in Western Europe under Bretton Woods', in *Central banks and the nation states*, O.Feiertag and M.Margairaz (eds), Paris, Sciences Po, forthcoming; Monnet, Eric (2013) 'Financing a planned economy, institutions and credit allocation in the French golden age of growth (1954-1974)', BEHL Working Paper n°2, University of Berkeley; Hodgman, Donald (1973) 'Credit controls in Western Europe: An evaluative review', *Credit Allocation Techniques and Monetary Policy*, The Federal Reserve Bank of Boston.

through the direct investment of Western European governments in some specific sectors (housing, agriculture, industry etc) and support industrial policies or resort to the development of state-owned credit institutions or public banks as substitutes to banks

All in all, these policies were used – at different degrees across countries– to control risk in the banking sector, to support industrial policy, facilitate government-financing needs and control inflationary risks²¹.

These tools also shared a strong national bias; most savings, investments, government financing came from domestic sources and financial regulation aimed to mitigate risks and influence the allocation of credit at the national level. As a consequence, the political economy of these systems relied on connections and coordination²² at the national level between government agencies, public and private lending institutions and industries. Employees circulated easily and frequently between public administrations and nationalised firms or banks. In the name of the public interest, industries negotiated with governments in order to receive subsidies, to be given priority, and sometimes to be rescued²³.

It is only in the late 1970s and 1980s, that these symbiotic relations between Western European governments and their national banking systems approach were challenged by profound intellectual changes about the merits of financial liberalisation and independent central banking and that the negative effects of governments interventions (unproductive rents, crowding out, over-saving by state owned institutions) became more central to economic thinking and policymaking. As a result, the recourse to these interventions and instruments gradually but rapidly vanished. Countries – prominently France– experienced a radical liberalisation in the mid 1980s and all converged towards an open financial system with a mature money market in the early 1990s.

As a result of this new settlement, financial ecosystems were organically but deeply redesigned, and as a result, financial and political relationships were recomposed. The expansion and deepening of

²¹ Monnet Eric (2012) 'Monetary policy without interest rates. Evidence from France's Golden Age (1948-1973) using a narrative approach', *Working Papers* 0032, European Historical Economics Society (EHES).

²² Eichengreen, Barry (2008) *The European economy since 1945: coordinated capitalism and beyond*, Princeton University Press.

²³ Pontusson & Raess (2012) 'How (and Why) Is This Time Different? The Politics of Economic Crisis in Western Europe and the United States', *Annual Review of Political Science*, vol. 15, pp. 13-33; Zysman, John (1983) *Governments, markets, and growth: financial systems and the politics of industrial change*, Cornell University Press. The academic literature that builds on the "varieties of capitalism" has studied extensively how these national characteristics and "institutional complementarities" were shaped and reinforced by the role of the state, then shaping these various forms of "capitalism". Schonfield, A. (1965) *Modern Capitalism: The Changing Balance of Public and Private Power*, Oxford University Press. Peter Katzenstein (1985) *Small States in World Markets*, Ithaca, Cornell University Press; Peter Hall, David Soskice (eds) (2001) *Varieties of Capitalism*, Oxford University Press.

cross border capital flows supported further financial market openness, independence of central banks and disengagement from the public sector²⁴.

In sum, while distinct financial ecosystems characterised by symbiotic relationship and reciprocal patterns of influence between governments and their banking industry have exercised a significant influence in the past, these differences have frequently been presented as in decline at the turn of the century. The question remains whether the current crisis has interrupted this decline and reinvigorated past behaviours and historical relationships?

4. THE EUROPEAN CRISIS AND THE RECOMPOSITION OF NATIONAL ECOSYSTEMS

The abrupt interruption in cross border capital movement has triggered a clear renationalisation of finance over the last three years and has profoundly modified relations between national financial systems and governments in Europe²⁵. The vast and ubiquitous use of government expenditures and guarantees to support the financial system²⁶ has been followed by widespread calls for tighter regulation and supervision of the financial sector as a whole and of the banking sector in particular. In addition, in many instances, the crisis has unsettled governments' access to financial markets and increased their borrowing cost. The economic downturn has in turn woken up a certain desire and a need to address credit shortages and intervene more forcefully in the financial system to improve and augment the extension of credit and facilitate the recovery. However, if governments in Europe have not resorted completely and openly to the policies and instruments that had characterised the Bretton Woods era, a number of developments could indicate a redefinition of the relations between the public and the financial sector along the lines of pre-existing historical relations and behaviours.

The most common and clearly identified aspect of these changing landscapes is the extent to which holdings of public debt have been on balance re-nationalised. Debt sustainability concerns, uncertainty about the integrity of the European monetary union and the reluctance of the central bank to address risks of multiple equilibria in sovereign debt markets in the euro area²⁷ have all contributed to put sovereign debt markets under strain and forced governments to rely on national savings and

²⁴ Mügge, Daniel (2006) 'Reordering the Marketplace: Competition Politics in European Finance', *Journal of Common Market Studies*, 44(5), 991–1022.

²⁵ Carmen Reinhart (2012) 'The return of financial repression', CEPR, DP8947; Sapir, André, and Wolff, Guntram (2013) 'The neglected side of banking union: reshaping Europe's financial system', *Policy Contribution*, Bruegel; Goodhart, Charles (2013) 'Lessons for monetary policy from the Euro-area crisis', *Journal of Macroeconomics*.

²⁶ Stolz, S. M., and Wedow, M. (2010) 'Extraordinary measures in extraordinary times: Public measures in support of the financial sector in the EU and the United States', *Occasional Paper 117*, European Central Bank.

²⁷ De Grauwe, Paul (2011) 'The European Central Bank: Lender of last resort in the government bond markets?' CESifo working paper: Monetary Policy and International Finance (No. 3569). De Grauwe, Paul, and Ji, Yuemei (2012) 'Mispricing of sovereign risk and multiple equilibria in the Eurozone', Centre for European Policy Working Paper 361.

national financial institutions to finance their expenditures. Despite these developments, the current re-domestication of government debt holding does not appear to be an unseen phenomenon, nor a direct return to the pre-EMU situation. Among countries of the euro area, only Spain has today a level of sovereign debt held by residents (including central banks and financial corporations) higher than before it joined the euro.

The huge exposure of government towards their banking system is therefore not a phenomenon that was born during the crisis but is a well-established feature of European economies since the 1980s. Nevertheless, what is true on average is not necessarily true on an individual basis. Ireland and Portugal for instance, have experienced a dramatic increase in this ratio from 2006 to 2011 while in Germany, Belgium and France, on the contrary, the financial crisis has not stopped a downward trend in the domestic holding of government debt. These trends are characterised by a strong path dependency, which supports the argument that historical trends are still important for the structure of bank holdings.

A second aspect of these changing landscapes is the evolution in the centrality of central banks in the European national financial ecosystems. This role had significantly been curtailed after the demise of Bretton Woods with the creation of the Eurosystem, the centralisation of key central prerogatives within the ECB and the emergence of principle of central bank independence. However, during the current crisis, with growing financial fragmentation, impaired transmission mechanisms, the European Central Bank was forced to take a more active role to repair transmission channels and it contributed to increase the holding of government bonds held by central banks of the Eurosystem. This modification of its collateral framework also allowed National Central Banks to exert some discretion in the types of claims they could accept as collateral which may have increased the national bias in the refinancing of credit claims²⁸.

These dynamics have provoked a vivid reaction denouncing both financial repression and “fiscal dominance”²⁹ of central banks but these criticisms seem to ignore the fact that the most striking feature of European national central banks’ balance sheet expansion is not the result of greater accumulation of public debt but rather of an historically unprecedented increase in central bank credit to the private economy. Central bank balance sheet usually increased during wars and recessions mostly to ease government financing. After 1945, some central banks became more involved in

²⁸ Merler, Silvia, and Pisani-Ferry, Jean (2011) 'Hazardous tango: sovereign-bank interdependence and financial stability in the euro area', *Financial Stability Review*, [16], 201-210.

²⁹ In a 25 November 2013 speech, J. Weidmann said that “*Monetary policy runs the risk of becoming subject to financial and fiscal dominance*”, see <http://www.bis.org/review/r131126b.pdf>.

directed credit and used their balance sheet to finance long-term investment and influence the allocation of credit through re-discount privileges and choices. However, even in the central banks that used these techniques extensively such as France, the ratio of central bank's claim on the domestic banking sector never really exceeded 8-10 percent of GDP. In the euro area, it has now reached more than 30 percent of GDP. This contrasts starkly with the UK and the US where the Bank of England and the Fed assets purchase were largely government and quasi-government liabilities³⁰.

Arguably, a large part of these claims, are in reality claims on the financial sector caused by the extension of large amounts of liquidity to the banking sector. Indeed, never in history did central banks support an entire financial system to this extent. While the UK stands out here as having provided relatively little liquidity support to its banking sector beyond purchase of government bonds, the ECB, on the contrary, has accumulated claims to the banking sector by a record amount. In 2011, central bank claims on the banking sector in the euro area was 30 percent of GDP, ranging from 0.1 percent for the Bank of Finland to 68.7 percent for the Bank of Ireland. Interestingly, those central banks that have the least government debt, tend to have the most claims on the private sector thereby potentially revealing important differences in the structures of national ecosystems.

The intervention of central banks in the financial sector has further been increased by the acknowledgement that macro-prudential regulation is a necessary complement to modern central banking. The new macroprudential mandate acquired granted during the crisis to central banks is in part a return to the theory and practice of central banking 30 years ago in Europe (even though the term "macroprudential" was coined recently) when central bankers thought their role extended well beyond the narrow remit of monetary policy.

A third significant evolution in the relationship between governments and the financial system that has in part turned the clock back can be found in the return of "public credit institutions" (also known as "development banks"). These state-owned lenders in France, Germany, Italy and Spain, respectively the Caisse des dépôts et consignations (CDC), the Kreditanstalt für Wiederaufbau (KfW), the Cassa depositi e prestiti (CDP) and the Instituto de Crédito Oficial (ICO) have considerably increased their scope as of recently. The CDC and CDP are old state owned institutions (created respectively in 1816 and 1863) that played an important historical role in the economic development of France and Italy. The KfW was created in 1948 to support the reconstruction of the German economy while the Spanish ICO is more recent (1971). Their role in the economy has increased greatly and rapidly during the

³⁰ For example, speech by David Miles from the BoE: 'Government debt and unconventional monetary policy', at the 28th NABE Economic Policy Conference, Virginia, 26 March 2012.

financial crisis. While total assets of the credit institutions of the Euro Area increased by only 4 percent from 2008 to 2012, assets of public credit institutions increased by at least 30 percent and even 128 percent for the ICO. These institutions have also, together with the European Investment Bank, which has also expanded its lending activities quite substantially by 56 percent over the same period (2008-2012), collectively created the “long-term investors” club to promote their role in the economy as a provider of long term financing³¹.

The detailed balance sheets of these institutions show that they have performed various functions over time with different emphasis in each country. The Cassa de Depositi e Prestiti for example has expanded its credits to the public sector tremendously, extending some €85bn worth of loans to public (mainly local) entities and purchasing some €90bn in Italian government bonds and bills. In France, the CDC has repositioned its portfolios away from European peripheral countries’ debt into French sovereign debt where the exposure almost doubled. The CNP insurances company, which is the 6th European insurance company in assets size and which is owned by the CDC, has also accomplished a similar portfolio rebalancing towards domestic debt.

Meanwhile, in Germany, KfW played a quite different role by first being largely used to provide capital, loans and guarantees to the financial sector³² during the first wave of the crisis in particular in the case of IKB. It also expanded its financing to local SME and infrastructure in Germany and abroad. Indeed, the KfW played an important role in German financial aid to other European countries as in Greece with some €22bn of outstanding credits at the end of 2011, Italy with some €1.7bn, Ireland with €1.4bn, Spain with €3.2bn. These institutions are therefore not only important to understand the political economy of national eco-systems but also of new financial relationships between European nations during the crisis. Indeed, in Spain for instance, KfW lends to Spanish SMEs through the ICO. It is also interesting to observe that the countries that did not have an important “development bank” (such as Portugal and Greece) are now in the process of creating one³³.

In essence, the existence of these institutions has allowed reactivating practices and mechanisms of intrusion in the intermediation system that were an essential part of the financial ecosystem over the last century. Their role is probably even reinforced in European countries today by the fact that national

³¹ The long-term investors club: <http://www.ltic.org/>. See also green paper by the European Commission on long-term finance: http://ec.europa.eu/internal_market/finances/financing-growth/long-term/index_en.htm.

³² Between the end of 2007 and February 2008, IKB had to go through several rounds of financial support in which banks and the KfW agreed to two more bailout packages, which ended up increasing KfW's participation in IKB from 38 percent to 90.8 percent. For more details see Cornelia Woll (2014) *The Power of Collective Inaction: Bank Bailouts in Comparison*, Ithaca, Cornell University Press.

³³ 'Germany to help Spain with cheap loans', EUObserver, 28 May 2013, <http://euobserver.com/economic/120278>.

central banks and governments cannot provide direct public support or target specific sectors via subsidised loans as they used to do in the immediate post war period. In many countries (but not in all) national credit institutions never really disappeared, they just blended in. The CDC's total assets for instance represent 15 percent of GDP in 2012 when it was equal to 17 percent of GDP in 1970. Governments for the most part therefore never really disbanded the institutions they had built of the last century and they proved relatively easy to awaken and mobilise as the crisis hit.

Contrary to Carmen Reinhart's argument, it is misleading to these developments as a mere "return of financial repression"³⁴. The intervention of European states in their financial system have not intended to become substitute for fiscal or industrial policy and thus differ drastically from historical quantitative tools used by central banks thirty years ago. Nonetheless, it is clear that the greater re-nationalisation in the holding of public debt by domestic financial institution, the unprecedented increase in central bank credit to the private economy, and the return of public credit institutions are three developments since the financial crisis that have reaffirmed the centrality of distinct European financial ecosystems after two decades in which these ties had been eroded by financial liberalisation and the process of European monetary integration.

5. EUROPEAN FINANCIAL ECOSYSTEMS AND THE MOVE TOWARDS A BANKING UNION

The previous section has discussed how the changes in the patterns of financial intermediation and sovereign debt holding emerged in response to the crisis, but the implications of these trends extends well beyond economics and deep into the political arena and the debate concerning the reform in the European financial architecture.

The long and troubled history of the construction of an integrated market for financial services in Europe has often been described as a "battle of the systems" across different European countries, in particular between systems such as Britain where capital markets played a key role as the main source of financing and the continent where banks dominated the provision of credit³⁵. But on the continent itself, national practices and structures also differ greatly and are somewhat embedded in the domestic institutions and possibly in different varieties of capitalism³⁶.

The realisation of an integrated financial market encouraged first by the Banking Directive in 1977, the

³⁴ Reinhart, C. M. (2012) 'The return of financial repression', *Financial Stability Review*, 16, 37-48.

³⁵ Story, Jonathan, and Walter, Ingo (1997) *Political Economy of Financial Integration in Europe: The Battle of the Systems*, MIT Press.

³⁶ Hall, Peter and Soskice, David (2001) *Varieties Of Capitalism: The Institutional Foundations of Comparative Advantage*, Oxford University Press.

Single European act in 1986 and the Lamfalussy Report in 2001 had partially redesigned the fault lines in European financial policies. The traditional conflicts across different countries reflecting the preferences of their national champions was complemented by the emergence of coalitions of large pan-European groups with a strong interest in removing obstacles to the emergence of an integrated financial market for financial services in Europe, often pitted against firms with a more local or national outlook threatened by this trend.

The dynamics triggered by the financial crisis have reinforced the channels of pressure and influence between European governments and their banking systems. The greater nationalisation of financial intermediation as well as the wave of re-regulation revive strong national preferences and tensions in the design of financial policies. Debates surrounding the design and implementation of Basel III for example, have instead witnessed the re-emergence of traditional national cleavages, with different European regulatory authorities frequently running in support of their banking industry at the negotiating table. The violent realisation that the monetary union did imply lesser avenues for economic adjustment in response to shocks has certainly strengthened the reluctance of national governments to deprive themselves of policy levers to influence credit intermediation. On the other hand, the financial sector seems to have been able to use this dependency in order to extract concessions from national regulatory authorities that would serve its own interests. The influence of financial industry groups over the position of their respective governments has not been confined to countries with large financial sectors, but it has been pervasive also in countries where the financial industry occupies a smaller position in the economy³⁷.

The path towards a banking union – a single supervisory mechanism applying a single rulebook and eventually a single resolution mechanism – is therefore particularly important in this respect. If successful, it should precipitate a profound redefinition of national financial ecosystems in Europe and have broader consequences on the underlying structure of financial intermediation in Europe. This may not be completely compatible with sustaining national preferences as far as the organisation of the financial system is concerned. But it could also reduce the ability of member states to use their financial system to play a cushioning role in the event of economic downturns. This could imply a further reduction in the ability of member state to stabilise their economies and entail much more radical changes in the structures of national capitalisms. The tensions existing between these changes and the historical ties between different governments and their banking systems explain the opposition of domestic financial interests and some national governments have been source of

³⁷ Howarth, David, and Quaglia, Lucia (2013) 'Banking on Stability: The Political Economy of New Capital Requirements in the European Union', *Journal of European Integration* (May), 37–41; Bruegel blogpost by Nicolas Veron: <http://www.bruegel.org/nc/blog/detail/article/1019-basel-iii-europes-interest-is-to-comply/>.

resistance on the way for the establishment of a banking union. The resilience of history within national financial ecosystems and the symbiotic relationships remaining between western European governments and their national banking systems are a key factor shaping the path towards the Europeanisation in the regulation, supervision, resolution of the financial sector that the banking union entails. Will the union break national ties, create a new balance of public and private power at the European level or, on the contrary reinforce domestic specificities and relationships such that a dual system might emerge with two separate levels of activities and political economies (national and European)? There is a wide research agenda ahead as very little has been written up to now on the potential consequences of the banking union for the political economy of national financial ecosystems. The debate has not even fully started and insights from economics, history and political sciences are more than needed at this stage.

6. CONCLUSION

Despite their renewed popularity among economists and policymakers since 2008, neither the notions of “capture” nor “financial repression” appear sufficient to fully understand today’s European dynamic and complex patterns that characterise the relationship between governments and their financial industries at the national and increasingly at the European level.

These seem to be evolving profoundly in two directions. First an apparent rapid reduction of banks’ balance sheets that will probably increase the role of non-banks in the provision of credit and thereby certainly affect profoundly the ties between banks and government insofar as they influence the extension and allocation and credit to the economy. Second, and maybe more importantly, the ongoing process of Europeanisation of financial policy is likely to have profound ramifications for both financial ecosystems themselves and for the relationships that governments and financial institutions develop. In particular, it could be expected that relationships that were so far developed within the confines of national borders would be gradually transferred over to the European level via the process of the banking union, thereby side-lining or at least minimising the importance of national governments.

However, developments in the last few years very much question this notion as it appears clearly that the financial crisis has actually awakened institutions, practices and relations that have strengthened the ties between governments and their respective financial ecosystems. Starting from the breadth and scope of financial support³⁸, to the reactivation of certain supervisory and even monetary practices, the ties between national governments and the banking system has been in many ways reactivated in a

³⁸ Woll [2014]. See footnote 32.

way that tends to blur the rigid categories of capture and repression. As a result, a more nuanced prism is needed, focusing on *agency* that national specificities will be able to develop within European contexts as well as on the non-trivial equilibria between public and private interests. The political science literature, which has highlighted the existence and persistence of “varieties of capitalism” in Europe and the resilience of national ecosystems, will be particularly helpful in this respect. This strand of work should also help us to introduce the perspective brought by the political economy literature in the debates about the European monetary union over and above the importance of the need for a banking union as a necessary stabilising feature of the single currency.