Beyond financial repression and regulatory capture.

The recomposition of European financial ecosystems after the crisis

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Abstract

The financial crisis has radically and rapidly changed the political economy of the European financial system. The evolution of relations between European states and their respective financial systems has given rise to two competing narratives. On the one hand, government agencies are often described as being at the mercy of the financial sector, regularly highjacking political, regulatory and supervisory processes. This trend is often referred to as "regulatory capture" and would explain the "soft touch" regulation and bank bailout. On the other hand, governments are portrayed as subverting markets and abusing the financial system for their benefit, mainly to obtain better financing conditions and allocate credit to the economy on preferential terms, a trend called "financial repression" that is considered corrosive to the proper functioning of free markets and a source of capital misallocation. This paper takes a critical look at this debate in the European context. First, he argues that the relationship between governments and financial systems in Europe cannot be reduced to the polar notions of "capture" and "repression", but that the channels of pressure and influence between governments and their financial systems have often been two-way. Secondly, it puts these issues in a historical perspective and shows that the current reconfiguration of national financial systems in Europe is not simply a return to the "interventionist" policies of the past, although it is influenced by the path-dependency of national institutions and characterised by a broader political and economic role for public bodies (public credit institutions, financial supervision agencies, central bank, European relief fund, etc.).

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I. Introduction

In the long shadow of the global financial crisis and then the euro area crisis, the implementation of regulatory reforms and the fight to sustain the flow of credit to governments and corporates have brought the relationship between governments and their banks at the centre of the policy debates across Europe. The attempt to interpret the patterns of pressure and influence running between governments and their financial system has led academics and commentators to rediscover and give new life to concepts originating from earlier debates such as "regulatory capture" and "financial repression".[1] On the one hand, 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 good.[2] An opposite view has instead pointed the finger towards the states - broadly defined -, which are 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

[1] A "financial system" is defined as the set of institutions that allow the exchange of funds between lenders, investors, and borrowers. Banks are key elements of financial systems, not least because of their power to create money and accept deposits. This paper's approach focuses on national financial systems, although it is acknowledged that financial systems interact globally. As we will argue, the national level is still relevant because governments influence financial transactions at this level, through subsidies, personal relationships, moral suasion, bank and financial regulation or monetary policy. The European level creates a new level that needs to be studied in itself, as the elements described above (moral suasion, bank regulation etc.) interact with those at the national level. Note that the term "financial system" is usually seen as broader than the one of "financial center", and more nationwide. For a recent review of the use of "financial center", see Cassis, Youssef. "Londres, New York et la dynamique des places financières internationales, fin xixe-début xxie siècle." Monde (s) 1 (2018): 25-47.

[2] 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, Capture in Financial Regulation: Can We Redirect It Toward the Common Good?, Cornell Journal of Law & Public Policy 175-200 (2011). The origins of the concept see Cf George J. Stigler. "The Theory of Economic Regulation", The Bell Journal of Economics and Management Science, Vol. 2, No. 1 (Spring, 1971). 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, "The Quiet Coup", Atlantic Monthly, May 2009 and Daron Acemoglu and Simon Johnson, 'Captured Europe', Project Syndicate, May 2012 http://www.project-syndicate.org/commentary/captured-europe.

participants.[3]

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. The notion of *capture* presupposes that public authorities are passive recipients of the pressures from the sector they regulate, and the notion of *repression* is based on the idea that the public intervention constrains the regulated sector, without the latter benefiting from the power of the state. We obverse, instead, a two-way relationship where the power of the state and the power of finance are interrelated and even sometimes self-reinforcing.[4]

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 by social, political and financial relations. Patterns of pressures and influence within these interconnected financial and political systems have always run in both directions and often been framed as a strategic game of dominance between the fiscal, monetary and financial sector. The relationships we are talking about often take the form of social ties that can be explained in part by professional trajectories of individuals.[5] But they also can be framed conceptually by

3 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 2012 ; Allianz Global Investors, Financial Repression. It Is Happening Already, report, 2013 https://www.allianzglobalinvestors.de/cms-out/kapitalmarktanalyse/docs/pdf-eng/analysis-and-trends-financial-repression-it-is-happening-already.pdf; Becker, Bo, and Victoria Ivashina. "Financial repression in the European sovereign debt crisis." *Review of Finance* 22.1 (2017): 83-115. Reinhart, Carmen M., and M. Belen Sbrancia. "The liquidation of government debt." Economic Policy 30.82 (2015): 291-333.

[4] Cornelia Woll presents a third option, where the inaction of the financial sector shapes the design of bank bailout packages in favor of the industry. She argues that, during the recent financial crisis, banks were powerful when they were disorganized because it imposed more pressure on the State to act and save financial institutions. Our view in this paper is different – although not incompatible - as we emphasize the mutual interests of public authorities and financial institutions. Cornelia Woll. *The power of inaction: Bank bailouts in comparison*. Cornell University Press, 2014.

[5] See for example Lebaron, Frédéric. "Central bankers in the contemporary global field of power: a 'social space'approach." *The Sociological Review* 56.1_suppl (2008): 121-144. Denord, François, Paul Lagneau-Ymonet, and Sylvain Thine. "Le champ du pouvoir en France." *Actes de la recherche en sciences sociales* 5 (2011): 24-57. Laurens, Sylvain. *Les Courtiers du capitalisme. Milieux d'affaires et bureaucrates à Bruxelles*. Agone (Éditions), 2015. Young, Kevin, Marple, Tim and Heilman, James. 2017. "Beyond the Revolving Door: Advocacy Behaviour and Social Distance to Financial Regulators", *Business and Politics* 19(2): 327-364.

understanding how debt and liquidity are central to the relationship between states and financial markets. In neoliberal societies, the financial sector, spearheaded by the banking system is essentially in the business of maximising profit under regulatory constraints (imposed by governments) and liquidity constraints (imposed by the central bank). It seeks to lighten its regulatory burden by pressuring, lobbying governments (regulatory capture) and to lean on central banks both in general as well as in crisis situations to maximise the amount of liquidity available. Governments have also an ambiguous relationship with the financial sector, they may seek to tax profits, contain systemic risks by imposing regulations but in environments where they do not have full control over the central bank and private financial institutions, they are also dependent on private finance to fund their deficits, and thus are willing to foster the development of liquid debt markets.[6] The fiscal authority is the place where political authority and where in principle democratic decisions are made. It has delegated some powers to the monetary authority for the purpose of issuing currency, targeting inflation and most of the time supervising the financial sector. The financial sector, largely composed of private sector banks plays a critical role in the issuance of money because it has the ability to expand credit on the basis of liquidity provided by the central bank. These actors are therefore connected by a complex web of social, political and economic interactions.

Around this nexus of debt and liquidity, the interactions between fiscal authority, the central banks and private finance take different forms, depended on how they are embedded in social networks, political conflicts, vested interests, and institutions which show a high degree of path dependency. Following a recent literature in financial sociology and political sciences, we make use of the concept of ecosystem to stress the need for a broader view of how financial industry actors are embedded in complex interdependent

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Quennouëlle-Corre, Laure. *La place financière de Paris au XXe siècle: Des ambitions contrariées*. Comité pour l'Histoire économique et financière, 2015. Elsa Massoc, *Banking on States. The Divergent European Trajectories of Finance after the Crisis*, PhD Dissertation in Political Sciences, UC Berkeley, 2018.

[6] See Lemoine, Benjamin. *L'ordre de la dette: Enquête sur les infortunes de l'État et la prospérité du marché*. La Découverte, 2016, for a presentation of policies to develop liquid markets for public debts in France. For a discussion at the international level, see Gabor, Daniela, and Cornel Ban. "Banking on bonds: the new links between states and markets." *JCMS: Journal of Common Market Studies* 54.3 (2016): 617-635.

relationships with a range of different actors.[7] Our analysis will emphasize the need to take into account various financial institutions – whether public, semi-public or private – and various types of political connections to make sense of the recent evolutions of the balance of public and private power in finance. By doing so, we draw on the intellectual tradition that has studied the varieties of financial systems through the lens of institutional complementarity,[8] and we connect it to the more recent literature on financial ecosystems which emphasizes the strength of social networks.

As Andrew Shonfield argued in 1965 in one of the first detailed and comparative analyses of the "balance of public and private power" in Western capitalism after the Second World War, these different financial systems in Europe varied across countries because of different histories, varieties of capitalism and institutions that framed such relationships. 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

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[7] Existing 'population ecology' approaches to the study of interest groups and other political actors have highlighted how the actions of groups is not simply the result of the individual incentives and resources of each group, but is often conditioned by the environments in which these actors find themselves. See Gray, V., & Lowery, D. (1996). *The Population Ecology of Interest Representation*. Ann Arbor, MI: The University of Michigan Press. Along the same lines, different works on the political economy of finance have stressed the need for a broader view of how financial industry actors are embedded in complex interdependent relationships with a range of public and private actors, much like relationships in an ecosystem. For instance, Haldane and May (2011) conceptualize to 'banking ecosystems' in a similar relational frame. Haldane, A. G., & May, R. M. (2011). Systemic risk in banking ecosystems. *Nature*, *469*, 351–5. Seabrooke and Tsingou (2014) draw on Abbott's (2005) notion of 'linked ecologies' to theorize the professional connections within finance. See Abbott, A. (2005). Linked Ecologies: States and Universities as Environments for Professions. *Sociological Theory*, *23*(3), 245–274. Seabrooke, L., & Tsingou, E. (2014). Distinctions, affiliations, and professional knowledge in financial reform expert groups. *Journal of European Public Policy*, *21*(3), 389–407. A review of the use of the notions of ecosystem and ecology in finance is presented in Stefano Pagliari, and Kevin Young, (2015). The interest ecology of financial regulation: interest group plurality in the design of financial regulatory policies. Socio-Economic Review, 14(2), 309-337.

[8] Andrew Shonfield, *Modern capitalism.The changing balance of public and private power,* Oxford University Press, 1965.A subsequent literature in economics and political sciences has coined the term of "varieties of capitalism" to study these differences and their institutional roots Colin Crouch, and Wolfgang Streeck*,* eds., The Political Economy of Modern. Capitalism: *Mapping Convergence* and Diversity, London: Sage, 1997. Peter A. Hall, David Soskice (eds.): *Varieties of Capitalism. The Institutional Foundations of Comparative Advantage*. Oxford: Oxford University Press, 2001. Bruno Amable, The diversity of modern capitalism. Oxford University Press, 2003; Amable, Bruno. "Institutional complementarities in the dynamic comparative analysis of capitalism." *Journal of Institutional Economics* 12.1 (2016): 79-103.

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 ecosystems.[9]. The response to the financial crisis seems to have further encouraged this trend through the creation of European supervisory authorities following the De Larosiere Report.[10] As a result of the euro crisis and the more specific risks of financial fragmentation inside the monetary union, the European Union moved towards the establishment of a single supervisory mechanism lodged at the European Central Bank, followed by a directive to harmonise resolution of banks. However, claims suggesting that this dynamic would mark the end of national financial systems in Europe are at best premature. This paper discusses how national financial systems in Europe continue in fact to exercise a significant influence over financial policymaking and how the transition towards a more integrated financial framework (ie. Banking union and a capital markets union in the parlance of Brussels) influences these relations. The financial crisis has provoked a sudden stop in financial integration and therefore a sharp collapse in private credit creation, visible in the reduction in cross border lending between banks, and repatriation of lending, in stark contrast with decades of expansion and transnationalization of private finance.[11] This renationalization of finance has reawakened practices, ties and

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9 Committee of Wise Men on the Regulation of European Securities Markets, Alexandre Lamfalussy, and David Wright. *Final report of the Committee of Wise Men on the regulation of European Securities Markets*. 2001. For a detailed history of this process:

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

[10] Jacques De Larosiere, former head of the Banque de France and the International Monetary system, adviser at the French bank BNP, was tasked to chair a "High Level Group on Financial Supervision" in the EU 2009. He recommended the creation of the European supervisor for financial markets (ESMA), for Banks (EBA) and for pensions funds (EIOPA). URL: http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf

11 For the literature on financial retrenchment globally see: Cf. Lund, Susan et al., 2013, "*Financial globalization: retreat or reset?*", Mc Kinsey report, Global Institute.

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-nationalization 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., & 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., & Woll, C. (2012). *Economic patriotism: reinventing control over open markets*. Journal of European Public Policy, 19(3), 307-323. Schmidt, V. A., & Thatcher, M. (Eds.). (2013). Resilient liberalism in Europe's political economy. Cambridge University Press.

institutions that have deep historical roots and are embedded in a national context. The most obvious example is the role played by state-led credit institutions in some countries (Caisse des Depots et Consignations (CDC) in France, Cassa Depositi e Prestiti (CDP) in Italy, KFW in Germany) to secure funds to (local and central) governments and corporates during the crisis.[12] The crisis has therefore provoked two opposite reactions: first a renationalisation of private finance, and, second, a strong political drive to take a further step in European financial integration to break historical ties within national financial institutions and politics. It is important to take a look at these opposite movements and what they say about the new political economy of European financial integration. The emphasis on "capture" and "repression", which tends to dominate academic debates and political narratives, would not allow us to understand this dynamic. It is necessary to navigate beyond these two notions and investigate the two-way relationship between states and private finance.

II. Regulatory Capture Theories: US and European Perspectives

Scholarship on the power of the financial industry

The relationship between banks and the State has been the subject of a long-standing debate spanning across different eras and disciplines. In particular, US political debates and scholarship on this subject has often been characterized by suspicions over the involvement of politically powerful banks in the political sphere. This view 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 1791[13]. Most recently, views regarding the political power of the financial industry have found new salience in the aftermath of the global financial crisis, many commentators seeking to explain the

[12] A recent article makes a similar argument, focusing on the role of these institutions in the *Investment Plan for Europe*. Mertens, Daniel, and Matthias Thiemann. "Market-based but state-led: The role of public development banks in shaping market-based finance in the European Union." *Competition & Change* 22.2 (2018): 184-204.

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

regulatory failures at the origin of the financial crisis have repeatedly pointed the finger towards the political clout of financial lobbies. For instance, 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 2008.[14] Others have highlighted the pernicious role of the preferential access to regulation allowed by the system of "revolving doors" (movement of personnel) between Wall Street and US regulatory agencies.[15] The power of the financial industry has been presented both a key factor explaining the loose regulatory oversight that allowed the financial crisis and the weak regulatory response that essentially left existing financial structures, interests and personnel in place after large bank bail-outs granted by the US government under the “Geithner plan”[16]. This power was also supported by economic analysis, some of which produced by academics who had undisclosed conflicts of interest with the financial industry.[17]

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

14 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 2009. According to the data recently made available by the website OpenSecret, the total lobbying expenditures of the financial industry (insurance, banks, investment and securities) equal that of the pharmaceutical and health industry (4 billion over 1998-2018) . https://www.opensecrets.org/lobby/top.php?indexType=i These are the two leading industries in this respect. It is difficult to put these numbers in a comparative international perspective, since the type of lobbying disclosure requirements that are available in the US are not present in other countries. There is an EU Transparency Register but this captures only a subset of lobbying happening in Europe (only Eu-level lobbying, not domestic lobbying).

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

16 For a detailed account of the plan and how it came about, see Ben Bernanke, The courage to act: A memoir of a crisis and its aftermath, Norton and Company, 2015 and Timothy Geithner, Stress Test: Reflections on financial crises, Deckle Edge, 2014. For a criticism of the plan and alternative solutions debated by the Obama administration to support the financial system see Joseph Stiglitz, A Bank bail out that works, The Nation, March 5th, 2009 or Paul Krugman, Does he pass the test, The New York Review of Books, July 10th, 2014

17 Carrick-Hagenbarth, Jessica, and Gerald A. Epstein. "Dangerous interconnectedness: economists’ conflicts of interest, ideology and financial crisis." Cambridge Journal of Economics 36.1 (2012): 43-63.

and the political system through the lenses of "regulatory capture" theories. The origin of this concept is often linked to the Chicago School and the work of Stigler.[18] In his "Theory of Economic Regulation", Stigler argued that "as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit."[19] Since Stigler's work, an important scholarly tradition within the economics literature, known as the "special interest" theory of regulation, has analysed the failures in the action of government agencies and in particular the dynamics which may lead regulatory agencies to unduly favour the industry they had responsibility for regulating and thus to deviate from the public interest.[20] Over the years, a number of authors have theorized a broader range of conditions and mechanisms under which capture of regulation likely prevails, from bribes, campaign contributions, threats of legal retaliation, promises of future jobs in the regulated industry, cultural ties and the cognitive and social pressures that emerge from the interaction between special interest and regulators. Besides its use in the academic literature, the notion of capture is also used ambiguously by political activists, either to criticize vested interests and the power of lobbies or, on the other side of the spectrum, to suggest to regulation is inefficient and dangerous.[21]

European Perspectives on Regulatory Capture

This description of the financial industry as capable to systematically "capture" the design and implementation financial regulatory reforms has however resonated more broadly in the US than on the other side of the Atlantic. The focus of most US-centric analyses on

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[18] For an historical overview of the intellectural roots of the notion of regulatory capture see Novak, William (2013). A Revisionist History of Regulatory Capture. In D. Carpenter & D. Moss (Eds.), Preventing Regulatory Capture: Special Interest Influence and How to Limit it (pp. 25-48). Cambridge: Cambridge University Press. doi:10.1017/CBO9781139565875.004

[19] George J. Stigler. "The Theory of Economic Regulation", The Bell Journal of Economics and Management Science, Vol. 2, No. 1 (Spring, 1971).

[20] See Peltzman (1976). 'Towards a More General Theory of Regulation.' *Journal of Law and Economics*, 19: 211-48; Gary S. Becker, "A Theory of Competition among Pressure Groups for Political Influence," *Quarterly Journal of Economics* 98 (3) (August 1983): 371–400; Gene M. Grossman and Elhanan Helpman, "Protection for Sale," *American Economic Review* 84 (4) (September 1994): 833–50; Laffont and Tirole (1991). 'The politics of government decision making. A theory of regulatory capture.' *Quarterly Journal of Economics*, 106: 4. For a review of this literature see Dal Bó (2006). 'Regulatory Capture: A Review.' *Oxford Review of Economic Policy*, 22(2): 203-25.

[21] For a review, see Carpenter, D., & Moss, D. A. (Eds.). (2013). *Preventing Regulatory Capture: Special Interest Influence and How to Limit it* (pp. 1–22), Cambridge: Cambridge University Press

financial resources, campaign contributions and revolving doors (movement of personnel between regulators and industries) as means through which the financial industry is capable to routinely "buy" regulatory policies did 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. 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 which banks influence state 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 28% of the assets of the German Banking sector in 2015 remain owned and controlled by regional governments[22], which naturally creates a peculiar relationship. In practice, between 1/5 and 1/3 members of the boards from these local banks are local politicians and they derive as much as 10% of their income from these activities. About 90% of the chairperson of these institutions are elected officials suggesting profound ties into politics[23]. In Italy, state-owned banks have been privatized 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 parties.[24] 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

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[22] 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. A recent paper examines in an econometric framework the impact of political ties on the rescue of German saving banks during the crisis: Behn, Markus & Haselmann, Rainer & Kick, Thomas & Vig, Vikrant, 2015. "The political economy of bank bailouts," IMFS Working Paper Series 86, Goethe University Frankfurt, Institute for Monetary and Financial Stability (IMFS).

[23] See this summary by Nicolas Veron and Jonas Markgraf of a forthcoming PhD dissertation by Jonas Markgraf at the Hertie School of Government. http://bruegel.org/2018/07/germanys-savings-banks-uniquely-intertwined-with-local-politics/

[24] 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.

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 civil servants, politicians and bankers are trained together come to form networks of influence organises around the *Grands Corps*.[25] 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 influence over the regulatory process through their political connections. This is reinforced by professional trajectories and mechanism of social identification. In a study of regulatory capture in the Netherlands, De Haan and Veltrop use surveys to show that supervisors with previous tenure in the financial sector are more likely to socially identify with the financial sector.[26] A 2012 study by Jabko and Massoc on the French policy to rescue banks during the crisis stresses again the importance of such links and informal interconnections and concludes by highlighting "the role of an informal consortium among public and private actors in the French financial establishment" and they "argue that the bank support plan should be viewed as a gift that members of the same elite group extended to each other in exchange for future, albeit still indeterminate, counter-gifts."[27] Informal ties also played a role in policy institutions at the level of the European Union, but the nature of these ties

[25] 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 », *L'instrumentation de l'action publique (*sous la dir. de Pierre Lascoumes et Patrick Le Galès), Presses de Sciences Po, Paris, p. 301-330. More general references are Swartz, David (1985), .French Interlocking Directorships: Financial and Industrial Groups., in Networks of Corporate Powers: A Comparative Analysis of Ten Countries, Stokman, Ziegler and Scott Eds. 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. Swartz, David (1985), .French Interlocking Directorships: Financial and Industrial Groups., in Networks of Corporate Powers: A Comparative Analysis of Ten Countries, Stokman, Ziegler and Scott Eds. Kadushin, Charles (1995) , .Friendship Among the French Financial Elite., *American Sociological Review*, Vol 60, N_2, pp 202-221. Amable and Hancke also shown how the French government was able to influence strategic choices of private corporations through this elite network that had been previously active when firms were nationalized. Amable, Bruno, and Bob Hancké. "Innovation and industrial renewal in France in comparative perspective." Industry and Innovation 8.2 (2001): 113-133.

[26] De Haan, J., and D. Veltrop. *Regulatory Capture of Financial Sector Supervisors through their social identification with the Financial Sector*. DNB working paper, 2014.

[27] Nicolas Jabko and Elsa Massoc "French capitalism under stress: How Nicolas Sarkozy rescued the banks", in Review of International Political Economy, 19, 4, 562-585 (2012).

are different at this level - as they are different in each country of the Union - because they are embedded in social structures that are shaped by different forms of education and circulation of elites.[28]

Another characteristics 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 policymakers. 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”.[29] 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”.[30] This sentence echoes strongly the results of the investigation of Jabko and Massoc in the management of the banking crisis in France. The same dynamics have been fully in display 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 respective 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

[28] For recent work studying such links at the EU level, see Braun, Benjamin. "Central banking and the infrastructural power of finance: The case of ECB support for repo and securitization markets." *Socio-Economic Review* (2018); Laurens, Sylvain. *Les Courtiers du capitalisme. Milieux d’affaires et bureaucrates à Bruxelles*. Agone (Éditions), 2015.
29 Woll, Cornelia (2013), “The power of banks”, Speri, University of Sheffield, July 2013
30 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 Unlevel Playing Fields", University of Warwick

establish.[31] Financial industry lobbies seem to have achieved concessions base on their capacity to highlight the impact of different pieces of regulation over their capacity to provide credit to the broader economy. 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.[32]

The significant political influence of banks is not uniquely a US phenomenon. But the influence of European banks over the design of financial policies frequently arises from a number of structural characteristics of the different financial and political systems in which they find themselves operating. Shifting the focus from the direct lobbying of financial institutions towards the characteristics of different financial systems in Europe reveals a further corrective to the narrow notion of "capture" that has frequently been used to interpret the relationship between banks and government agencies. These reciprocal channels of influence between European governments and their banking systems have historical roots that will be explored in the next section. Investigating these historical roots also casts doubt on the usefulness to oppose the notion of "financial repression" to the one of "regulatory capture". The US debates tends to over emphasize the opposition between the interest of the state (seen as the interest of the society) and the interest of the bankers. This longstanding view – again usually tracked to the opposition between Hamilton and Jefferson – had a direct impact on the history of the US financial system and partly explains why (after two failed attempts in the early XIXth century) the USA set up a central bank in 1913 only.[33] In Europe, there is a stronger tradition of complementarity between visions of the state and of financial institutions, which had been encompassed in the history of central banks and other state-led financial institutions (which could be privately owned, but were attributed a public mission by the state).

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[31] Howarth, David, & Quaglia, Lucia. (2013). "Banking on Stability": The Political Economy of New Capital Requirements in the European Union", *Journal of European Integration* (May), 37–41.;

[32] Pagliari, Stefano, & 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. The arguments used by the banking industry rely on economic studies which show that higher capital requirements are likely to decrease the volume of bank loans. For a review of this literature and recent contribution to it, see Couppey-Soubeyran, Jézabel, et al. *Le financement de l'économie dans le nouveau contexte réglementaire*. La Documentation française, 2013, Rapport du Conseil d'Analyse Economique ; Gropp, Reint, et al. "Banks Response to Higher Capital Requirements: Evidence from a Quasi-Natural Experiment." *The Review of Financial Studies*, forthcoming.

[33] The central bank was seen as a conglomerate of bankers acting against the public good.

III. Historical perspectives on European financial ecosystems

Examples of the symbiotic relationship between European governments and their financial system abound throughout contemporary 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 post-war reconstructions are only some of the many examples 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 firms[34].

The involvement of the State in financial developments in the XIXth century went beyond the promotion of international champions. During this period, financial liberalization 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 process[35]. Central banks, − which were still at the time institutions with private shareholders granted with a monopoly on the right to issue − were perfect examples of these connections between governments and financial capitalism that developed throughout the XIXth century, the "first era of financial globalization". 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 et Consignation and Crédit Foncier in France and the

34 Goldstein, Morris and Veron, Nicolas, 2011, "Too Big to Fail: The Transatlantic Debate ", Peterson Institute for International Economics Working Paper No. 11-2.,
Gerschenkron, A. (1962). *Economic backwardness in historical perspective. Economic backwardness in historical perspective*, Harvard University Press.
35 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, *Mobilizing Money: How the World's Richest Nations Financed Industrial Growth*, New York: Cambridge University Press, 2012.

Cassa Depositi e Prestiti in Italy.

The Bretton Woods consensus

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. This was not seen as contradictory to the expansion of private profits. 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 banks nationalizations and the increasing role given to public credit institutions. In the years following the end of the war, Western European governments continued to strategically directs their domestic banking system towards the achievement of specific public policy objectives. 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 expenditures.[36] 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 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

36 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 et M.Margairaz éd, Paris, Sciences Po, forthcoming. Monnet, Eric. (2013). "Financing a planned economy. institutions and credit allocation in the french golden age of growth (1954-1974).'", University of Berkeley, BEHL Working Paper n°2. Hodgman, Donald, 1973 "Credit controls in Western Europe: An evaluative review", in 'Credit Allocation Techniques and Monetary Policy', The Federal Reserve Bank of Boston.

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 risks. 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 coordination[37] at the national level between government agencies, public and private lending institutions and industries. Employees circulated easily and frequently between public administrations and nationalized 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 rescued.[38]

The neoliberal turn

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 the rise of neoliberalism, the spread of public choice literature and the European turn towards liberalisation.[39] These profound intellectual and political changes emphasized the merits of financial liberalisation and promoted independent central banking, by stressing the negative effects of governments interventions (unproductive rents, crowding out, over-saving by state owned institutions). These views became central to economic thinking and policymaking.[40] Countries –prominently France– experienced a radical liberalization in

37 Eichengreen, Barry, 2008, The European economy since 1945: coordinated capitalism and beyond. Princeton University Press.

38 Pontusson & Raess, « 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, 2012, p. 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: Oxford University Press.Peter Katzenstein, *Small States in World Markets* (Ithaca, Cornell University Press, 1985) ; Peter Hall, David Soskice (dir.), *Varieties of Capitalism* (Oxford, Oxford University Press, 2001)

39 On the public choice literature and its relationship with financial liberalization, see Guex, Sébastien. "La politique des caisses vides." Actes de la recherche en sciences sociales 1 (2003): 51-62.

40 Loriaux, Michael et al. 1997. *Capital ungoverned: liberalizing finance in interventionist states*. Cornell University Press; Fourcade-Gourinchas, Marion, and Sarah L. Babb. "The rebirth of the liberal creed: Paths to neoliberalism in four countries." *American Journal of Sociology* 108.3 (2002): 533-579. Abdelal, Rawi. *Capital rules: The construction of global finance*. Harvard University Press, 2007.
; Monnet Eric, 2018, *Controlling Credit*. Cambridge University Press.

the mid-1980s and all converged towards capital account openness allowing greater capital mobility, privatisation of banks, opening of money markets that would loosen the control on domestic interest rates. It is important to note, however, that the process of liberalization took different paths across countries. Many European countries – most prominently France – liberalized their financial markets and capital account before privatizing the banks. As a result of this new settlement, financial ecosystems were deeply redesigned, although they also relied on the similar personal connections that had been widespread under state capitalism. In many countries, the opening of markets was indeed led by people who had been circulated between civil service and nationalized banks.[41] But the opening of markets changed the purposes and contexts of these connections and as a result, financial and political relationships were recomposed. The expansion and deepening of cross border capital flows supported further financial market openness, independence of central banks and disengagement from the public sector.[42] The introduction of the single currency in Europe only accelerated and accentuated this process in particular by weakening further the ability of national central banks to lean on their banking system and directed credit.[43] In effect, removing monetary policy from the hands of national governments transformed yet further the dynamic between national governments and their financial system. It is however inaccurate to believe that it has completely put an end to these peculiar relationship as the euro area crisis and the response to it would come to demonstrate (see part IV).[44]

The return of financial repression?

The term "financial repression" – coined by the influential Stanford economist Ronald McKinnon in the early 1970s to describe developing economies in Asia and Latin America − has been used retrospectively to characterize the policies of the state towards

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[41] Abdelal, op. cit. Fourcade and Babb, op. cit., Monnet, Controlling Credit, op.cit., Lemoine, l'ordre de la dette, op. cit.

[42] Mügge, Daniel. (2006). Reordering the Marketplace: Competition Politics in European Finance. *Journal of Common Market Studies*, *44*(5), 991–1022. Gabor, Daniela, and Cornel Ban. "Banking on bonds: the new links between states and markets." *JCMS: Journal of Common Market Studies* 54.3 (2016): 617-635.

[43] On this historical process, see Eric Monnet, Controlling Credit., CUP, forthcoming, chp.7.

[44] For a nuanced discussion of these two opposite arguments on the impact of financial liberalization on the links between states and national banks, see Epstein, Rachel A. *Banking on Markets: The Transformation of Bank-State Ties in Europe and Beyond*. Oxford University Press, 2017, chapter 5.

the financial system in the postwar period (the "Bretton Woods consensus"), in Europe and elsewhere, before financial liberalization.[45] In McKinnon's writings, this term specifically designated a wide range of targeted 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. The core of McKinnon's argument was that – by imposing these different controls – the state maintained artificially low interest rates, thus preventing investors to finance investment. The notion of financial repression remained mostly used in development economics during decades by economists criticizing the role of the state in the development process.[46] It was imported in the debate on US and European economies only after the 2008 crisis, to suggest that these advanced economies were returning to policies implemented in the postwar years, when the state was heavily involved in credit allocation. The term was especially used to characterize the various policies of renationalization of government debt (i.e increase in the holding government debt by domestic banks and the central banks) which are accused of artificially lowering the interest rate on government debt. One of the main promoters of the term in this new context was the economist Carmen Reinhart whose work originally dealt with exchange rate and debt crises in South America and other emerging markets.[47] Hence, the term was imported in the post-crisis debate on economic management in "advanced economies" (mostly USA, United Kingdom, Japan and European Union) from a literature which had mostly focused in criticizing the role of the state in emerging markets. The frequent use of the term "the return of financial repression" suggested that there was a risk that these advanced economies would return to past policies which they had endorsed in the past but had then been limited to some emerging markets.[48]

The term "financial repression" is not a consensual term in the historical, economics or political science literature. Many have argued that heavy involvement of the postwar states in directed credit did not prevent economic growth and the development of financial

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[45] McKinnon, Ronald,1973,. Money and capital in economic development. Brookings Institution Press.

[46] For a review, see Williamson, John, and Molly Mahar. A survey of financial liberalization. International Finance Section, Department of Economics, Princeton University, 1998.

[47] See references in the introduction (footnote n°3).

[48] Reinhart, C. M. (2012). "The return of financial repression", Financial Stability Review, 16, 37-48.

markets.[49] This is not the purpose of the present article to assess whether this term is adequate to describe the consequence of state intervention in financial system in Europe until the 1970s or emerging markets until the 1990s. But we argue that, either applied to history or to the recent situation, it falls short of understanding the two way relationship between public authorities and the financial system. Moreover, as the next section will make clear, the rhetoric of the "return of financial repression" fails to grasp the new nature of public intervention in European financial systems which is very different today than in the postwar era, although we observe some legacies of the past in the post-crisis reconfiguration

IV. The European crisis and the recomposition of national ecosystems

The abrupt interruption in cross border capital movement provoked by the freeze of interbank markets in Europe and in the US has triggered a breakdown in financial intermediation, which in turn led to clear renationalisation of finance from 2008 onwards. This has not only modified financial relations, it has profoundly modified relations between national financial systems and governments in Europe[50]. In particular, the vast and ubiquitous use of government expenditures, guarantees and liquidity measures by central banks to support the financial system[51] has changed the political economy of relationships between banks and their governments. In practice, the events starting by the Irish decision to guarantee all of Irish banks deposits in September 2008 created a first precedent and the firm decision by Chancellor Merkel in subsequent months to avoid European solutions to

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49 Amsden, Alice Hoffenberg. 2001, *The rise of" the rest": challenges to the west from late-industrializing economies*. Oxford University Press..
Wade, Robert. 2004, *Governing the market: Economic theory and the role of government in East Asian industrialization*. Princeton University Press.. Monnet Eric, 2018, Controlling Credit. Cambridge University Press.
50 McKinsey report, Sapir, André., & Wolff, Guntram. (2013). The neglected side of banking union: reshaping Europe's financial system. Bruegel Policy Contribution.
Goodhart, Charles.. (2013). Lessons for monetary policy from the Euro-area crisis. Journal of Macroeconomics.
51 Stolz, S. M., & Wedow, M. (2010). Extraordinary measures in extraordinary times: Public measures in support of the financial sector in the EU and the United States. ECB Occasional Paper, (117).

restore financial stability opened the door to a return of national governments[52]. In turn, the blanket but successful efforts to save the banks have 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. But while these measures were broadly described as designed to restore financial integration and allow again the normal flow of bank loans and capital across border, 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. In addition, as Waltraud Schelkle[53] explained in her account of the development of the European monetary union during the crisis, the aversion to common European instruments and mutualisation forced national governments to devise their own "self-protection" strategies that were primarily directed at the financial system and the economy. Governments in Europe have not resorted completely and openly to the policies and instruments that had characterized the postwar Bretton Woods era. But 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. Rose and Wiedalek[54] for example show that British banks once nationalised maintained lending to the domestic economy while foreign banks retreated and engaged in "financial protectionism". Behn, Haselmann, Kick and Vig show how long-term political ties are key to understand which and how regional saving banks were bailed out in Germany.[55]

Domestic credit

The most common and clearly identified aspect of these changing landscapes is the extent to which holdings of public debt have been concentrated again in national financial institutions. Debt sustainability concerns, uncertainty about the integrity of the European

[52] For a detailed account of these events as well as a comprehensive account of the measures undertaken to support the European financial system, see Adam Tooze, Crashed: How a decade of financial crises changed the world, Penguin Press, August 2018

[53] Waltraud Schelkle, The political economy of monetary solidarity: understanding the euro experiment, Oxford University Press, 2017

[54] Rose, Andrew and Tomasz Wieladek (2011), "Financial Protectionism: the First Tests", NBER Working Paper 17073.

[55] Behn et al. op. cit.

monetary union and the reluctance of the central bank to address risks of multiple equilibria in sovereign debt markets in the Euro area[56] have all contributed to put sovereign debt markets under strain and forced governments to rely on national savings and national financial institutions to finance their expenditures.[57] Ongena, Popov and Van Horen find that domestic banks (and especially state-owned banks) in fiscally stressed countries were considerably more likely than foreign banks to increase their holdings of domestic sovereign bonds. The large exposure of government towards their banking system is not a phenomenon that was born during the crisis but is a well-established feature of European economies, even since financial markets were liberalized in the 1980s. These trends are characterized by a strong path dependency, which supports the argument that historical trends and the evolution of national financial ecosystems are important for the ownership structure of sovereign debt holdings. Figure 1 shows the evolution of public debt owned by resident banks and national central banks in five countries of the euro system. In all these countries but Germany, the crisis created a surge in the ownership of public debt by resident banks which looked like a return to pre-crisis average. But differences between countries remained. In Spain and Greece, this share increased above 30% , a level reached in the late 1990s, while it remained below in France and Italy which had a tradition of a smaller holding of public debt by resident banks. Interestingly, the share decreased in Germany during the crisis but is still above the level of many other European countries. For countries where domestic banks holdings increased during the worse moments of the crisis, it is interesting to note that these domestic holdings declined after the ECB started to embark on its quantitative easing programme in the beginning of 2015 (although the decline seemed to have started a little bit earlier).

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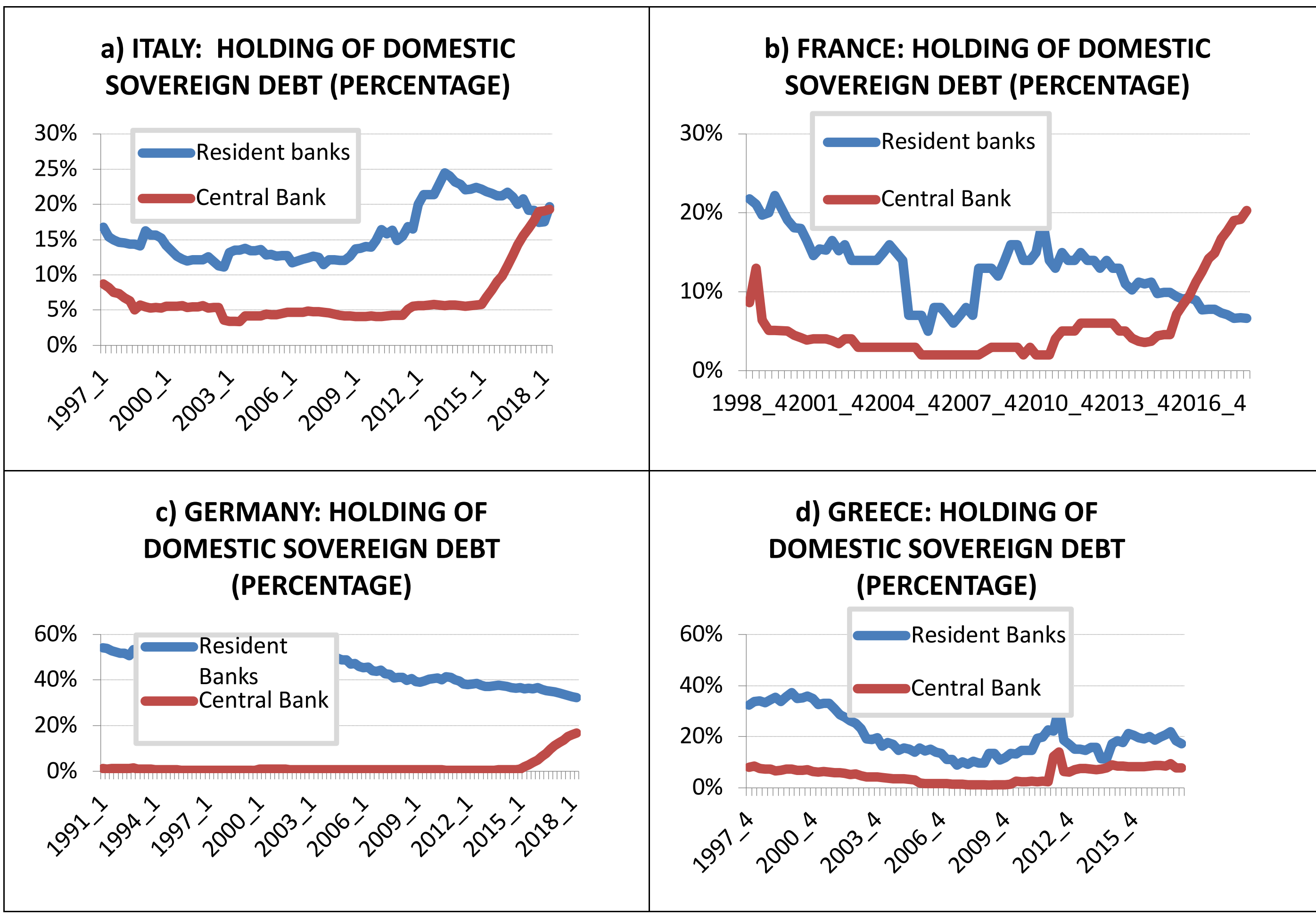
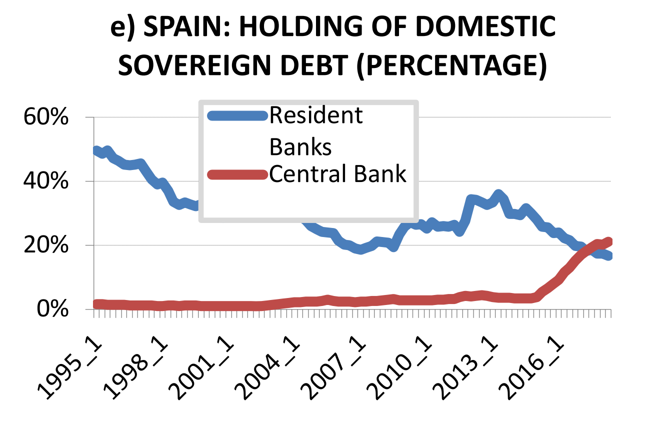
56 De Grauwe, Paul (2011). The European Central Bank: Lender of last resort in the government bond markets? (No. 3569). CESifo working paper: Monetary Policy and International Finance. De Grauwe, Paul, & Ji, Yuemei (2012). Mispricing of sovereign risk and multiple equilibria in the Eurozone. Centre for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

57 Abbas, S. A., Blattner, L., De Broeck, M., El-Ganainy, M. A., & Hu, M. (2014). Sovereign debt composition in advanced economies: a historical perspective (No. 14-162). International Monetary Fund ; Becker, Bo, and Victoria Ivashina. "Financial repression in the European sovereign debt crisis." Review of Finance 22.1 (2017): 83-115. Ongena, S., Popov, A., & Van Horen, N. (2016). *The invisible hand of the government:" Moral suasion" during the European sovereign debt crisis* (No. 11153). CEPR Discussion Papers.

Figure 1: holding of government debt by resident banks and national central banks in five European countries





Source: Bruegel database of sovereign bond holdings developed in Silvia Merler and Jean Pisani-Ferry, "Who's afraid of sovereign bonds“, Bruegel Policy Contribution 2012|02, February 2012. Update: October 2018.

The return of national of central banks

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 centralization of key central prerogatives within the ECB and the decrease of activist credit policies by these institutions. 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, notably by introducing new long term refinancing operations which effectively allowed banks to place their government bond holdings at the central bank in exchange for cash. These refinancing operations effectively led to a rapid expansion of the central bank's balance sheet as it played the role of lender of last resort to the European banking system. As a result (see Figure 2), the balance sheet of the ECB grew from about EUR 1000bn in 2008 to EUR 2000bn by the summer of 2012 and 3500bn in 2018 (that is 35% of the GDP of the Euro area). In addition, the European central bank modified the rules of eligibility of for the collateral, allowing National Central Banks to exert some discretion in the types of claims they could accept as collateral so as to respond to specific domestic needs. This practice combined with requirements to maintain domestic credit growth imposed by many governments in exchange for financial support to their domestic banks has contributed to increase the national bias in the refinancing of credit claims[58].

These dynamics have provoked a vivid reaction denouncing both financial repression and "fiscal dominance"[59] bringing to the fore a debate about the interactions between governments, the monetary authority and the financial sector. Sargent and Wallace[60] denounced as "fiscal dominance" the framework in which governments can lean on their central bank to secure better funding for their economies, their fiscal deficits and their inflationary consequences. Public choice theory and the resulting central bank independence had seemingly put these concerns at bay. But the distress in the financial and the consequences on the real economy have forced central banks to take unprecedented measures as a result to what some have called "financial dominance", that is an accumulation of private financial debt that would put the economy at risk. This triptych is symptomatic of the strategic interactions between the financial sector, governments and central banks

But these criticisms that have focused on the holding of government debts by central banks (whose increase is blatant on Figures 1 and 2) seem to ignore the fact that the most striking feature of European national central banks' balance sheet expansion until the introduction of quantitative easing in 2015 is not the accumulation of public debt but rather the unprecedented increase in central bank credit to the private economy by way of the banking system. Put differently, the relative size of loans of central banks to the non-government sector has reached unprecedented historical levels. It is higher than during the decades when central banks were running interventionist credit policies (i.e were akin to state-led development banks), that some authors view as typical of financial repression.[61]

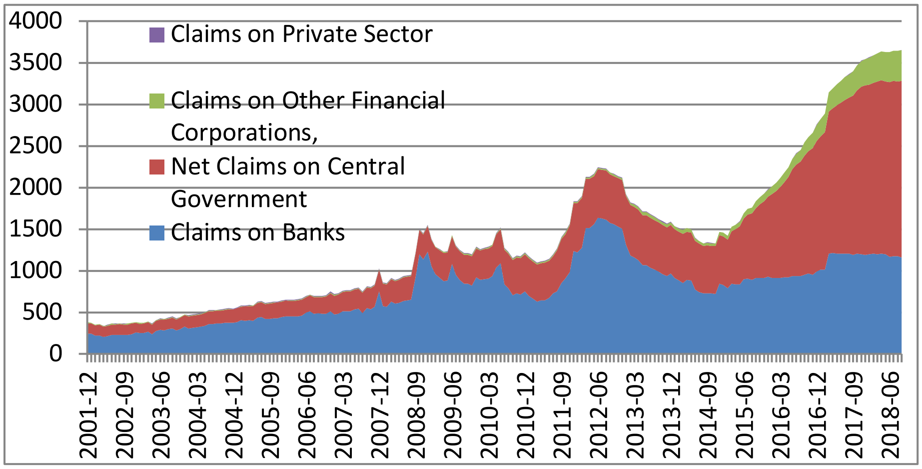
58 Merler, Silvia., & Pisani-Ferry, Jean. (2011). Hazardous tango: sovereign-bank interdependence and financial stability in the euro area. Financial Stability Review, (16), 201-210.

[59] In a 25 Novembre 2013 speech, J.Weidmann stated that "Monetary policy runs the risk of becoming subject to financial and fiscal dominance" http://www.bis.org/review/r131126b.pdf

[60] Thomas Sargent and Neil Wallace, Some unpleasant monetarist arithmetic, Quarterly Review of the Federal Reserve Bank of Minneapolis Vol 5 N3, Fall 1981

[61] On development central banking, see Epstein, Gerald. *Central banks as agents of economic development*. No. 2006/54. Research Paper, UNU-WIDER, United Nations University (UNU), 2006. Monnet, Eric. *Controlling Credit: Central Banking and the Planned Economy in Postwar France, 1948–1973*. Cambridge University Press, 2018.
The tools used by central banks at that time (reserve requirements, credit ceilings, cap on interest rates) are seen as typical of "financial repression"

Figure 2: Eurosystem claims on sectors of the economy (billions of euros)



Source: International Financial Statistics

Central bank balance sheet usually increased during wars and recessions mostly to ease government financing. After 1945, some central banks became more involved in directed credit and used their balance sheet to finance long-term investment and influence the allocation of credit through rediscount privileges and choices. However, even in the central banks that used these techniques extensively in the 1950s and 1960s, such as France, the ratio of central bank's claim on the domestic banking sector never really exceeded 8-10% of GDP, and the total assets of central banks over GDP were kept below 20% in peacetimes.[62] In the euro area, it recently reached more than 16% of of GDP when it peaked in the summer of 2012 (and the total assets of the ECB of GDP is 35%).[63] So despite the general discourse over fiscal dominance, the striking feature of the intervention of the European Central Bank during the euro crisis has been its increasing indirect financing of the private sector via its refinancing operations and asset purchases programmes. The rhetoric of the return of financial repression completely misses this point. Arguably, in Europe, 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. One of the key support of the ECB towards to the financial sector was the Targeted *longer-term refinancing operations* (LTRO) scheme. These operations provide long-term loans to banks, under the condition that they lend to households and businesses (i.e the more loans banks issue to

[62] Monnet, op.cit,

[63] Source: IMF statistics. NB: this number needs to be updated before publication.

non-financial corporations and households -except for house purchases -, the cheaper they borrow at the ECB).[64] The UK stands out here as having provided relatively little direct liquidity support to its banking sector beyond purchase of government bonds, the ECB, on the contrary mostly lent to banks before the policy of quantitative easing started in March 2015. With quantitative easing, the ECB started to accumulate mostly claims on the government (Figure 2). The claims of the Bank of England on the private sector surged very temporarily in the fall of 2008 at the moment of the Lehman failure but dropped shortly thereafter to be replaced entire by a large programme of sovereign bonds purchases. In the United States, despite the violence of the shock of 2008, the Federal Reserve increased modestly its claims on banks but its balance sheet grew in almost equal proportion through a large programme of purchase of sovereign bonds and private sector claims. As a result, the large share of claims on banks is very unique to the ECB. In 2018, this share is 10% at the Bank of Engalnd and 1% at the Fed, whereas it is 55% at the ECB. Some commentators have attributed the difference in policies before 2015 to the difficulties of the ECB to buy government bonds in a context of the absence of a unique sovereign.[65] From an historical perspective however, it is worth noting that it is reminiscent of different practices of central banks before the 1990s: after the Second World War, the Bank of England (as well as the US Federal Reserve) mostly conducted its operations through purchases and sales of governments bonds whereas central banks on the European continent continued to lend directly to banks – at short or even long terms – until the 1980-1990s. In many ways, the LTRO seemed a reactivation of historical practices, but these practices cannot be described as a mere repression to force banks to hold government debt. What is crucial here has been the common interest of the private financial institutions and the state to maintain liquid markets, for private and public assets. The central bank was the

[64] Andrade, Philippe, et al. "Can the Provision of Long-term Liquidity Help to Avoid a Credit Crunch? Evidence from the Eurosystem's LTRO." *Journal of the European Economic Association* (2015), argue that it indeed pushed up lending to business. For a dissenting view: Daetz, Stine Louise and Subrahmanyam, Marti G. and Tang, Dragon Yongjun and Wang, Sarah Qian, Can Central Banks Boost Corporate Investment? Evidence from the ECB Liquidity Injections (May 17, 2018). Available at SSRN: https://ssrn.com/abstract=2915800 or http://dx.doi.org/10.2139/ssrn.2915800

65 Cf speech by David Miles from the BoE : « Government debt and unconventional monetary policy », at the 28th NABE Economic Policy Conference, Virginia, 26 March 2012.

key player in this respect, thus standing at the centre of the financial system.

The national promotional banks

A third significant evolution in the relationship between governments and the financial system that has in part turned the clock back is the return of "public credit institutions" (also known as "national promotional or 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 through the crisis. 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 financial crisis. While total assets of the credit institutions of the Euro Area are equal in 2018 to their 2008 level, assets of public credit institutions increased by 25 % for the KFW, 55% for the EIB (European Investment Bank), 110% for CDP, 130% for the ICO between 2008 and 2017.[66] These institutions collectively created the "long-term investors club", a lobbying group to promote their role in the economy as a provider of long term financing with a public mission.[67] In 2014, the European Investment Bank was given a new role in the roll out of the European Fund for Strategic Investment (EFSI) and therefore increased its lending activities by more than EUR 68.8bn between 2014 and 2018.[68] 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 (CDP) for example has expanded its credits to the

[66] These figures are derived from our examination of the financial reports of these institutions. The French CDC has experienced several reorganizations of its activity over the period 2008-2017, so the figures are not comparable overtime. However, if we include CDC and BPI France, we find a 10% increase over the period.

67 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

[68] See also Mertens, D., & Thiemann, M. (2017). Building a hidden investment state? The European Investment Bank, national development banks and European economic governance. *Journal of European Public Policy*, 1-21.

public sector tremendously, extending some 85bn euros worth of loans to public (mainly local) entities and purchasing some 90bn euros 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 in particular in 2011. In 2012, a new institution was even created, the Banque Publique d'Investissement (BPI), which played a significant role in its first years in channelling credit to small and medium sized companies as well infrastructure projects. This renewed enthusiasm for such interventions has found echoes across Europe and is now a central part of the Labour manifesto in the UK or Movimento Cinque Stelle in Italy, which when it came to power in March 2018 argued for the CDP to play a much more forceful role in directing credit to the economy, taking inspiration from the French BPI.[69]

Meanwhile, in Germany, the KfW played a quite different role by first being largely used to provide capital, loans and guarantees to the financial sector[70] during the first wave of the crisis in particular in the case of the failing bank 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 euros of outstanding credits at the end of 2011, Italy with some 1.7bn euros, Ireland with 1.4bn euros, Spain with 3.2bn euros. 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.[71]

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

[69] URL: https://www.lettera43.it/it/articoli/economia/2018/03/28/m5s-cassa-depositi-prestiti-nomine-roventini-costamagna/219065/

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

71 "Germany to help Spain with cheap loans", EUObserver 28/05/2013, http://euobserver.com/economic/120278

European countries today by the fact that national central banks and governments cannot provide direct public support or target specific sectors via subsidized 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% of GDP in 2012 when it was equal to 17% 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 mobilize as the crisis hit.

It is misleading to view these developments as a mere "return of financial repression". The intervention of European states in their financial system have not exactly intended to back fiscal or industrial policy and thus differ drastically from historical quantitative tools used by central banks thirty years ago. Typical of the neoliberal turn, recent state interventions were justified as fostering or fixing the development of private financial markets and investment, not as a substitute. Nonetheless, it is clear that the greater renationalization 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 liberalization and the process of European monetary integration.

V. Conclusion: European integration and the path-dependency of national systems

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 characterize the relationship between governments, central banks and their financial industries at the national and at the European level. As a result, a more nuanced prism is needed, focusing on national specificities that 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 financial ecosystems, is still particularly helpful in this respect.[72] The process of Europeanization is far from linear and is not met in the same way in every country. Many national institutions both public and private tend to exert their agencies to resist this change and preserve their room for manoeuvre. 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 credit[73]. 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 capitalism[74].

The realisation of an integrated financial market encouraged first by the Banking Directive in 1977, the 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 and systems 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 nationalization of financial intermediation as well as the

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[72] See Zysman, J. (1983). *Governments, Markets and Growth: Finance and the Politics of Industrial Change*. Ithaca, NY: Cornell University Press. Hall, P., & Soskice, D. (2001). Varieties of Capitalism: the Institutional Foundations of Comparative Advantage. Oxford: Oxford University Press. Amable, Bruno. *The diversity of modern capitalism*. Oxford University Press on Demand, 2003, and its recent application to the evolution of French capitalism: Amable, Bruno. (2017). Structural Crisis and Institutional Change in Modern Capitalism: French Capitalism in Transition. Oxford : OUP. For a competing perspective, see Hardie, I., Howarth, D., Maxfield, S., & Verdun, A. (2013). Banks and the False Dichotomy in the Comparative Political Economy of Finance. *World Politics*, *65*(04), 691–728. doi:10.1017/S0043887113000221

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

[74] Hall, Peter and Soskice, David, Varieties Of Capitalism: The Institutional Foundations of Comparative Advantage, Oxford University Press, October 2001

wave of re-regulation revives strong national preferences and tensions in the design of financial policies. Debates surrounding the design and implementation of Basel III accords, which was agreed in the aftermath of the global financial crisis 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.[75]

On the other hand, the agreement reached in the summer of 2012 to launch a "banking union" aimed at unifying bank supervision in Europe has responded to this renationalisation by promoting European financial integration anew on the basis of a new institutional settlement. Indeed, the establishment of a single supervisory mechanism (SSM) applying a single rulebook, was designed to limit the tendencies of national supervisors (most of the time national central banks) to favour domestic banks at the expense of European financial integration and free and fair competition in the single market. As a consequence, three European regulatory agencies, including the European Banking Authority, were designed to upgrade and harmonize European banking regulation 2011.[76] However, it is not clear that this drive to restore the conditions for financial integration has succeeded at this stage. This is in part because the crisis has demonstrated, as Mervyn King and Charles Goodhart said, that *banks are global in life remain fundamentally national in death*.[77] The steps taken to europeanise supervision and regulation of the financial system have not fundamentally addressed that basic truth which was revealed forcefully during the crisis. While the EU has also established a Single Resolution Mechanism (SRM), it has proven relatively powerless, and because both of its governance and its lack of fiscal resources fundamentally incapable of responding to

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[75] Howarth, D., & Quaglia, L. (2013). Banking on Stability: The Political Economy of New Capital Requirements in the European Union. *Journal of European Integration*, *35*(3), 333–346. doi:10.1080/07036337.2013.774780

[76] The European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance Occupational Pension Authority (EIOPA) were all established in 2011 following the recommendation of the High Level Group on Financial Supervision in the EU chaired by Jacques de Larosiere report published in February 2009, which argued for the upgrading and Europeanisation of the financial sectors regulatory institutions. https://ec.europa.eu/info/system/files/de_larosiere_report_en.pdf

[77] This quotation is attributed to both Bank of England Governor Mervyn King and economist Charles Goodhart. See Epstein, Rachel A., and Martin Rhodes. "International in Life, National in Death?." Political and Economic Dynamics of the Eurozone Crisis (2016): 200-232.

moderate banking distress needs in Italy in 2016-2017 for example.[78] As a result, while the renationalization of finance caused by the crisis has motivated a very substantial Europeanization of regulatory and supervisory to limit the negative consequences of financial fragmentation, these steps have not fundamentally destroyed national ecosystems nor ended the demands by national governments to preserve some control over a financial system that until proven otherwise, remains their very own liability and a potential instrument to deploy macroeconomic policies that might be more contained in other areas (Keynesian policies being constrained by fiscal rules and monetary policy outsourced to the European Central Bank). Indeed, a complete denationalization of finance could imply a serious reduction in the ability of Member State to stabilise their economies and entail much more radical changes in the structures of national capitalisms.

These are the reasons why domestic financial interests and many national governments have been a key source of resistance on the way for the establishment of a banking union, which explains why a few years into its existence, and despite its ambition, this process remains incomplete and appears far more limited than originally intended.[79] Indeed, negotiations have allowed countries like Germany for example to secure very important carve-out for their small and medium sized *Sparkassen*. The governance has allowed national governments to continue to play a strong role in protecting their national interest and various cases in Spain or Italy have exposed the inability to really Europeanise the resolution of banks that are deemed macro-economically or politically relevant at the national level. All in all, despite the calls for new push in European monetary and financial integration since the euro crisis, the resilience of history within national financial ecosystems and the symbiotic relationships between Western European governments and their national banking systems remain a key factor shaping the path towards the Europeanisation in the regulation, supervision, resolution of the financial sector and financial crises.

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[78] Two banks were bailed out, following rules and practices at odds with those designed in the SSM. See the statement of the European commission on this event: URL: http://europa.eu/rapid/press-release_IP-17-1791_en.htm

[79] For a comprehensive description of these negotiations and decisions, see Véron, Nicolas. "EU Financial Services Policy since 2007: Crisis, Responses, and Prospects." *Global Policy* 9 (2018): 54-64.