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Fiscal Fault, Financial Fix?
Capital Markets Union and the Quest for Macroeconomic Stabilization in EMU

Benjamin Braun and Marina Hübner

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Abstract

This paper argues that Capital Markets Union – the EU's attempt to establish a more market-based financial system – is a result less of financial policymaking than of macroeconomic governance in a politically fractured polity. The current governance structure of Economic and Monetary Union (EMU) severely limits the capacity of both national and supranational actors to provide a core public good, macroeconomic stabilization. While member states have institutionalized fiscal austerity and abandoned other macroeconomic levers, the European polity lacks the fiscal resources necessary to achieve stable macroeconomic conditions: smoothing the business cycle, ensuring growth and job creation, and mitigating the impact of asymmetric output shocks on consumption. Capital Markets Union, we argue, is an attempt by European policymakers to devise a financial fix for this structural capacity gap. Using its regulatory powers, the European Commission, supported by the European Central Bank (ECB), seeks to harness *private* financial markets and instruments to provide the *public* policy good of macroeconomic stabilization. We trace how technocrats, think tanks, and financial-sector lobbyists, through the strategic use of knowledge and expertise, established securitization and market-based finance as solutions to EMU's governance problems.

Keywords: Regulation, securitization, euro area, fiscal policy, financial markets, European Commission, ECB

Zusammenfassung

Woher rührt das politische Streben in Brüssel nach einer Kapitalmarktunion und damit nach einem stärker marktbasierten europäischen Finanzsystem? Dieser Aufsatz legt dar, dass es sich nicht in erster Linie um ein finanzmarktpolitisches Projekt handelt, sondern um ein Projekt makroökonomischer Steuerungspolitik innerhalb eines fragmentierten Mehrebenensystems. Die Struktur der Europäischen Wirtschafts- und Währungsunion (EWU) beschneidet Steuerungskapazitäten auf der nationalen Ebene, ohne sie auf der supranationalen Ebene zu stärken. National verordnete fiskalische Austerität in Kombination mit dem Verlust anderer Steuerungshebel haben in der Eurozone ein institutionelles Umfeld geschaffen, in dem die notwendigen fiskalischen Ressourcen zur Gewährleistung stabiler makroökonomischer Bedingungen fehlen – allen voran Konjunkturglättung und Wachstumsförderung. Das Projekt Kapitalmarktunion, so unser zentrales Argument, ist der Versuch europäischer Entscheidungsträger, diese strukturelle Kapazitätslücke mit den zur Verfügung stehenden regulativen Mitteln zu füllen. Konkret versucht die Europäische Kommission, unterstützt durch die Europäische Zentralbank, das *öffentliche* Gut makroökonomischer Stabilität über den Umweg *privater* Finanzmärkte und Finanzinstrumente zu erreichen. Im Rahmen einer detaillierten Prozessanalyse zeichnen wir nach, wie Technokraten, Think Tanks und Finanzlobbyisten Wissen und Expertise mobilisierten, um Kreditverbriefung und marktbasierte Finanzierung als Lösungen für die Steuerungsdefizite der EWU zu etablieren.

Schlagwörter: Regulierung, Kreditverbriefung, Euroraum, Steuerpolitik, Finanzmärkte, Europäische Kommission, Europäische Zentralbank

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Fiscal Fault, Financial Fix? Capital Markets Union and the Quest for Macroeconomic Stabilization in the Euro Area

1 Introduction

In the wake of the 2008 financial crisis, policymakers and scholars alike identified market-based finance as the main culprit. Shadow banking in general, and the securitization of mortgage loans in particular, were seen as fraught with problems of information asymmetry and moral hazard and prone to excessive leverage and systemic contagion. In light of this post-crisis consensus, the re-emergence of market-based finance as a top-priority for the European Commission, in the form of a Capital Markets Union (CMU), constitutes a puzzle. Whereas existing research emphasizes the logic of the common market or the power of financial interests, this paper highlights the explanatory importance of macroeconomic considerations. In doing so, the paper brings together the literature on EU single-market policy and the literature on euro area governance, filling important gaps in both.

The literature on euro area governance has shown that the Global Financial Crisis and the subsequent euro crisis have accelerated the transfer of national state powers to the supranational level, in particular in the areas of fiscal policy and of banking regulation and supervision (Genschel and Jachtenfuchs 2014; Epstein and Rhodes 2016; Howarth and Quaglia 2016). What has been missing from this literature, however, is an appreciation of the overall thrust of these individual reforms. Our starting observation is that monetary integration, internal adjustment through deflationary wage policies, and institutionalized fiscal discipline have had a dramatic negative cumulative effect on the capacity for macroeconomic steering in the euro area. Specifically, EMU's current governance structure has undermined its capacity to fulfil a basic function traditionally ascribed to governments in democratic capitalism, namely *macroeconomic stabilization* – smoothing the business cycle, protecting growth and employment, and reducing the effects of output shocks on consumption (Musgrave 1959, 22–24). From a political economy perspective, the key feature of the post-crisis EMU governance regime is a *structural capacity gap* with regard to this public policy good.

This structural capacity gap has translated into a political imperative to alleviate it via the negative impact on EMU's output legitimacy. This impact has varied dramatically between the core and the periphery of the euro area (Scharpf 2016; Copelovitch, Frieden, and Walter 2016; Schmidt 2015). The structural capacity gap has not done much harm to output legitimacy in the core countries, which have weathered the European

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banking and sovereign crises relatively well. Periphery countries, by contrast, have suffered long and painful recessions, high and persistent unemployment, and declining real wages. Here, the high degree of macroeconomic instability has severely damaged EMU output legitimacy.

We argue that CMU is the European Commission's attempt to provide a financial fix to this structural – above all, fiscal – fault. While CMU is a multi-faceted project, the common thrust of its more than thirty proposed measures is to strengthen financial intermediation via capital markets – that is, the roles bond, equity, venture capital, and securitization markets play in the financing of "real" economic activity. One prominent measure on the borrower side is to lower the information requirements for public companies, making it easier for small and medium-sized enterprises to access equity financing. At the other end of the investment chain, the Commission seeks to promote household participation in the stock market by promoting, for instance, a pan-European personal pension product. Banks, meanwhile, are expected to securitize a greater share of their loans; that is, to sell more asset-backed securities to capital market investors.

These policy goals are not new. The advocates of CMU can tap into a long tradition, reaching back to the 1960s, of technocrats lamenting European companies' overreliance on bank loans for financing. It would appear natural, therefore, to harness existing approaches to explain CMU as the continuation of European market integration without a deeper "purpose" (Posner and Véron 2010; Grossman and Leblond 2012; Quaglia 2007) or as the latest iteration of neoliberal restructuring (van Apeldoorn 2002; Bieling 2013; Macartney 2011).[1] These explanations cannot, however, account for the unprecedented scale and ambition of CMU. This paper therefore presents an explanation that combines a micro-level focus on technocratic "bricolage" (Kalyanpur and Newman 2017; Carstensen 2011) with a macro-level focus on the structural constraints and incentives of governing a large, financialized economy. Seeking to address EMU's structural capacity gap and resulting output legitimacy deficit, supranational technocrats use and re-purpose their regulatory powers in the area of financial policy – an instrument that, while not ideally suited to the task at hand, has the advantage of being in the Commission's toolkit (Majone 1997). Note that this does not entail the argument that the Commission believes private finance to be the "first-best" solution to the problem of macroeconomic stabilization. Instead, we reconstruct the process of technocratic powering and puzzling through which the Commission, in interaction with a range of public and private actors, convinced itself that CMU would create credit and capital markets sufficiently deep, diversified, and resilient for private lenders and investors to compensate for the lack of public macroeconomic steering capacity.

1 Another account, espoused especially by financial journalists, explains CMU as an EU "carrot" to the City of London in the run up to the 2016 Brexit referendum. However, this account is at odds with the observation that the vote in favour of Brexit accelerated the CMU implementation process and increased the project's overall ambition, especially in the area of European capital markets supervision. These post-Brexit developments strongly indicate that other, structural dynamics are driving the CMU project (Commission 2016b).

Regarding the structural element of the explanation, our argument highlights a *deeper affinity* between fiscally limited and fragmented state structures and a political bias towards finance-centered, supply-side oriented economic policies. Such an affinity has been demonstrated, above all, by the work of Greta Krippner and Sarah Quinn on the United States. Their main finding, directly relevant to our argument regarding CMU, is that in the United States, the history of state-led financialization is one of fiscally constrained and institutionally fractured federal governments seeking ways to "govern the economy 'at a distance' through the market" (Krippner 2007, 506; 2011; Quinn 2010; 2017; Braun, Gabor, and Hübner forthcoming). While we lack space to fully develop this comparison – we will return to it in the conclusion – drawing the connection nevertheless helps place CMU in the broader context of the evolution of the state–finance nexus. From this perspective, CMU appears to be a technocratic response to the structural constraints and incentives associated with macroeconomic governance under financialized capitalism – an explanation, we argue, that is relevant beyond the euro area.

Methodologically, the paper follows a process-tracing approach that reconstructs the outcome (CMU) as the result of a protracted supranational agenda-setting process that involved policymakers, central bankers, think tanks, and financial-sector lobbyists. The analysis is based on a detailed study of the full range of documentation on EMU reform, CMU, and securitization regulation, including official documents, as well as publications and statements by the various public and private actors involved. The paper triangulates the information gleaned from these documents with two further sources. First, the authors attended several conferences and seminars at which key policymakers discussed issues of EMU governance and financial market policy.[2] Second, over the period from 2013 to 2017, the authors conducted a total of 34 interviews with policy officials from the Commission, the ECB, and the German government as well as with European think tank researchers and financial market participants. While the paper does not draw directly on these interviews, they serve as a reality check for our reading of the public documents that are our primary source material, limiting the risk of misinterpretation or of missing "hidden agendas" (McConnell 2017).

The paper proceeds as follows. Reviewing how the integration of "core state powers" has undermined the capacity of national governments to provide the public policy good of macroeconomic stabilization, Section 2 elaborates the structural part of our explanatory framework. Section 3 focuses on the agency of technocrats whose strategic use of

2 Asset Backed Finance, True Sale International (TSI) Congress, September 23–24, 2015, Berlin; Das EU-Projekt Kapitalmarktunion – Ziele, Aufgaben und neue Rahmenbedingungen, TSI Conference, March 3, 2016, Frankfurt a.M.; Die Zukunft des Verbriefungs- und Structured Finance Marktes in Deutschland und Europa, TSI Congress, September 28–29, 2016, Berlin; Europe – On Achieving an Appropriate Economic Policy Stance (with Servaas Deroose and Thomas Wieser), October 4, 2016; Uneasy Calm: Fixing Europe's Economic and Institutional Woes (with Marco Buti), November 1, 2016, Harvard University; Summit on the Future of Europe (with Pierre Moscovici), November 14, 2016, all Harvard University; CEPS Summer School on EMU Governance Reform, September 4–9, 2017, Brussels.

knowledge and expertise played a crucial role in discursively establishing market-based finance – which in the aftermath of the Global Financial Crisis was widely considered part of the problem – as part of the solution for EMU's governance gaps.[3] Section 4 reconstructs the two agenda-setting movements that established securitization and market-based finance as tools for macroeconomic stabilization: the reframing of securitization as an instrument to promote jobs and growth and of financial markets more generally as a risk-sharing mechanism that would make the euro area more resilient in the face of macroeconomic shocks. Section 5 concludes the paper.

2 Integration of core state powers and the destruction of macroeconomic stabilization capacities

European integration scholarship has long puzzled over how to conceptualize the European polity. Because its authority is limited to regulatory policies, aimed at market integration and at "correcting various types of 'market failure'," the EU has been described as a "regulatory state" (Genschel and Jachtenfuchs 2014; 2015; Majone 1994). Prior to the launch of EMU, macroeconomic stabilization – a key form of public intervention in the economy – remained in the hands of member-state governments (Majone 1997, 141).

The narrow focus of European policymaking on regulation results from two main causes. First, the single-market project, enshrined in the Treaty of Rome and thus in the EU's institutional DNA, is predominantly regulatory in nature (Pelkmans 2011). Second, since the costs of regulation are borne by the regulated entities and implemented at the national level, the budgetary impact of regulation is relatively low (Majone 1994, 87). The European Commission, eager to maximize its own competences but constrained by a small and contribution-based budget,[4] has thus specialized in regulatory policymaking that is "largely immune from budgetary discipline" (Majone 1998, 26–27).

Assessing recent EU-internal reform efforts, a number of scholars have argued that European institutional capacities have grown "beyond the regulatory state" (Caporaso et al. 2014, 890). Whereas in the past, supranational policy-making was "limited to Pareto-improving issues of market creation and regulation," the post-2008 leap in European integration has brought control over "core state powers" to Brussels (Genschel and Jachtenfuchs 2014, 3). Law enforcement and the use of coercion aside, what is at stake here are the powers to tax and to borrow. While its own budget has not increased much, the EU has acquired significant powers to monitor and control taxation, borrowing, and spending in the member states (Caporaso et al. 2014; Genschel and Jachtenfuchs 2014; 2015).

3 We use the term "market-based finance" to denote that CMU aims to promote not only market-based banking, in the form of securitization (Hardie et al. 2013), but also capital markets, notably for equity and venture capital.

4 Currently, the EU budget accounts for 1 percent of the EU's combined GDP.

There is, however, a paradox. On one hand, fiscal integration has indeed taken the EU "beyond the regulatory state," in the sense that policy-making no longer focuses narrowly on market regulation. On the other hand, what has been centralized at the European level is the monitoring and control of national fiscal policies by *regulatory* means: "the EU uses regulation to constrain externalities of the national exercise of core state powers" (Genschel and Jachtenfuchs 2015, 45). Thus, in the area of fiscal policy, too, EMU governance is strictly regulation-based.

While the EU literature has carefully traced the causes of this recent evolution of the European polity – the incomplete nature of EMU and disagreement among member states over the path towards completion – it has largely neglected the *consequences* of the regulatory centralization of fiscal state powers for the *political economy of macroeconomic governance*. In particular, the EU literature has overlooked the adverse consequences of regulatory fiscal centralization on the capacity – at the EU and member-state level – to provide the public policy good of macroeconomic stabilization.

In Majone's (1997, 141) terms, macroeconomic stabilization "attempts to achieve and sustain satisfactory levels of economic growth and employment," as well as offsetting the direct effects of an output shock on consumption (see also Musgrave 1959). Traditionally, governments relied on fiscal and monetary policy to achieve these goals, as well as on labour market and industrial policy. We argue that the accumulated result of recent integration steps has been to strip EMU and its member states of the capacity to provide the public policy good of macroeconomic stabilization.

Consider the policy instruments that used to be available to national governments pursuing stabilization policies. With the introduction of the euro, EMU member states surrendered to the ECB control over *monetary policy* as a stabilization instrument, including, crucially, the possibility of competitive devaluation (Höpner and Spielau 2016). While the creation of genuine supranational monetary capacities compensates for the loss of national monetary sovereignty, the interest rate decisions of the ECB Governing Council are necessarily oriented towards the EMU average. The resulting "one size fits none" monetary policy stance often exacerbates rather than mitigates intra-EMU divergence (Enderlein 2012; Johnston and Regan 2016). In the area of *fiscal policy*, the Maastricht Treaty did not foresee supranational fiscal capacities for macroeconomic stabilization, and the Stability and Growth Pact prohibited any fiscal transfers between member states. This institutional design was based on the "sound finance" idea that rule-compliant behavior would give EMU members enough fiscal space to adjust individually to national business cycle movements. However, the post-2010 modifications of the EMU fiscal framework, including the six-pack and two-pack legislation, as well as the fiscal compact, further diminished member states' fiscal room for maneuver, effectively transforming them into "consolidation states" (Streeck 2015; Scharpf 2014; Hallerberg 2014). As for *labor market policy*, pre-crisis heterogeneity of wage regimes and the post-crisis imperative for creditor countries to adjust via internal devaluation

has eliminated wage coordination for stabilization purposes (Copelovitch, Frieden, and Walter 2016; Höpner and Lutter 2017; Hall 2018; Höpner and Seeliger 2017).

In sum, the full centralization of monetary policy, the partial but consolidation-oriented centralization of fiscal policy, and the neutralization of labor market policy in creditor countries have locked in a "politics of constrained choice" at the national level with regard to macroeconomic stabilization (Laffan 2014; Schmidt 2015). At the same time, the EU has failed to build up *supranational* macroeconomic steering tools. The upshot is that pre- and post-crisis developments, most of which are related to the exigencies of the common currency, have created a *structural capacity gap* with regard to macroeconomic stabilization. The predominance of the preferences of creditor countries, most notably Germany, has prevented the build-up of a supranational budget that would allow for discretionary fiscal expansion and/or cross-border insurance and transfer mechanisms that would achieve an "automatic stabilizer" effect (Hallerberg 2014).

While this dysfunctional macroeconomic governance apparatus establishes the structural conditions that, as shown by Krippner and Quinn, are conducive to a "governing through markets" strategy, this does not, of course, amount to an explanation of CMU. Structures, after all, "do not come with an instruction sheet" (Blyth 2003). How and why did European policymakers embrace this strategy?

3 Devising a financial fix: Puzzling, powering, bricolage

In terms of macroeconomic stabilization, the lack of intergovernmental agreement on European fiscal capacities put the ball in the supranational court, where the ECB and the Commission were the key players (Becker et al. 2016; 1026; Nugent 2016). While the ECB, by resorting to large-scale asset purchases ("quantitative easing"), engineered an – arguably sub-optimal – monetary fix to a fiscal fault, the Commission, with the active help of the ECB, resorted to regulatory policy to engineer a financial fix.

Building on an established literature, we conceptualize supranational EU policymaking as an expert-driven process in which technocrats and private-sector lobbyists use knowledge and expertise in ways that effectively erase Heclo's classic distinction between "powering" and "puzzling" (Heclo 1974; Boswell 2008; Vauchez 2016). The central explanatory role of the intra-technocratic, coordinative discourse about CMU is due to two separate but interrelated reasons. First, market-based finance was not the obvious solution to the problem at hand, namely macroeconomic stabilization. This mismatch between policy goal and available instruments meant that the Commission and the ECB acted as "bricoleurs," re-purposing the regulatory tools at their disposal for what are primarily macroeconomic policy goals (Carstensen 2011, 154). Second, and closely related, bricolage comes with a high degree of uncertainty. Since it involves

putting established policy instruments to new, untested uses, technocrats act without a clear blueprint, making "intra-elite persuasion" an integral part of the policymaking process (Blyth 2007). In this process, (claims to) knowledge and expertise constitute a "way of substantiating … policy preferences" (Boswell 2008).

Such technocratic bricolage, although generally described as mere problem-solving by participants, is necessarily power-laden and political. "Using the cognitive schemas at their disposal," technocratic bricoleurs always "construct strategies of action based on pre-constructed ideational and political institutions" (Carstensen 2011, 147). Supposedly neutral "rational speculation" based on "scientific procedures" (Caramani 2017, 62) is thus invariably colored by the prevalent theoretical or policy consensus (Braun 2014; Blyth and Matthijs 2017; Heimberger and Kapeller 2017). Considering that securitization and market-based finance had played a key role in the financial crisis, CMU would have been unlikely to emerge as a policy solution had it not been for the resilience of the pre-crisis consensus among European technocrats that properly regulated financial markets tend towards efficiency (Mügge 2013; Schmidt and Thatcher 2013). Given this enabling background condition, various policy experts could use knowledge and ideas strategically to transform market-based finance from "the problem" into "the solution" (Jabko 2006; Schmidt 2014). Importantly, this transformation was achieved not by public actors alone. The expert-powered EU policymaking style provides ample opportunities for private-sector actors to become involved and mobilize expert knowledge to advance their own interests (Richardson 2012, 6). Since private interest groups do, to a certain extent, contribute knowledge to the policymaking process that is unavailable to public technocrats, their involvement is not pure "powering," which further blurs the lines between "puzzling" and "powering" (Culpepper 2002). In short, the financial solution to Europe's macroeconomic governance problems is neither ideologically innocent nor developed without private sector input.

The explanatory weight our theoretical framework assigns to private actors is limited but important. We do not view the Commission and the ECB as captured institutions that link finance-friendly policies to macroeconomic governance merely to legitimize "policies that would otherwise not have been possible," thus pursuing a "hidden agenda" (McConnell 2017, 6). Nevertheless, financial interests clearly influence the technocratic agenda-setting process. The key variable for the success of financial sector lobbying, however, is the strategic interest of policymakers in market-based finance as a governance infrastructure (Braun 2017). For instance, when opponents of the financial transactions tax found themselves pushing against an open door with policymakers, the primary reason was the ECB's strategic interest in a deep and liquid repo market (Gabor 2016b; Kalaitzake 2017; Kastner 2017). As Cornelia Woll (2014, 45) argues convincingly, in the relationship between finance and the state, "being needed is of fundamental importance, not influence peddling, as many assume". While it is a truism that in a capitalist economy finance is, and has always been, in a structurally powerful position (Block 1977; Gill and Law 1989), the degree of influence varies with the structure of the state and the availability of macroeconomic policy tools, *as well as* with the prevailing ideas about the nature of financial markets.

In the next section, we trace the agenda-setting process through which supranational technocrats, in interaction with financial-sector actors and think tanks, translated the structural bias in favor of governing through financial markets into a concrete policy agenda that established securitization and market-based finance as a financial fix for EMU's fiscal faults.

4 Macroeconomic stabilization, EMU style: Securitization and market-based finance

After the end of the emergency crisis phase in mid-2012, political deadlock between EMU "creditor" and "'debtor"' countries prevented the creation of a European fiscal union (Brunnermeier, James, and Landau 2016, Chapter 2). In this context of constrained political choice, European policymakers and central bankers, always in consultation with private interest organizations, began to seek alternative options to overcome macroeconomic instability in the euro area. As defined earlier, solid output growth and high employment signal stable macroeconomic conditions. In case of a negative output shock, it is the job of the government to stabilize the economy, both by mitigating the immediate impact of an output shock on consumption and by creating conditions that put the economy on a renewed growth path. It is generally understood that the main instrument for such stabilization is the consolidated *public balance sheet* (comprising the balance sheets of the government and of the central bank). Current EMU macroeconomic stabilization, by contrast, attempts to achieve the same purpose through *private balance sheets.* Specifically, the institutionally and geographically fractured EU policymaking state, lacking the fiscal capacities for demand-led growth, has focussed on the supply side, using budget-neutral regulatory powers to enlist private financial markets to provide the public good of macroeconomic stabilization. This section will first lay out how the ECB and the Commission identified securitization – and market-based finance more broadly – as means to improve the financing of small and medium-sized enterprises (SMEs) and thereby support job creation and economic growth. The second part will show that when it became clear that a European fiscal capacity was out of reach, the debate on improving EMU's institutional capacity to buffer the impact of future regional or national economic shocks on consumption turned to financial markets as private instruments of shock absorption. These discursive developments were crucial in garnering support, in Brussels and in the member states, for the 2015 CMU proposal and for subsequent legislative activities.

The financial path to economic prosperity: Securitization for SMEs, jobs, and growth

The European Commission's macroeconomic rationale for CMU is stated in the first sentence of its *Action Plan on CMU*: "The Commission's top priority is to strengthen Europe's economy and stimulate investment to create jobs" (Commission 2015a, 3). Similar language can be found in the recently adopted EU legislation on so-called "simple, transparent and standardized" (STS) securitizations (COM/2015/0472 final) and the accompanying legislation on regulatory capital requirement adjustments for STS investments (COM/2015/0473 final). The purpose of these measures, central to the CMU agenda, is to revive the European securitization market.

Securitization is a financial technology that transforms non-tradable loans into asset-backed securities (ABS), which are tradable on financial markets. Starting from very low levels in the late 1990s, the European securitization market subsequently grew rapidly, from 78.2 billion euros in 2000 to 453.7 billion euros in 2007 (Hardie et al. 2013, 712). Although the European ABS market suffered far fewer defaults during the financial crisis than its US counterpart, securitization activity collapsed in 2008 and has not recovered since.[5] Annual issuance in 2016 stood at 237.6 billion euros, of which only 96.4 billion euros was "placed"; that is, sold to investors (AFME 2017).

While the diagnosis of diminished securitization activity is correct, there is good reason to be skeptical of the Commission's claim that reviving this financial instrument is essential for its "priority objective to support *job creation* and a return to sustainable *growth*" (Commission 2015b, 2). Most importantly, the largest segment of the securitization market, both in the United States and in Europe, comprises residential mortgage-backed securities – a sector not generally considered central to the growth potential of advanced economies (Engelen and Glasmacher 2016, 9). In addition, the Global Financial Crisis was directly connected to the collapse of the US subprime ABS market, where banks had abused the information asymmetries inherent in securitization for their own gain, namely through excessive loan origination and fraudulent misselling of securities (Financial Crisis Inquiry Commission 2011). How, then, did the ECB and the Commission convince themselves and others that securitization could be an engine for jobs and growth?

The key to understanding this outcome lies in the institutional setting of the EMU regime and the heterogeneous preference structure of its participating members. In the first two years of the euro crisis, emergency euro-rescue policies and accompanying reforms of the European Economic Governance framework dominated the European political agenda. Over the course of 2012, however, stagnant growth, exploding unemployment rates in the southern periphery of the euro area, and rising social unrest put pressure on European policymakers to prioritize economic growth. A coalition of

5 Engelen and Glasmacher (2016, 12–13) argue that the lower default rates of European ABSs had more to do with differences in bankruptcy law than with lending standards and loan quality.

France – led by the newly elected President François Hollande – Italy, and Spain pushed for a European growth agenda to complement the austerity-enforcing Fiscal Compact that had been adopted in early 2012. Thus, at the June 2012 Council meeting – which also yielded the decision to form a European Banking Union – the heads of state agreed on a "Compact for Growth and Jobs" (Council 2012).

This Growth Pact, however, illustrated EMU's lack of capacity for expansionary macroeconomic policies. On the *demand side*, the Pact refrained from loosening the shackles of austerity, calling instead for "differentiated growth-friendly fiscal consolidation" (Council 2012, 8). Notwithstanding the plan to increase the capital base of the European Investment Bank (EIB) and thus its overall lending capacity – an idea that would ultimately find its way into the 2014 Investment Plan for Europe (Mertens and Thiemann 2017; 2018) – the main focus of the Growth Pact was on the *supply side*. Specifically, it aimed at reducing "the overall regulatory burden at EU and national level" and at deepening the European Single Market, while emphasizing the growth-enhancing effects of "restoring normal lending to the economy" and of "completing the restructuring of the banking sector" (ibid., 8–10). In short, the Growth Pact took a strictly supply side-oriented approach, centered on market integration, regulatory changes, and bank balance sheet repair. Especially in the banking sector, these supply side-oriented policy actions addressed real problems. Banks in the Southern European countries in particular suffered from fragmented euro-area interbank markets, unstable bank refinancing conditions, high levels of sovereign debt and of non-performing loans on banks' balance sheets, tightened regulatory capital requirements, and, as a result, strong pressure to deleverage. Taken together, these problems diminished banks' ability to lend to the real economy, especially to SMEs, which are most dependent on traditional bank loans (ECB 2012a: 2012b; Nassr and Wehinger 2014).

On the back of this finding, SME financing came to be perceived as the crucial bottleneck of the euro area's economy. The Commission, the ECB, and a number of other institutions, both public and private, identified SMEs as the part of the economy that was most negatively affected by unequal financial conditions in the euro area and whose difficulties in obtaining credit were most damaging to growth and employment, especially on the periphery. From here, it was only a small step to the discursive transformation of securitization from problem into solution.

In April 2012, the OECD Financial Roundtable, which included both policymakers and private sector representatives, was dedicated to the topic of "Bank deleveraging, the move from bank to market-based financing, and SME financing." According to the official summary of the meeting, "securitization was broadly agreed to be necessary to support the deleveraging process," and a large part of the discussions focused on what it would take to revive the market (Wehinger 2012, 9). Also in April, Andrea Enria, chair of the European Banking Authority, speaking about bank deleveraging from a supervisory perspective, highlighted that deleveraging was "structurally easier" for US banks, which could "sell assets due to the dis-intermediated structure of the financial sector, where

capital markets play a pivotal role" (Enria 2012, 11). Enria did not fail to highlight securitization as a potential remedy – namely, an instrument for banks to strengthen their capital position by selling off otherwise illiquid loans. Proponents of this argument emphasized that a lighter regulatory approach would be necessary to make investment in securitized products more profitable (Nassr and Wehinger 2014; Aiyar et al. 2015). The ECB, too, played an important role in the CMU agenda-setting process. In the summer of 2012, after Mario Draghi's "whatever it takes" speech had effectively neutralized the immediate threat of a euro area break-up, the ECB turned its attention to the twin problems of banking sector deleveraging and SME funding shortages. Specifically, the ECB cited concerns over the implementation and transmission of its monetary policy, arguing that the "heterogeneity" or "fragmentation" of borrowing conditions for SMEs posed a fundamental problem, since it prevented the "homogeneous pass-through of its key interest rates" across the euro area (ECB 2012b, 63).

These assessments by financial regulators and policymakers were reflected in the Commission's influential March 2013 *Green Paper on Long-Term Financing of the European Economy*, which launched a public consultation on that same topic. The *Green Paper* advanced four main arguments. First, it identified SMEs as having the "potential to underpin the long-term growth of the future" (Commission 2013, 16). Second, the fallout from the crisis forced European banks to deleverage, thus diminishing their ability to make long-term loans (ibid., 3). Third, due to Europe's "relatively underdeveloped" bond and equity markets, "non-bank financing remains largely inaccessible to SMEs" (ibid., 3). Fourth, and as a result, European SMEs "suffer from a continual lack of liquidity" (ibid., 4). Again, the document mentioned securitization as a potential remedy, noting that European securitization markets were "under-developed compared [with] other parts of the world" and that "dedicated markets especially for SMEs" were "important topics to consider" (ibid., 11, 12).

The Green Paper on Long-Term Financing acted as a catalyst that focused the minds of both lobbyists and technocrats on securitization. Within a year of the Green Paper's publication, securitization achieved silver-bullet status in relation to the twin problems of bank deleveraging and SME credit scarcity that would propel it to the top of the CMU agenda. In response to the *Green Paper*, the Association for Financial Markets in Europe (AFME) produced a detailed report titled "Unlocking funding for European investment and growth" (AFME and Oliver Wyman 2013). Coming in at 116 pages and citing research that included 75 hours of interviews with market participants, the report was both a manifesto extolling the benefits of securitization and an industry wish list of regulatory measures. In another follow-up to the *Green Paper*, the ECOFIN Council appointed a High Level Expert Group, with members from both the public and the private sectors, to compile a report on "SME and Infrastructure Financing," large parts of which focused on the potential contribution of securitization markets (Giovannini 2013).

The ECB had offered steadfast support to the securitization market since 2010 (Braun 2017, 13–16). In 2013, the Executive Board began making the link between securitiza-

tion and overcoming financial fragmentation and the SME credit crunch. In addition to propping up the securitization market through collateral and quantitative easing, the ECB began to advocate regulatory easing (ibid., 16–19). Members of the Executive Board repeatedly called on regulators and European lawmakers to ease the regulatory burden that the *Solvency II Directive* and the new *Capital Requirements Directive* threatened to impose on securitization (Mersch 2013; 2014; Draghi 2014). In late 2014, the ECB solidified its pro-securitization position in a discussion paper, published jointly with the Bank of England (ECB and BoE 2014).

To conclude, securitization became a European policy priority through a supranational agenda-setting process in which economic policymakers with no fiscal levers to pull scrambled to respond to political pressures to deliver on growth. Looking at the growth problem only through the lens of regulatory policy, what they saw was uneven bank deleveraging and SME borrowing constraints. From this diagnosis, it was only a small step to prescribing securitization as a remedy. When the securitization lobby pushed against the Commission's door, they found it already wide open.

Stabilizing instability in EMU: Capital Markets Union and the risk-sharing angle

Macroeconomic stabilization is based on two pillars. While it seeks to create favorable conditions for economic growth and prosperity, the immediate concern is generally with mitigating the impact of an output shock on consumption. As will be shown in this section, in addition to casting it as a budget-neutral instrument for the new European growth agenda, supranational policymakers also discovered securitization – and market-based finance more generally – as a mechanism for private EMU-internal shock absorption, or, to use the technical term, private risk-sharing. The basic function of risk-sharing in a monetary union is to provide an insurance mechanism that allows countries or regions hit by an asymmetric economic shock to mitigate the impact of the resulting decline in output growth on consumption growth (Schelkle 2017). In principle, risk-sharing can happen through public budgets or through private markets (that is, on the balance sheets of governments or of private financial entities). *Public risk-sharing* requires at least partial centralization of national budgets. High levels of public risk-sharing are commonly associated with "complete monetary unions." The basic idea is simple: if Country A experiences a negative output shock while the economy of Country B experiences a cyclical upswing, a central budget allows for a public redistribution of incomes from A to B. *Private risk-sharing*, by contrast, works primarily through debt and equity markets. A basic requirement for private risk-sharing across borders is a high level of financial market integration. Income smoothing is ensured through internationally diversified investment portfolios. Individual economic units can protect themselves from the vagaries of local economic circumstances by owning claims – through both equity and debt investment – on output produced in other coun-

tries (Kalemli-Ozcan, Sørensen, and Yosha 2004). On the other hand, from a debtor-country perspective, when things go wrong, the larger the share of the losses borne by foreign investors, the softer the blow to the domestic economy . This is why Banking Union, which promises to bail-in the (surplus-country) creditors of failing (deficit-country) banks, is seen as improving private risk-sharing (Sandbu 2017).[6] The main focus of advocates of private risk-sharing, however, is not on traditional bank finance but on market-based forms of banking and financing.

European policymakers diagnosed the lack of EMU-internal risk-sharing tools as a key aggravating factor in the euro crisis (Commission 2016a). This diagnosis is compatible with the consensus explanation of the crisis as the consequence of the institutional heterogeneity of different varieties of capitalism jointly participating in a "non-optimal currency area," and the resulting divergences in price competitiveness between the Northern export-led economies and the consumption-led economies of Europe's South (Scharpf 2013; Hall 2014; Johnston and Regan 2016; Baccaro and Pontusson 2016). Without challenging this explanation, the risk-sharing argument states that the crisis would have been less severe had robust risk-sharing mechanisms cushioned the economic shocks experienced by peripheral economies.

Such risk-sharing mechanisms were at the heart of post-2010 expert debates on EMU reform. At the June 2012 Council summit in Brussels, the EMU member states invited Council President Herman Van Rompuy "to develop, in close collaboration with the President of the Commission, the President of the Eurogroup and the President of the ECB, a specific and time-bound road map for the achievement of a genuine Economic and Monetary Union." This call resulted in the "Four Presidents' Report" on EMU governance reform, which highlighted the need to build genuine fiscal capacities at the supranational level. Besides announcing an intention to further strengthen the supranational regulation of core fiscal state powers, the report advocated a "qualitative move towards a fiscal union" after 2014 in order to improve "the resilience of EMU through the creation of a shock-absorption function at the central level" (Four Presidents' Report 2012, 5). Importantly, the debate focused solely on the issue of public risk-sharing, not even mentioning private risk-sharing as a complementary or even alternative instrument. In fact, the "Four Presidents' Report" expressed doubts regarding the capacity of private capital markets to facilitate adjustment to country-specific economic shocks, arguing that "capital flows are susceptible to sudden swings that can undermine financial stability" (ibid., 10).

How, then, did European policymakers pivot from this critical assessment toward the private risk-sharing agenda that features so prominently in the CMU plans? Tracing the developments since 2012, it is revealing that, as political fears of an uncontrolled euro area breakup abated following Draghi's "whatever it takes" pledge in July 2012, ambi-

6 If implemented, the *European Deposit Insurance Scheme* (EDIS) would add another, public–private risk-sharing mechanism to Banking Union.

tions for political reform waned, too. Besides slowing down Banking Union (Hellwig 2014), this effect was most pronounced with regard to the political will to strengthen public risk-sharing in the euro area. National interests played an important role. Germany, supported by the other creditor countries, feared that increased fiscal leeway at the European level would establish a permanent transfer system from the North to the South, plagued with moral hazard problems (Brunnermeier, James, and Landau 2016).

In this context of political stalemate, European expert circles, in late 2012, began to toy with the idea that private risk-sharing through financial markets could substitute for public risk-sharing. The theory behind the concept of private risk-sharing was developed in the mid-1990s. Firmly rooted in the neoclassical worldview that dominated economics at the time, the relevant literature is based on the assumption of an Arrow-Debreu world of complete markets and "the belief that financial markets are efficient and imperfect largely because of regulatory-political segmentation" (Schelkle 2015; Buch, Körner, and Weigert 2014). An article by Pierfederico Asdrubali, Bent E. Sørensen and Oved Yosha on "Channels of Interstate Risk-sharing: United States 1963–1990" was particularly influential (Asdrubali, Sørensen, and Yosha 1996). Not only was it the first article to provide an integrated framework for measuring how economic shocks are cushioned through different risk-sharing channels, but also, most importantly, it asserted that "39 percent of shocks to gross state product are smoothed by capital markets, 13 percent are smoothed by the federal government, and 23 percent are smoothed by credit markets." Since late 2012, advocates of private risk-sharing as a path towards EMU completion frequently referenced these results, notwithstanding the fact that Asdrubali, Sorensen, and Yosha studied only the US case; did so for a different, less financialized time period; and used a methodology that "does not grasp endogenous risks arising from financial integration itself" (Schelkle 2015).

The authors of that article also intervened directly in the EMU debate. Pierfederico Asdrubali became a senior economist at the Commission in May 2013. Bent E. Sørensen published another article in which he argued that national political resistance to EMU-internal public risk-sharing "limits the amount of risk-sharing that is possible through sustained fiscal transfers in severe downturns" and emphasized in late 2012 that "ideas [about the importance of private risk-sharing] are missing when we look at the current discussion in Europe" (Hoffmann and Sørensen 2012). Think tanks, too, promoted the idea. Bruegel, a leading EU think tank, published several optimistic papers on private risk-sharing (Wolff 2012; Sapir 2013; Allard 2013). Diego Valiante, the author of a comprehensive study on "Europe's Untapped Capital Markets" for another think tank (CEPS), which emphasized the benefits of financial integration for risk-sharing, became a senior economist at the Commission in July 2016 (Valiante 2016).

The ECB, too, became an outspoken advocate of private risk-sharing. In a November 2014 speech on "Stability and Prosperity in Monetary Union," ECB President Mario Draghi explained his support for the CMU project by its beneficial effects for private risk-sharing (see also Constâncio 2016; 2017):

> In all national economies, permanent [fiscal] transfers take place from richer to poorer regions … But as such transfers are not foreseen within the euro area … we need a different approach to ensure that each country is permanently better off within the Union than outside. [An] implication that follows from not having fiscal transfers is that EMU countries need to invest more in other mechanisms to share the cost of shocks. … In our case this means deepening financial integration in ways that improve private risk-sharing – that is, through having more diversified financial portfolios that can spread risk and reward across regions, and more integrated credit markets that can smooth consumption patterns. … This means, first, advancing with the agenda of the new Commission President to establish a genuine Capital Markets Union in Europe.

The discourse about the desirability of more private risk-sharing in EMU was thus already firmly established when the new Juncker Commission published its CMU proposal, in which the idea of private risk-sharing figured prominently. CMU falls squarely in the EU's "core business," the single market – the only area where the EU has "hard competences" (Pelkmans 2011, 2). Given its goal of pushing risk-sharing at the EMU level with minimum fiscal resources, playing the single market card was good politics from the Commission's perspective.

Since the publication of the CMU proposal, the idea of resorting to markets and market mechanisms in EMU reform efforts has become a focal point for technocrats and politicians in search of a common agenda. Thus, private risk-sharing has been at the heart of the two latest high-level policy papers on deepening EMU: the "Five Presidents' Report" published in May 2015 (a follow-up to the "Four Presidents' Report" of 2012), and the Commissions' recent "Reflection Paper on the Deepening of the Economic and Monetary Union" (Commission 2017). The Five Presidents' Report (2015, 4, 12) states:

> For all economies to be permanently better off inside the euro area, they also need to be able to share the impact of shocks through risk-sharing within the EMU. … A well-functioning Capital Markets Union will strengthen cross-border risk-sharing through deepening integration of bond and equity markets, the latter of which is a key shock absorber. … This in turn reduces the amount of risk-sharing that needs to be achieved through financial means (public risk-sharing).

Crucially, the discourse of private risk-sharing has been received positively in Germany, EMU's largest creditor country. The German government conceives of CMU as the lowest common denominator for short-term EMU-internal risk-sharing, a fact that has contributed to Germany's support for CMU. This view has repeatedly been expressed by the German Council of Economic Experts (Sachverständigenrat 2015a; 2015b; Feld and Osterloh 2013), an influential advisory body to the German government, and by the Bundesbank (Buch 2016; Weidmann 2016).

5 Conclusion: The political economy of governing through financial markets

In the early days of EMU, Maurice Obstfeld, among others, warned that Europe "has taken a gamble in placing monetary unification so far ahead of political unification" (cited in Issing 1999). Recent developments seem to have proved these critics right. The euro crisis has laid bare the political and economic fragilities of a regime that pools monetary sovereignty at the supranational level but retains authority over fiscal, labour market, and banking policy at the national level. A supranational fiscal capacity, which would be a key building block of a complete monetary union (De Grauwe 2017, 127), remains out of reach due to diverging member state preferences and the complexities of the multilevel EMU governance regime. The result has been an institutionally ingrained, structural capacity gap that leaves the European polity – at both the national and the supranational levels – unable to provide the public good of macroeconomic stability.

On the basis of that assessment, this paper seeks to make three contributions. In order of ascending generality, these concern the explanation of CMU, the nature of EU financial policymaking, and the financialization of economic governance.

First, the Commission's embrace of securitization and of the broader project of a Capital Markets Union was tied directly to considerations of macroeconomic governance. CMU constitutes an attempt by European policymakers to use the regulatory policy tools at their disposal in order to devise a financial fix for the fiscal faults of the European regulatory state. As public expectations towards and the ambitions of EU policymakers have grown with regard to macroeconomic objectives of growth and EMU stabilization, the Commission and the ECB have resorted to regulatory policy to harness financial markets to deliver on those objectives. Rather than marking the first steps "beyond the regulatory state" (Caporaso et al. 2014, 890), recent developments have thus deepened the European "regulatory state," extending it into the field of macroeconomic stabilization. Specifically, we have shown how policymakers, central bankers, think tanks, and financial sector actors reconfigured securitization as an instrument for SME financing and thus as a remedy for low growth and high unemployment. More generally, they established market-based finance as a solution to the intractable problem of smoothing intra-euro area output shocks or, in technical terms, risk-sharing. The primary purpose of this envisaged transformation of the European financial system is thus to support the policy goal of macroeconomic stabilization.

Second, this explanation amounts to a broader contribution to the literature on EU financial policymaking. One way to structure that literature is along the spectrum of conceptions of the role of technocrats. In simple terms, they tend to range from "benevolent problem solvers" to "servants of capital." In the case at hand, the former view would imply taking at face value the Commission's narrative about CMU offering the best available solution to the structural capacity gap in the area of macroeconomic stabilization. By contrast, the second view would imply that the Commission's narra-

tive is merely a smokescreen to obscure a different, hidden policy agenda, namely the preferences of financial market actors. Our analysis suggests that with CMU at least, the answer lies squarely in the middle. This finding is consistent with the literature that has found policymaking to increasingly blur the lines, drawn originally by Heclo, between "powering" and "puzzling" (Heclo 1974; Boswell 2008; Culpepper 2002; Mudge and Vauchez 2012). On one hand, solid evidence exists of the structural and instrumental power of finance in the European political process, especially at the EU level (Culpepper and Reinke 2014; Gabor 2016b; Woll 2016; Young and Pagliari 2017; Kastner 2017). At the same time, technocrats undoubtedly pursue their own policy goals, and they "puzzle" over how to achieve them.

But this puzzling occurs within a given set of political, ideational, and instrumental constraints. Politically, the Commission (and the ECB) have operated within the confines of budgetary discipline and euro-skepticism, which put a grand fiscal bargain well out of reach. Ideationally, the realm of the possible continued to be defined by orthodox economics and thus by a belief in the efficiency of deep and liquid – albeit well-regulated – financial markets. In terms of its instruments, the Commission remained dependent on its regulatory policy toolkit. Given this set of constraints, it is unsurprising that "bricolage" led the Commission to turn to financial markets. Crucially, this does not imply that the Commission is fully committed to the theory that CMU will actually solve the problem of macroeconomic stabilization. However, our analysis has shown that policymakers have gone to great lengths to establish the validity of that narrative.

The third contribution is to the broader literature on the state–finance nexus and concerns the structural relationship between technocratic economic governance and financialization. Here we argue that, despite the somewhat convoluted policymaking process, the result – a decisive turn to finance motivated by macroeconomic governance considerations – follows an established pattern. Specifically, the case of CMU follows a pattern of state-led financialization, uncovered, above all, by Greta Krippner and Sarah Quinn. Quinn, in her work on the origins of US mortgage securitization, has highlighted the attraction – given the "fractured" nature of the state – of financial markets as indirect policy tools "that function by inducing another entity into action toward a desired end" (Quinn 2010, 6; 2017). In a similar vein, Krippner (2011, 149) has shown how US policymakers, in response to falling growth rates in the 1970s, sought to reinvigorate the economy "indirectly through market mechanisms," notably by liberalizing financial markets to transform "capital scarcity and perennial credit shortages into apparent prosperity." From this perspective, the political power of finance appears deeply embedded in modern governmental strategies and technologies (Gabor 2016a; Gabor and Ban 2016; Braun 2017; Woll 2017). Rather than forming a puzzle, state-led financialization in contemporary Europe is following a well-trodden path.

This path of state-led financialization may be well-trodden, but it is not without alternatives. The obvious, EMU-specific alternative is, of course, a stronger fiscal capacity for macroeconomic stabilization at the supranational level. This option has been

extensively discussed, and the political obstacles in the way of fiscal centralization are well understood. Perhaps more interestingly, alternatives exist also with regard to the role of the state within the financial system. Here, CMU implies continuity, in that it continues the long-standing European project of "perfecting" private financial markets while assigning the state a purely regulatory and supervisory function. This project is based on the conviction that deep and liquid financial markets offer the best way of sharing risks ranging from individual-level risks to the macroeconomic risks faced by entire societies. The belief in perfectibility keeps at bay concerns over the tendency of market-based finance to fuel mortgage debt rather than SMEs, or the regressive distributional bias of market-based risk-sharing arrangements in favour of owners of financial assets (Fernandez and Aalbers 2017). Contrasting this vision, progressive scholars of the state–finance nexus have advocated more – not less – state involvement in the financial system. Emphasizing the essentially hybrid, public–private character of the 'finance franchise,' this literature argues that a stronger role for public actors in creating and allocating credit and absorbing financial risk would improve economic outcomes not only in terms of equity, but also in terms of efficiency (Hockett and Omarova 2017; Block 2014; cf. Moss 2002). Rather than relying on risk-averse, short term-oriented private investors to allocate capital, public development banks and public wealth funds could play a much more prominent role (Mertens and Thiemann 2017; 2018; Mazzucato and Penna 2016; Griffith-Jones and Cozzi 2017). Similarly, the fickleness and procyclicality of private capital markets cast doubt on their ability to serve as societal risk-sharing mechanisms in areas such as pension policy and macroeconomic stabilization.

In short, the point of describing the path of state-led financialization as well-trodden is not say that alternatives do not exist. Instead, our argument points out the agency of those that do the treading – namely, technocrats whose room for maneuver tends to be tightly circumscribed by political, ideational, and instrumental constraints. Carving out genuinely *new* paths requires ideas and instruments that technocrats are ill-equipped to develop, let alone implement – it requires public debate, contestation, and a legitimacy-generating political process.

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