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Fiscal fault, financial fix? Capital Markets Union and the quest for macroeconomic stabilization in the Euro Area

Benjamin Braun and Marina Hübner
Max Planck Institute for the Study of Societies, Köln, Germany

Abstract
This article seeks to situate and explain the European Union's push for a Capital Markets Union – and thus for a more market-based financial system – in the broader context of macroeconomic governance in politically fractured polities. The current governance structure of the European Monetary Union 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 output shocks on consumption. Capital Markets Union, we argue, is the attempt of European policymakers to devise a financial fix to this structural capacity gap. Using its regulatory powers, the 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 the European Monetary Union's governance problems.

Keywords
Regulation, securitization, euro area, fiscal policy, financial markets, European Commission, European Central Bank

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Corresponding author:
Marina Hübner, Max-Planck-Institut fur Gesellschaftsforschung, Paulstraße 3, Köln 50676, Germany.
Email: Marina.Huebner@mpifg.de

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 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 European Union (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 (Epstein and Rhodes, 2016; Genschel and Jachtenfuchs, 2014; 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, the current governance structure of European Monetary Union (EMU) 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 effect 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 translated into a political imperative to alleviate it via negative impact on the EMU's output legitimacy. This impact has varied dramatically between the core and the periphery of the euro area (Copelovitch et al., 2016; Scharpf, 2016; Schmidt, 2015). The structural capacity gap has not done much harm to output legitimacy in the core countries, which have weathered the European 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 role 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 could tap into a long tradition, reaching back to the 1960s, of technocrats lamenting European companies' over-reliance 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 deeper 'purpose' (Grossman and Leblond, 2012; Posner and Véron, 2010; Quaglia, 2007) or as the latest iteration of neoliberal restructuring (Bieling, 2013; Macartney, 2011; van Apeldoorn, 2002).[1] These explanations cannot not, 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' (Carstensen, 2011; Kalyanpur and Newman, 2017) with a macro-level focus on the structural constraints and incentives of governing a large, financialized economy. Seeking to address the 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.

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-centred, 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 US, the history of state-led financialization is the history of fiscally constrained and institutionally fractured federal governments seeking ways to 'govern the economy "at a distance" through the market' (Braun et al., 2018; Krippner, 2007: 506, 2011; Quinn, 2010, 2017). 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 as 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 *sui generis* euro world.

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 European Central Bank (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, the next section elaborates the structural part of our explanatory framework. This is followed by a section that focuses on the agency of technocrats whose strategic use of 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 a part of the problem – as a part of the solution for EMU’s governance gaps.[3] Then the next section 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. The final section concludes.

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. Its authority being 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 policy-making which 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 much increased, 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).

There is, however, a paradox. On the 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 the EMU and its member states of the capacity to provide the public policy good 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 control over *monetary policy* as a stabilization instrument to the ECB, 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 behaviour 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 legislations as well as the fiscal compact, further diminished member states' fiscal room for manoeuvre, effectively transforming them into 'consolidation states' (Hallerberg, 2014; Scharpf, 2014; Streeck, 2015). As for *labour market policy*, pre-crisis heterogeneity of wage regimes and the post-crisis imperative for creditor countries to adjust via internal deflation has eliminated wage coordination for stabilization purposes (Copelovitch et al., 2016; Hall, 2018; Höpner and Lutter, 2017).

In sum, the full centralization of monetary policy, the partial but consolidation-oriented centralization of fiscal policy, and the neutralization of labour market policy in creditor countries, have locked in a 'politics of constraint 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 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 stabiliser' 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?

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' (Boswell, 2008; Heclo, 1974; 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 coloured by the prevalent theoretical or policy consensus (Blyth and Matthijs, 2017; Braun, 2014; 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 paradigm among European technocrats that properly regulated financial markets tended 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 to be 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) convincingly argues, 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 favour of governing through financial markets into a concrete policy agenda that established securitization and market-based finance as a financial fix for the EMU's fiscal faults.

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 et al., 2016: ch. 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. 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 (see next section). In addition, when it became clear that a European fiscal capacity was out of reach, the debate on improving the institutional capacity of EMU to buffer the impact of future regional or national economic shocks on consumption turned to financial markets as private instruments of shock absorption (section 'Stabilizing instability in EMU: Capital markets union and the risk sharing angle''). 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 Commission's macroeconomic rationale for CMU is stated in the first sentence of the Commission's *Action Plan on CMU*: 'The Commission's top priority is to strengthen Europe's economy and stimulate investment to create jobs' (European Commission, 2015: 3). Similar language can be found in the recently adopted EU legislation on so-called 'simple, transparent and standardised' (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 in 2000 to €453.7 billion 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, of which only €96.4 billion were 'placed', that is sold to investors (AFME, 2017).

While the diagnosis of diminished securitization activity is correct, good reasons exists to be sceptical 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, 2015: 2). Most importantly, the largest segment of the securitization market, both in the US and in Europe, are residential mortgage-backed securities – a sector not generally considered central to the growth potential of advanced economies (Engelen and Glasmacher, 2018). In addition, the Global Financial Crisis was directly connected to the collapse of the subprime ABS market in the US, 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 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' (European Council, 2012).

This Growth Pact, however, illustrated the EMU's lacking 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' (European 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' (European Council, 2012: 8–10). In short, the Growth Pact took a strictly supply side-oriented approach, centred 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 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, high pressures 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 became 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 was most damaging to growth and employment, especially in 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, 'securitisation 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, chairperson 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 (Aiyar et al., 2015; Nassr and Wehinger, 2014). 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 threat of an immediate 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' (European Commission, 2013: 16). Second, the fallout from the crisis forced European banks to deleverage, thus diminishing their ability to make long-term loans (European Commission, 2013: 3). Third, due to Europe's 'relatively underdeveloped' bond and equity markets, 'non-bank financing remains largely inaccessible to SMEs' (European Commission, 2013: 3). Fourth, and as a result, European SMEs 'suffer from a continual lack of liquidity' (European Commission, 2013: 4). Again, the document mentioned securitization as a potential remedy, noting that European securitization markets were 'under-developed compared to other parts of the world' and that 'dedicated markets especially for SMEs' were 'important topics to consider' (European Commission, 2013: 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 the 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 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', comprising members from both the public and the private sector, to compile a report on 'SME and Infrastructure Financing', large parts of which focused on the potential contribution of securitization markets (Giovannini and Moran, 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 securitization 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 (Braun et al., 2018). 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 (Draghi, 2014; Mersch, 2013, 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 favourable 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 mechanisms 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 – both through equity or debt investment – on output produced in other countries (Kalemli-Ozcan et al., 2004). On the other hand, from a debtor-country perspective, when things go wrong the blow to the domestic economy is softened the larger the share of the losses born by foreign investors. 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 of the euro crisis (European 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 of the resulting divergences in price competitiveness between the Northern export-led economies and the consumption-led economies of Europe's South (Baccaro and Pontusson, 2016; Hall, 2014; Johnston and Regan, 2016; Scharpf, 2013). 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 intentions to further strengthen the supranational

regulation of core fiscal state powers, the report advocated a 'qualitative move towards a fiscal union' (Van Rompuy, 2012) 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 doubt 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' (Four Presidents' Report, 2012: 10).

How, then, did European policymakers pivot from this critical assessment toward the private risk sharing agenda that feature 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, political reform ambitions 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 et al., 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' (Buch et al., 2015; Schelkle, 2015). 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 et al., 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. 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 that Asdrubali et al., 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 against EMU-internal public risk sharing 'limits the amount of risk sharing that is possible through sustained fiscal transfers in severe downturns' and emphasized that in late 2012 '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 (Allard, 2013; Sapir and Guntram, 2013; Wolff, 2012). 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 into the EU's 'core business', the single market – the only area where the EU has 'hard competences' (Pelkmans, 2011: 2). Given the 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 to resort 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 the deepening of EMU: the 'Five Presidents' Report' published in May 2015 (a follow-up on the 'Four Presidents' Report' of 2012), and the Commissions' recent 'Reflection Paper on the Deepening of the Economic and Monetary Union' (European Commission, 2017):

'For all economies to be permanently better of 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).' (Five Presidents' Report, 2015: 4,12)

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 (Deutscher Sachverständigenrat, 2015a; 2015b; Feld and Osterloh, 2013), an influential advisory body to the German government, and by the Bundesbank (Buch, 2016; Weidmann, 2016).

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 level – unable to provide the public good of macreoconomic 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 CMU was directly tied 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 fault of the European regulatory state. As public expectations towards and ambitions of EU policymakers with regard to macroeconomic objectives of growth and EMU stabilization have grown, 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 re-configured securitization as an instrument for SME financing and thus as a remedy for low growth and high unemployment; and established market-based finance more generally 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, which, simply put, 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 narrative 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' (Boswell, 2008; Culpepper, 2002; Heclo, 1974; Mudge and Vauchez, 2012). On the one hand, solid evidence exists of the structural and instrumental power of finance in the European political process, especially at EU level (Culpepper and Reinke, 2014; Gabor, 2016b;

Kastner, 2017; Woll, 2016; Young and Pagliari, 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-scepticism, 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. What our analysis has shown, however, is 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 (Braun, 2017; Gabor, 2016a; Gabor and Ban, 2016; 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 (Block, 2014; Hockett and

Omarova, 2017; 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 (Griffith-Jones and Cozzi, 2017; Mazzucato and Penna, 2016; Mertens and Thiemann, 2017, 2018). 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 or 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 to the agency of those that do the treading – namely, technocrats whose room for manoeuvre 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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Notes

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 (European Commission, 2016b).
2. Asset Backed Finance, True Sale International (TSI) Congress, 23–24 September 2015, Berlin; Das EU-Projekt Kapitalmarktunion – Ziele, Aufgaben und neue Rahmenbedingungen, TSI Conference, 3 March 2016, Frankfurt a.M.; Die Zukunft des Verbriefungs- und Structured Finance Marktes in Deutschland und Europa, TSI Congress, 28–29 September 2016, Berlin; Europe – On Achieving an Appropriate Economic Policy Stance (with Servaas Deroose and Thomas Wieser), 4 October 2016; Uneasy Calm: Fixing Europe's Economic and Institutional Woes (with Marco Buti), 1 November 2016, Harvard University; Summit on the Future of Europe (with Pierre Moscovici), 14 November 2016, all Harvard University; CEPS Summer School on EMU Governance Reform, 4–9 September 2017, Brussels.
3. We use the term 'market-based finance' rather than 'market-based banking' (Hardie et al., 2013) to denote that CMU aims to promote not only market-based banking (notably securitization) but also non-bank forms of intermediation, such as equity and venture capital markets.

4. Currently, the EU budget accounts for 1% of the EU's combined Gross Domestic Product (GDP).
5. Engelen and Glasmacher (2018) 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.
6. If implemented, the *European Deposit Insurance Scheme* (EDIS) would add another, public-private risk-sharing mechanism to the Banking Union.

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