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Can finance be used for European Integration?

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ABSTRACT

Although the sub-prime crisis did not challenge the foundations of modern finance it did open the way to new and vital ways of thinking. The financial system has become a key sector of knowledge economies and we can no longer consider it as a veil covering economic relations the regulation of which is supposed to guarantee fluidity and transparency. The financial sector is an economic sector in its own right the bearer of its own risk - "systemic risk" - which has to be seen globally via macro-prudential regulation. To do this the new European Systemic Risk Board (ESRB) has to be given real financial and human resources in the same way as its American counterpart, the OFR. Macro-financial regulation has to be open to European issues so that finance can become part of society again and so that it can recover its primary role: to foster investment to build the future. Whether this involves innovation, demographic issues or environmental policy, finance has to be open to these and offer adapted solutions. This is why it is important for the goals that are set for the nascent European financial regulation to be the focus of political debate in association with the major issues of European integration. Hence finance may once again be at the service of business and citizens.

INTRODUCTION

The sub-prime crisis did not just reveal the excesses of the financial system, it also showed the weaknesses in its regulation. It is easy to blame the financial establishments, from investment banks to credit rating agencies, but in doing this we forget their rise and development have only been possible within a regulatory framework that provided them with the opportunity to do so. The regulators are just as responsible for the crisis as the financial players; "We conclude that there were widespread failures in financial regulation and supervision which proved disastrous for the stability of the financial markets," revealed the US Financial Crisis Inquiry Commission [1].

In Europe financial regulation was taken by surprise by sheer size of the crisis. At that time European regulation was fragmented between the Member States, whilst the banks and financial players were all or nearly all trans-national, European or international. Whereas financial regulation in the USA did not succeed in preventing a real estate bubble, the EU did not succeed in building a resilient, integrated, strong financial system Europe wide. And it was the lack of community regulation that weakened the European economy. Antonio Borges, Director of the European Department at the IMF believes that "risks which weigh on recovery are the weakness of the banking sector." [2].

It is now urgent to rebuild the European banking system on sound foundations providing it with an integrated, informed European regulation. This is where the new agencies that were created at the beginning of 2011 according to the conclusions of the Larosière Report come in. [3]. But lessons have to be learnt from the crisis on either side of the Atlantic and the position occupied by finance in the economy has to be re-examined. The extremely rapid development of the financial sector, an increase in monetary mass, the increasing complexity of financial products oblige us to re-examine financial regulation to make it more effective and legitimate.

Above all we have to ask ourselves: what kind of financial system do we need to rise to political, economic, demographic and social challenges that Europeans face?

1. Conclusions of the Financial Crisis Inquiry commission, March 2011 (author's translation).

2. IMF Bulletin, Europe Department Briefing, Bonnes perspectives pour l'Europe, mais la dette et le système bancaire inquiètent, 17th April 2011, available on : http://www.imf.org/external/french/pubs/ft/survey/so/2011/car041711af.pdf

3. Report managed by Jacques de Larosière (2009), The high-level group on financial supervision in the EU, 25th February 2009.

1. DEREGULATION OR ALTERNATIVE REGULATION? TOWARDS EUROPEAN FINANCE?

1.1. Decentralise towards the market

What we usually call "deregulation" is in reality a complex phenomenon that started at the end of the 1970's which does not really imply a withdrawal of all forms of regulation but rather more a radical change in the conception of what regulation is. The crisis in 1929 revealed the dangers of leaving the financial system to its own devices and many measures – including the most famous of these, the Glass-Steagall Act [4], were taken to guarantee its stability and to support economic growth. It was a "boring profession, at the service of the public and the economy." [5]

The internationalisation of business and trade, as well as the development of the knowledge economy at the beginning of the 1980's encouraged governments to liberalise their financial systems. The key feature of this was the disintermediation of finance: businesses and households were no longer financed by the banks but directly by the financial markets. The banking establishments therefore became financial players, which were of course important, but which faced competition on the part of others. With strong growth in world savings freeing thousands of billions in capital and the development of new information and communication technologies enabling instantaneous trade, together with the constant refining of financial products, the trend gathered pace.

The basic idea in this process is that markets are better equipped to deal with information flows than the banks: the decentralisation of information management improves its effectiveness. This is particularly important in a globalised knowledge economy of which it is impossible to have a centralised, clear, strategic view of everything that is at stake.

From now on financial regulation is seen as the shepherd responsible for ensuring that the markets fulfil their role correctly. The work of George Akerlof and Joseph Stiglitz, Nobel Economy Prize 2001, showed that the financial markets cannot be effective if the information they have to manage is incomplete or imperfect. Financial regulation must therefore guarantee the transparency and fluidity of the information on the markets: compatibility requirements, prohibition of insider trading etc … Hence from a regulation that aimed to control financial flows (1945-1980) we have moved on to a type of regulation that aims to guarantee market efficiency (1980-2011).

1.2. Finance, the key feature of the Common Market or rather its weakness?

The EU followed the same path as the USA. Every country has gradually "deregulated" its financial system (privatisation of the banks, opening of financial markets and disintermediation) and has built up a new type of financial regulation. Since every financial system is specific, linked to historic and cultural factors, financial regulations have been country specific: the harmonisation of regulations is new and extremely gradual.

The liberalisation of the European financial system was the vital condition for the construction of the Economic and Monetary Union. The free movement of goods and capital was to rely on borderless financial markets. European banks have restructured in order to grasp new opportunities and respond to international competition. At the turn of the 21st century a great number of mergers and acquisitions took place in this direction. "The introduction of the single currency has simply amplified these trends," recalled Jacques de Larosière in 2000 [6]. Even though the fragmentation of national regulations slowed the movement, transnational establishments gradually emerged during the first decade of the 21st century.

From one year to another a European banking system developed, but it was still set on national foundations (commercial banks, savings banks) and supervised by national regulators. Financial Europe is a European giant with national feet: the aid governments gave as a priority to their national establishments at the peak of the sub-prime crisis was a clear demonstration of this.

The development towards a disintermediated, European financial system has had major effects on the economy, particularly in terms of business governance. The EU has gradually adopted an Anglo-Saxon business approach, in which the company is deemed to be a place where value is created for the shareholder [7], unlike the "German" approach in which the company is a social place for the production of goods and services. From accounting to management style, this change has contributed to the strengthening of the position of the financial system in the European economy and has made it one of the key features of community integration.

4.American Law of 1933 separating savings bank activities from those of investment banks

5. Attali J. (2009), Le métier de banquier doit redevenir ennuyeux, CCIFJ.

6. De Larosière J. (2000), La concentration bancaire en Europe, speech given to the Union of North African Banks, Algiers, 3rd July 2000.

7. Aglietta M. Et A.Rebérioux (2004), Dérives du capitalisme financier, Centre Saint-Gobain, Editions Albin Michel Economie

1.3. Prudential Regulation, Self-Regulation or Public Regulation?

Over three decades the financial sector has become a key feature of the States' economies, but several factors make it difficult to regulate: the financial sums involved, the complexity of the established systems and the multiplicity of relationships with all of the other players in the economy. Human and financial means will be necessary which the regulators do not have to hand.

They find it difficult to follow the extremely rapid developments in financial products that are increasingly more refined. Some merchant banks are purposely complex to stay ahead of the regulators, so that they can conjure up financial products that will remain beyond the field of regulation or standardisation for several months. The attractiveness of remuneration in the private sector deprives the public sector of its best talent, thereby creating a significant asymmetry in terms of competence [8] : the regulators do not have the human resources at their disposal in order to take on the responsibilities given to them.

Another example: the sums of money at stake. The Bank of International Settlments (BIS) estimates trade on the stock exchange at a daily 4,000 billion $; the Wall Street Journal estimates flows on the shares market at 134 billion $ [9]. How can the regulators supervise sums of money, as diversified as this and which are spread across the entire world? This is a question of fundamental competence.

The answer given to date has been prudential regulation: for want of having an overall vision of the system, the most important players are asked to self-regulate. The Basel or Solvency Agreements are based on this idea: only the players themselves are in a position to assess their own risks and to follow codes of good conduct thereby guaranteeing the good functioning of the markets. These agreements set prudential ratios, liquidities which the banks have to hold in the event of a crisis for example, they require banks to provide themselves with risk analysis resources etc ... Nothing is really binding and every relies on a kind of gentleman's agreement.

Financial regulation is based on two discrete policies. On the one hand "noble regulation" checks that rules and regulations are respected on the markets and guarantees the transparency of information and the security of transactions. It aims to provide a legal, secure structure to the markets and tries to correct certain deviations (guaranteeing transparency to avoid asymmetrical information). It emerged initially on a national financial level and then became international in the wake of harmonisation between countries.

"Prudential regulation" on the other hand is undertaken by the banks. It implies good risk management, the sharing of good practice and the progressive standardisation of financial products. A management tool for the banks, it is now international and is formed in trading places such as the Financial Stability Council, which brings together the main Central Banks as well as the main banking and financial establishments.

The building of a Common Market went hand in hand with that of a European financial market. But statutory regulation did not become European at the same pace. It is still fragmented between countries whilst prudential regulation developed internationally. The crisis revealed the dangers of a discrepancy like this in national fragmented regulations and international prudential regulation.

2. FINANCIAL REGULATION, THE EUROPEAN OPTION

The sub-prime crisis accelerated, heightened and changed the establishment of European financial regulation. It did not really reveal the weakness of a market sector (real estate) or of a macro-economic policy (excessively low interest rates) as in the US but rather the weaknesses of a divided financial system. The Larosière Report, published in 2009, set the agenda until 2012: firstly there would be preparation for the transfer over to a European Financial Supervision System (2009-2010) then its establishment (2011 – 2012).

The new system that has been established is the reward for over a decade's work towards harmonising Europe wide financial regulation. It also brings a particular focus on the weaknesses revealed by the crisis, whether these are specifically European issues or those shared with the USA: credit ratings agencies, hedge funds, remunerations etc.

But the most important novelty lies in the establishment of a macro-prudential supervisory system over systemic risk: it is the first stage in the supervision of the financial sector as a whole.

2.1. The Crisis, the Accelerator of Reform

The inadequacies of European financial regulation were known about well before the crisis. We just have to read a small passage written by Michel Aglietta dated 2004 to see this: "Interdependence that is greatly heightened by way of the markets, increased vulnerability towards price volatility and difficulties in

8. Phlippon T. and A.Reshef (2008), Wages and Human Capital in the U.S. Financial Industry: 1909-2006.

9. Quoted by the Wall Street Journal, 31st August 2010.

detecting the weak links in risk transfer techniques throw doubt over the quality of prudential regulation, the main principles of which were established in an entirely different environment."

Before the crisis the national dominated over the European: the harmonisation of prudential regulation (ratio of own funds, investor protection) and mutual acknowledgement of national practices. Everything else was the responsibility of national supervisors. Community coordination was undertaken on an individual basis: each national regulator tried to ensure that European coordination was not institutionalised so that his own preserve was not affected.

The lack of a common space that enjoyed the necessary competence to manage crisis situations encouraged the retreat of national regulators during the sub-prime crisis. The responses that were initially given were national before being European under the impetus of the European Central Bank.

Hence the crisis made everyone aware of the need and urgency for an acceleration in the integration of European regulation – to provide shared information on the financial system, to be able to respond in a coordinated manner to the systemic crisis and to improve the functioning of the markets.

The three agencies that were established at the beginning of 2011 – the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA), have led to the creation of coherent financial supervisory framework across Europe.

These three authorities intervene on a micro-prudential level setting out technical standards, coordinating national supervisors' action, collating information and having the power to ban or restrict certain activities or products that may threaten the good functioning of the financial markets.

They are the beginnings of a European financial regulation that only patient harmonisation work will help to complete.

2.2. From the USA to the EU, how should the financial markets be strengthened?

However the crisis did not just illustrate the importance of common regulation, it also revealed the shortfalls that had developed in the financial system – from the weakness of financial market funding, to securitisation and the poor spread of risk to the destabilising action of certain types of hedge fund.

Some are uniquely American problems (the real estate market [10], even though some European countries have also experienced a real-estate bubble) ; others are peripheral to the reality of the crisis (hedge funds, the old battle horse, easy scapegoats) [11].

The EU and the USA responded by reforming the financial system's weak links.

In terms of its banks the EU stepped up the obligation for financial players to hold the necessary capital requirements in the event of a crisis: this comes down to placing greater responsibility in the hands of the risk merchants. The previous decade witnessed an increasing dissociation between those responsible for lending and those who managed risk, which gradually eroded their frameworks of responsibility.

Hedge funds will have to be registered and be more transparent (Alternative Investment Fund Managers Directive). Credit ratings agencies will be subject to specific regulation in Europe which will probably require them to be more transparent in terms of how they assess risk. Finally accounting will have to be reviewed in order to reduce incentives towards the short-term and pro-cyclical effects. [12].

There is nothing revolutionary in this. On the contrary, these small reforms will make the existing system more resilient by providing it with greater regulatory authority.

2.3. The Macro-Prudential Approach: finance is an industry like any other (or nearly)

The real novelty is undoubtedly the European Systemic Risk Board (ESRB). This new institution enjoys extremely limited power: collating the statistics necessary for a global analysis of the financial markets and warning public decision makers of the identified systemic weaknesses or dangers. The Office for Financial Research (OFR) is the American equivalent of the ESRB: however it does have greater statistic power than the ESRB and its position within the Treasury provides it with greater influence than the latter which is simply a meeting place for the various European and national financial regulators.

In spite of this, the ESRB introduces a major change in concept. Until now regulation, which was exclusively micro-economic, focused only on individual cases. The macro-economic prism turns finance into an economic almost like any other. The regulator no longer simply looks at the institutions one by one – he needs to view the situation as a whole.

The financial sector as such, with its rules, players and principles was an unknown. "For forty years most compatibility and finance research focused on the business world – financial markets where businesses and investors meet," says Robert Kaplan. "But like the cartographers of Africa in the 19th century

10. *Reforming America's Housing Finance Market, A report to Congress, February 2011*

11. *Véron N.(2010), Régulation financière, où en est-on ?, Telos, 8th September 2010.*

12. *Véron N. (2010), EU Financial regulatory reform: a status report, Bruegel policy contribution, Issue 2010/11, December 2010*

we know less about what is happening in businesses than forty years ago." [13].

However finance has become a major financial sector in the economies of the developed countries. The financial system is an extremely complicated corpus of financial flows and commercial transactions. The intrication of its players is the source of systemic risk, ie risk associated with the financial system itself.

Hence when a bubble bursts in a small area of the market (subprime) it led to a widespread confidence crisis in the banking system that has had endless consequences. The liquidity and then the solvency crisis paralysed the entire economy. It really was a crisis specific to the financial system, and not a natural external phenomenon. Just as there can be risks when there is change or overproduction in the economy there is also a risk in the financial system itself.

This risk is all the more worrying since finance plays a vital role in the entire economy. The rise to power of Anglo-Saxon business governance for example lays companies quite open to the hazards of the market and therefore to systemic crises. The exponential increase of public debts also makes governments more dependent on financial approaches. Systemic risk is not therefore just a simple risk like any other: it affects all aspects of society.

By creating the ESRB the public authorities have signalled the beginning of a new economic discipline in the analysis of the financial sector and for the development of macro-financial regulation. Finance is no longer considered as a simple veil covering the economy, it is seen as a public good which has to serve the economy.

To be more precise, the financial markets can no longer be considered as simple, almost transparent and relatively neutral risk and flow management mechanisms, but as the heart of the capitalist economy, the irregular beat or palpitations of which can damage the entire system. As Jean-Claude Trichet said to the Economic and Monetary Affairs Committee at the European Parliament in February 2011, the ESRB will have very wide-ranging areas of control."

But without the adequate human and financial means the ESRB may very well be unable to undertaken this conceptual revolution completely. Moreover, as Paul Goldschmidt, former Director of the European Commission recalls "It is […] difficult to see how the ESRB, dominated by the Central Bank governors (with a majority of EMU members) will be able to analyse objectively and independently the risks associated with loans granted by their respective banking sectors to public borrowers" [14]. This situation may very well discredit the ESRB in the eyes of the market and reveal the EU's inability or at least that of the euro zone, to provide themselves with a real framework for financial regulation.

For the last thirty years regulation has endeavoured to decentralise the economic management of the markets. From now on the fluidity of international trade has recovered the level it had reached in 1914: capital can circulate almost freely from one side of the world to another. Hence it is no longer a question of knowing how to recover the mobility of capital but of seeing how to maintain it and prevent the major decline of the 1914-1945 period. [15]

Regulation has to learn to manage market instability. But can it be limited to that?

3. TOWARDS FINANCE AT THE SERVICE OF THE ECONOMY

The crisis has changed public opinion's relationship to finance. Unemployment, poverty, mediocre economic perspectives and pressure on public finance are leading to social discontent, for which finance has become an easy scapegoat. In the most weakened countries this situation feeds the feeling amongst the population that it has been cheated by the financialization of the economy. The real or imagined divorce between finance and society is worrying and calls for in-depth thought on the role that finance should play.

3.1. Managing risk or fostering investment?

To the simple question "What is finance?" the variety of answers is always surprising. But two attitudes can be distinguished. For some finance is a way of allocating resources and of spreading risk. A tonne of cacao produced in Africa can be purchased by a European chocolate manufacturer according to the law of supply and demand; a pension fund will invest in a balanced way in shares and bonds in order to spread the risk.

Finance is a time management system. We can buy goods at a set price one year before their production; we can borrow over thirty years or for just one second; we can trade financial flows to stabilise results. Financial products, call or put swaps, are to time what dams and locks are to rivers.

It can only function if information is perfectly transparent, trade is instantaneous and when there is a capacity for prescience and confidence. It is this approach that European and American regulation has fostered.

13. Kaplan R. (2011), The hollow science, Colonne, Harvard Business Review, mai 2011 (translation from the English by the author).

14.See Goldschmidt (2011), Prévention du risque systémique en Europe : "Qui veut la paix, prépare la guerre"..", Institut Thomas More.

15. Reinhart C. et K.Rogoff (2008), This Time is Different: A Panoramic View of Eight Centuries of Financial Crises.

However there is another interpretation. Finance plays a resource allocating role: what households and businesses manage to save should be used to prepare for the future. Finance is an intermediary: it stimulates and collects savings on the one hand, invests and builds for the future on the other.

From this point of view regulation should adopt an economic attitude: how should finance be fostered long term? "Accounting and prudential rules have to have a dual objective: reducing the risks of the system and optimising their role in support of funding the economy whose requirements are mostly long term" [16]. But as debate on the Solvency 2 regulation shows, these two goals can be contradictory – a overly prudent financial establishment will not be able to finance the economy effectively.

3.2. Finance and economic policy – is it the same battle?

As soon as regulation addresses investment it has to turn to thought on economic policy, because it has to define which type of investment it wants to foster. Thinking of finance just in terms of market efficiency and trusting in self-regulation is an easy political stance since it is seemingly neutral and mainly technical. But for finance to be part of society again, and for it to be at the service of the economy, debate has to be started in which the technical framework is left to one side.

Hence the Lisbon Strategy and the preparation for the 2020 Strategy raise the question over the link between finance and innovation. The funding of R&D, start-ups and innovative projects requires a reactive financial system, which is ready to take risks and which is sufficiently liquid. Many other areas of convergence can and must be defined: the ageing population raises the issue of funding pensions (inter-generational financial flows, pension management funds) and that of the use of savings. Pension funds represent significant capital, several tens of thousands of billions, which could be used as long term investment.

Public transport or communication infrastructures will require heavy investment in the future. How can investors be attracted to these long term projects? The spreading of risk between public and private players may be a response. The development of fiscal or regulatory incentives may be another. The deterioration of public finance is a particularly pertinent issue for the future in Europe [17]. Thought may also extend to other issues such as energy or environmental policies [18].

All debate on European economic governance, whether this is over the Competitiveness Pact or the enhancement of the European Semester initially, or even on a European economic policy, has to include the financial issue.

3.3. Financial regulation – a political issue

The financial system is not an economic sector like any other: it is the life blood of a living organism and it irrigates the social and economic body. Each company or citizen is linked to it. But if the financial system tries to distance itself from the society in which it exists a feeling of dispossession emerges on the part of the citizens and some companies. It is important to re-establish dialogue between civil society and financial players.

This implies both the re-appropriation of finance by society and the economy (opening finance to demographic, environmental, energy questions etc…) as well as the definition of a tool to achieve this (dialogue between representatives of each of these sectors). Financial regulation cannot afford to neglect thought on the regulation 2.0 [19] which aims to re-introduce greater interactivity between regulators/legislators and the players involved. Regulation should be able to anticipate the consequences it will have and therefore question its purpose. This purpose cannot only fall within the technical debate: finance has become far too important an issue to be left in the hands of businessmen alone.

However over reaction on the part of the public authorities, who are in a hurry to restrict the prerogatives of the financial sector, may be negative for the entire economy. Regulations on hedge funds or tax havens are more often than not based on political rhetoric rather than on economic reason: we saw that neither of these had a major role to play in the crisis and yet it was very easy to blame them, to bring them into the supervisory system and thereby neglect in-depth thought on the financial system. Economic science has to throw light on these extremely technical debates to reveal that they are driven by purely political forces.

This should for example, lead to the question of what type of business model we want in Europe. Until now the Anglo-Saxon model, supported by financial logic as described above, has dominated: it enables great flexibility in an ever changing world. But if in the future we need a more long term, "inclusive" economy [20], another type of financial system, closer to the German model, might fostered. In this case it will facilitate greater balance between financial, managerial, political powers and labour forces within companies.

Another pitfall ironically identified by Alan Greenspan [21], and communicated by the financial lobbies, is the risk of reducing

16. Francq T. (2010), Investissement de long terme et régulation des marchés financiers, in Glachant J. Etc. (2010), Investissements et investisseurs de long terme, report by the Economic Analysis Council.

17. Glachant J. Etc. (2010), Investissements et investisseurs de long terme, Economic Analysis Council Report.

18. Beacco J-M (2011), Quatre axes de recherche pour redonner du sens à la finance, Le Monde, 8th March 2011.

19. Regulation 2.0. : this is a regulation which is being written as a team with all parties concerned according to the web 2.0 logic

20. Including the populations in the labour market, a term used in the 2020 Strategy.

21. Greenspan A. (2011), Dodd-Frank fails to meet test of our times, Financial Times, 29th March 2011.

financial innovation. The complex products created over the last few decades did not only target speculation; on the contrary they facilitated the provision of practical solutions for businesses which found themselves in an uncertain, fluctuating world. Financial innovation has supported economic growth, the development of new technologies and global deployment.

Financial regulation therefore should be careful not to interfere too much with the financial system because "the baby should not be thrown out with the bath water" – it should be the contrary. Regulation should intervene wisely in terms of financial innovation without impeding it, and this requires a significant strengthening of its competences and better dialogue between the parties involved. Businesses which benefit the most from these innovations should also be involved in regulation.

CONCLUSION

Due to its sheer size the financial crisis affected the way people think. Contrary to what some forecast, there was no real challenge to the financial system. The reason for this might be that debate lies elsewhere: not with regard to the need to have an effective financial system or not but rather in terms of how it can be best integrated into society. Work is moving ahead slowly: the ESRB has to build up "macro-prudential supervision", the economists have to develop new analysis and exploration tools, decision makers have to appropriate this technical, yet vital issue, citizens have to learn to express what they want clearly. All of this can only be done with patience, method and tenacity within a context of continuous dialogue between all of those involved. To do this the ESRB must have the necessary financial and human means, like its American counterpart, the OFR, otherwise the EU is in danger of bypassing this conceptual revolution. Regulation is not changing shape but it has to take on board the effects of the choices that are made in terms of society, the economy, research and even policy. It cannot be left in the hands of financial players alone (prudential regulation) or national technicians (statutory regulation); it must become part of the definition of European economic governance. It is the only way to put finance back into the position it should never have quit: being at the service of business and citizens.

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