Europe's Mea Culpa: A Global Economy Gone Mad or a Crisis of Our Own Making?

Introduction

By the summer of 2009, the US financial system had broadly stabilized following the 2007-2008 global financial crisis (GFC), and the US economy had emerged from recession (albeit, into what can be described at best as a "stunted recovery"). In Europe meanwhile, concerns over the solvency of private financial institutions, as well recurring freezing of interbank markets and broader (systemic) financial instability persisted, while the Eurozone plunged into a prolonged period of economic crisis. The diverging fortunes of the US and European financial systems were, and remain, puzzling, particularly in light of the dominant narrative of the GFC which consistently identified the US financial and real-estate sectors as the epicenter of the crisis. Indeed, the GFC has often been dubbed as the "crisis of Anglo-Saxon Capitalism" by the burgeoning body of academic literature as well as the global financial media (e.g. Hay, 2013).

Thus, this article's main contribution is in challenging these widespread assumptions pervasive within Global Political Economy (GPE) scholarship as well as in European policy elite circles that view the GFC as a US made crisis, pushed out onto the rest of the world, including, and most visibly, Europe. In paraphrasing Queen Elizabeth's innocuous question to leading academics at the London School of Economics in November 2008 (The Queen reportedly asked *'if these things were so large, how come everyone missed them?'* Beattie,2008), the article offers an explanation for the epistemic failure of economists (and political economists) to recognize specifically, the accumulation of vulnerabilities within the European financial system responsible for Europe's persistent financial malaise.

The article therefore contributes to the growing body of literature seeking to elucidate why European financial institutions and the European financial system as a whole proved so susceptible to the GFC and why has financial instability persisted so long (Hardie and Howarth, 2009; Hodson and Quaglia, 2009; Becker and Jäger, 2012; Bruff and Horn, 2012; Lapavitsas, 2012; Berend, 2013; to name a few notable examples among many others).

Unlike much of the recent literature on the Eurozone crisis however, this article shifts the emphasis away from the well-rehearsed refrains concerning the flawed institutional design of the Eurozone (e.g. having a Monetary Union in the absence of a Fiscal Union or other mechanisms for intra-European surplus recycling, etc.). Rather the article reflects on the comparatively less understood and engaged with dimensions of the pre-crisis trajectory of European financialization, identifying the particular drivers of distinctive European forms of financialization and relating the former to the particular and idiosyncratic nature of the European financial crisis itself.

The argument offered in the paper is twofold. First, notwithstanding the numerous tensions between structural and institutionally informed narratives of European finance-led restructuring, the paper highlights a common underlying assumption accepted uncritically (indeed, often implicitly) by these two dominant conceptual frameworks; namely both view the emergence of US financial capitalism as a unique, isolated, and internally-driven transformation. The rest of the world, the European common market in particular, is subsequently cast in the role of financial laggard, playing (somewhat unsuccessfully) a catch-up game with its more advanced transatlantic rival.

The methodological implication of this assumption has been that financialization in Europe (and elsewhere) was, and still is, generally assessed against the yardstick of the US experience. This obscures from view the unique trajectory of European finance-led institutional innovation as well as the latter’s unique patterns of participation in what are global, as opposed to discretely American, structures of financial accumulation. It is this conceptual and methodological limitation which has been at the heart of the collective epistemic failure by academics and policymakers alike to recognise, let alone anticipate the true extent of Europe’s financial vulnerability to the crisis.

Second, and drawing on this conceptual insight, the article identifies some of the key innovations in Europe's financial markets as well as in the specific practices of systemically important financial institutions and the latters' mode of insertion into European and global financial circuits. These innovations are constitutive of the distinctive features of European Financialization and are at the heart of Europe's financial vulnerability. Thus, the article maps out aggregate trends in Europe's equity markets (documenting financial asset price appreciation), the expansion of leverage in Europe's banking sectors (credit to GDP ratios) and the growth of transnational financial flows, and crucially, identifies the microeconomic processes and dynamics constitutive of these aggrgate trends.

In so doing the article demonstrates that prior to the onset of the global crisis (and contrary to common perception), national European institutional configurations have proved remarkably "complementary" to the exigencies of global finance. These institutions were more successful than is generally acknowledged in promoting burgeoning, globally extensive, European financial sectors which rivaled the US. This, of course, proved a mixed blessing, as the very same institutions were left extremely vulnerable to the GFC.

In addressing the specificities of the emergence (and crisis) of financial capitalism in Europe, the paper further constitutes a significant conceptual contribution to the contemporary financialization literature (For a comprehensive and updated survey of 'the state of the art' on financialization see Van der Zwan, 2014). At the same time the pervasiveness and persistence of this tendency, to essentialize the US experience of financialization, extends beyond academia and is similarly influential in policy circles as well. As such, identifying the idiosyncratic practices underpinning European forms of financialization constitutes a significant contribution to the ongoing policy debates in Europe particularly over the reform of macro-prudential policy frameworks and banking sector regulation.

Theories of European Financialization

Within the field of GPE, the contours of debate about European financial integration and finance-led restructuring have been defined by differing appraisals of the relative strength of global financial markets versus national (or European) political institutions. Structural approaches have emphasized the hegemonic position occupied by Wall Street in global financial markets and its role in disseminating distinctly American structural transformations from their "original heartland" and throughout the developed world (Panitch and Gindin, 2004; Cafruny & Ryner, 2007; Seabrooke, 2006; Panitch and Konings, 2008). Institutional approaches on the other hand have highlighted the persistence of diversity across Europe in the face of common structural pressures and resistance to market-driven, finance-led restructuring emanating from the US (Lütz, 2004; Culpepper, 2005; Deeg, 2009; Iversen & Soskice, 2012).

However, as Konings notes, this ostensibly empirical disparity could only be upheld on the basis of a mutual (often implicit) understanding of how (financial) markets and (state) institutions are constituted and interact (diverging normative perspectives notwithstanding). In an important sense, these rival interpretations occupy opposite poles of a Polanyian understanding,

> …in which markets are seen as characterized by an expansionary, disembedding logic and political institutions are viewed as society's instruments to (re)-embed the market and subordinate it to social and political purposes (Konings, 2008: 254).

The resulting research agenda framed by this debate therefore tended to accept uncritically the underlying assumptions about the primacy of the US experience implicit in both these narratives and adopted a predominately comparative perspective, comparing and contrasting trends and developments within different national financial systems, seeking evidence (or lack thereof) for convergence towards the "original" transformations of the "more mature" Anglo-Saxon financial systems (Raviv, 2008; Lapavitsas and Powell, 2013).

Structural GPE – The Reemergence of Global Finance

Structural accounts of European financial integration and finance–led restructuring, when endorsed by mainstream academics and European policy makers, and when condemned by critical Global Political Economy scholars, attribute changes in domestic financial systems to the inevitable forces of market competition operating in the global marketplace. A common starting point for such analysis is rooted in the re-emergence of international capital mobility following the breakdown of the highly regulated international monetary system of the Bretton Woods era (Helleiner, 1994; Cohen, 1996).

The re-emergence of capital mobility has contributed to the shifting balance of power away from states and other holders of tangible and immobile assets (e.g. labor) in favor of owners of more intangible and mobile assets such as financial capital (Nitzan, 2001). The latter can now demand further reform and liberalization, generating additional investment and profit opportunities, or else threaten to exit and relocate to a more cooperative sovereign territory. The ensuing competition for capital forces states to bring their market regulations in line with the most liberalized states (Stopford, Strange, & Henley, 1991; Palan, Abbott, & Deans, 1996; Cerny, 1997). In this light, change in financial markets is therefore driven by a self-reinforcing structural market process, with the unmistakable consequence of dramatic expansion of global financial markets and transnational financial flows.

Of course, mainstream policy discourse and critical GPE diverge radically with respect to their normative perspective on these developments. In pursuing the completion of the Single European Market, European policymakers adopted the philosophical tenets of neoclassical economics to legitimate the agenda of increased financial liberalization and integration. Thus, pursuing further financial restructuring has always been portrayed as a necessary pre-condition for realizing the potential benefits of the Single Market[i].

Critical GPE literature, on the other hand, reaches diametrically opposed normative conclusions. In this view, financial globalization reflects the succession of the Bretton Woods regime by the global hegemony of the so-called Dollar-Wall Street Regime (Gowan, 1999; Panitch & Gindin, 2004; Panitch & Konings, 2008). Thus, as Konings puts it, by the time European governments

> …began to reconsider some of the basic institutional parameters of their models of welfare capitalism, they were already operating and making decisions in a global context of financial networks that had been profoundly shaped by the Americanization of its basic rules, practices and techniques (Konings, 2008:263).

Therefore, in this narrative, European financial restructuring, whether endorsed or criticized, can only be conceptualized as a reactionary response, whereby a variety of European political and economic agents have been pushed into re-orienting their strategies around institutional forms and dynamics driven and shaped by the globalization of specifically American finance. In so doing, these agents further facilitated the penetration of European economies by American capital, effectively incorporating them into the domestic capital circuit of the USA (Seabrooke, 2006; Schwartz, 2008).

While capital mobility has been established as "…one of the defining—the constituting, the proper—practices of a developed country" (Abdelal, 2006: 15), in a normative transformation, as Abdelal demonstrates, European policymakers played an instrumental role. This structural transformation did not in itself account for, or determine, the emergence of myriad specific micro-level strategies and practices at the level of individual banks, non-financial firms, and even households across Europe. Likewise, the dominant role of the US in global financial markets is undoubtedly beyond reproach. However, the claim that micro-level changes in the behavior of European economic agents can be explained simply on the basis of "strategic emulation" does not stand to empirical scrutiny.

Thus, while European financial integration and finance-led restructuring are certainly bound by a structural logic, particularly by the structural power of American finance, the former does not constitute an automatic adjustment to global market imperatives. Rather, the emergence of new, financialised, micro-level strategies of accumulation and social reproduction in Europe required and depended upon the establishment, or reform, of a host of supportive (extra-market) public and private institutions. If we are to account for the persistence of diversity across Europe in the face of common structural factors, and even more for Europe's active and influential role in pursuing financial liberalisation and restructuring across the globe, we must turn our attention to the European public and private institutions which facilitated and supported these processes.

Institutional GPE – Varieties of European Financial Capitalism

If structural explanations conceptualise financial integration and finance-led restructuring in Europe as a deterministic and automatic response to competitive pressures emanating from the global market, then institutional analysis conversely emphasizes the domestic and regional market and political sources of change. This reverses the image and implies that financial globalisation itself is essentially driven by a summation of micro-level strategies and domestic institutional configurations (Sobel, 1994; Palan, 1998; Palan and Cameron, 2003; Iversen & Soskice, 2012). Thus, in analyzing economic transformations, institutional modes of inquiry focus on the interaction between the agency of actors and pre-existing institutions in shaping both domestic and international financial market structures and regulation (Moran, 1991).

During the past two decades, institutional "Varieties of Capitalism" (VoC) scholars have been especially prolific in studying the relationship between the continental European and Anglo-American trajectories of financial development and accounting for the occurrence of institutional change in financial systems across the world (e.g., Aoki, 2001; Lütz, 2004; Culpepper, 2005; Vitols, 2005; Deeg, 2009). The VoC perspective maintains that the structure of financial systems, as well as transformations and finance-led restructuring, should be understood in the context of the broader model of production characteristics of the economy (Hall & Soskice, 2001; Hancke, et al, 2007). The concept of institutional complementarity denotes that institutional change will either spill over throughout the system or will remain minimal because the competitive advantages vested in the existing system drive actors to resist more radical change (Deeg, 2010).

One of the key tenets of institutional political economy is that markets are themselves institutionalized processes. However, that said, VoC literature in particular has focused overwhelmingly on the role of socio-political institutions in constraining and regulating markets. The logic of markets is therefore implicitly contrasted with that of social institutions – and state institutions above all others. In contrast, the VoC approach arguably neglects the role of institutions in constituting and facilitating the proliferation of financial market relations.

Furthermore, VoC literature evaluates financial systems primarily in terms of their efficiency in channeling society's savings into productive investments. This productivist bias is problematic insofar as it means that the VoC literature, almost by definition, comprehends contemporary processes of financial expansion (often unrelated to increases in productive investment) as speculative and dysfunctional to the healthy development of a real economy of production and trade (Stockhammer, 2004; Engelen and Konings, 2010).

Therefore, VoC literature is at its strongest when it comes to analysing how systemic characteristics of finance complement the organizational and market strategies of non-financial firms (which underlie, among other things, the central distinction between bank-based and market-based financial systems for example), and is thus better adapted for accounting for stability as opposed to change. As such, the VoC literature has been instrumental in rebuffing the structural logic implied in the notion of "institutional flattening," deflating the myth of globalization as a material-economic monolith, undermining the viability of the continental European variety of capitalism, and imposing neoliberal convergence on Europe's nation states. VoC scholarship has, therefore, made a compelling case in challenging these widely-held beliefs, and demonstrating that institutional specificities continue to matter greatly, even in an era of financial globalization.

Hence, the contradicting empirical evaluation of the relative strength of global markets and national or regional institutions notwithstanding, both structural and institutional theoretical perspectives have clearly identified global market forces as the key drivers behind finance-led restructuring; they simply disagree on the extent to which political institutions in Europe have been effective in resisting the former (as opposed to constitutive of it). Furthermore, both (implicitly or explicitly) subscribe to the view that financialization is inherently an American institutional transformation and proceed in substantiating their conflicting views on the basis of a common methodology – namely seeking evidence (or lack thereof) of convergence towards the "original" US experience of financialized institutional forms of accumulation.

This shared underlying assumption has hindered adequately registering the enormous transformations within Europe's financial sectors since the announcement of the Lisbon Agenda in 2000, and consequently served to obscure Europe's vulnerability to global financial instability. Operating through global markets, financialization is nevertheless negotiated, assimilated, and articulated in qualitatively different manners across different political spaces embedded in the global political economy. Arguably, rather than fostering convergence towards an American form of capitalist organization, the particular institutional arrangements supporting the (global) financialization of accumulation, can and do differ from one (local) economy to another, depending on the spatial and historical specificities unique to different localities within the global economy.

We now turn to the specific institutional configurations which supported a European form of financialization.

Micro-foundations and macro-trends in European financialization

Since the announcement of the Financial Services Action Plan (FSAP) in 1999, and even more since the European economies began to recover from the dot-com bubble in 2003, a rejuvenated European financial system seems to have woken from a long period of hibernation. The FSAP, a cornerstone of the Lisbon Agenda announced in 2000, catalyzed an era of unprecedented dynamism and rapid transformation of the European financial industry. The 2007 GFC and the still-unfolding Eurozone crisis beginning in the spring of 2009 have partially stymied, but did not reverse or even completely halt this trend.

European financial maturity and expansion were achieved, however, in the context of an altogether different institutional setting (a combination of distinctly national and European regulatory and cultural environments) and on the basis of particular configuration of agents, strategies, practices, and business models which cannot in any meaningful way be understood as the result of automatic adjustment to global market imperatives or strategic emulation of more successful institutional forms originating in the US. Yet as this section will demonstrate, at an aggregate level, the European financial industry has emerged as a worthy contender to its transatlantic rival, and at least as vulnerable.

European social and political institutions, therefore, played a much more constitutive role than is often afforded to them in the Varieties of Capitalism literature. The purpose of this section is to account for the differences, as well as the similarities, between the US and European experiences by locating the causes for the micro divergence and macro convergence in the institutional specificities and path-dependent developments of European financial systems as well as their unique mode of insertion into a global financial competition.

The literature on financial booms and busts has demonstrated that almost all major crises have been preceded by a combination of two correlated phenomena: an unusual appreciation in asset prices and a corresponding increase in leverage or credit expansion (Minsky, 1982; Kindleberger, 2001; Bonner and Wiggin, 2006; Nesvetailova, 2007). As will be demonstrated below, asset price appreciation and credit expansion were by no means unique to the US economy; European economies exhibited the same tell-tale signs even as these patterns were supported by altogether different institutional configurations.

Financial Asset Prices

According to the widely used MSCI index, in March 2007, at the peak of global equity markets and just before the onset of the GFC, US equity market capitalisation was 37% higher than the combined total of Europe’s 24 stock markets, including those of the UK, Russia, emerging Europe and Turkey (see Figure 1 below). This statistic confirms the prominent role of equity markets as primary sources of external financing in the US and their seemingly marginal role in Europe. As markets for corporate control ascended to dominance in the US, individual firm strategies, as well as overall macroeconomic performance, became more vulnerable to market discipline in the form of declining share price (Aglietta and Breton, 2001; Aglietta and Roberioux, 2005; Froud, Johal, Williams, and Leaver, 2006).

In contrast, in Europe, financial intermediaries dominate corporate finance. Financial intermediation ratios (showing up on banks’ balance sheets in the form of deposits and loans) tend to be high, as household savings are channeled largely through the banking system, while the use of equity in corporate finance is typically limited. In some cases, banks also play a prominent role in corporate governance, exercising influence over firms via large equity stakes and seats on company boards (Allen and Gale, 2000).

Figure 1. MSCI Indices Europe/US Market Capitalization (US$)

However, at the same time the MSCI index reflected a significant gap between the US and Europe, according to another index, Thomson Reuters Datastream, the value, or market capitalisation, of Europe's 24 equity markets (again, including those of the UK, Russia, emerging Europe and Turkey) had, in fact, risen to an unprecedented $15,720bn, edging past the $15,640bn value of the US equity market[ii] (see Figure 2 below). European equity indices have, in fact, outperformed US equity indices in dollar terms since the start of 2003. Spurred by improving corporate profitability and aided by Euro appreciation at a magnitude of 26% (see Figure 3 below), market capitalization in Europe rose by 160%, compared to a 70.5% rise for the US stock market.

Figure 2. Thomson Reuters Datastream Indices Europe/US Market Capitalization (US$)

The reason for the radically different appraisals of the two indices is that the Thomson Reuters Datastream does not adjust for the size of free floats, unlike the MSCI, which reduces weighting to shares that cannot be freely traded such as holdings of governments or controlling family shareholders. Europe has many more companies with such stakes. Arguably, therefore, the Thomson Reuters Datastream index better captures underlying value, while the MSCI better represents the reality facing investors (Authers, 2007). The gap between the indices also indicates an important characteristic of the institutional and organisational specificity of European financialization, namely that the increasing significance of markets for corporate control in Europe has been achieved in the context of structures of corporate ownership that are still markedly different than in the US – more concentrated and often reliant on minority state holdings and therefore presumably less susceptible to the disciplinary influence of institutional investors active in financial markets.

Figure 3. Euro-USD Quarterly Exchange Rate

There are, however, certain noteworthy equivocations. First, the definition of “Europe” is one that economists, market analysts, or even geographers would not normally recognize. It covers all of “emerging Europe,” including Turkey and Russia, and stretches the vision of Europe into Siberia and Anatolia. By crossing the Urals, “Europe” includes Russia’s fuel reserves. By crossing the Bosphorus, it gains the Turkish economy, at the time growing more than 6% annually. Demographically, this “Europe” is more than twice the size of US population. Indeed, North America, (The US, Mexico and Canada) offer a more appropriate comparison (Authers, 2007).

Still, the shift in corporate culture in Europe is telling and the aforementioned caveats in no way negate the secular and significant trend captured by the Datastream indices. In the decades following the end of World War II, and through peaks and troughs in the business cycle, the US corporate sector consistently delivered higher returns on equity for shareholders compared to its European counterpart. Evidently, European financial restructuring has served to substantially close the gap, if not turn the tables completely. On this, more inclusive quantitative gauge of financial maturity, the elevation of Europe’s equity markets to a preeminent global position is undeniable.

Equity markets, the pinnacle and quintessential institution of American financialization (van der Zwan, 2014), have grown exponentially in Europe, reaching levels which for many had been consigned to history. On this level at least, the geopolitical cartography of financial power seemed to be reverting to a long-past pattern, one which only a short while earlier would have been deemed implausible. After all, the last time Europe occupied such a position of ascendancy in capital markets was prior to World War I (Feis, 1930).

Leverage Business Models/Strategies - Disintermediation

Defining an accurate and universal benchmark for what is a sustainable level of leverage is notoriously difficult, as different economies are able to sustain varying credit to GDP ratios. However, high and especially rapidly increasing levels of leverage are symptomatic of a financial crisis and can, therefore, act as useful indicators in predicting instability (Christensen et al., 2016). This is because in the absence of sufficient economic growth (growth in profitability and associated rise in regular cash flows), agents who have issued promises to pay a certain nominal amount will depend on the continuous influx of fresh investment to meet their past obligations (Nesvetailova, 2007; Minsky, 2008).

A presumed hallmark of US financial capitalism, disintermediation, the tendency of borrowers as well as investors to access capital markets directly without relying on conventional banking services, is often highlighted as a fundamental condition to expanding leverage ratios (Seabrooke, 2001). In the process of disintermediation, the activities of banks, the traditional 'intermediaries', as well as other financial institutions thus shifted from borrowing and lending to providing advice, supplying market liquidity, underwriting, and other fee-yielding services related to capital markets (Erturk and Solari, 2007).

Disintermediation in the US, predominantly relied on a specific technique, commonly known as securitization. In a traditional securitization deal, the issuing institution assembles a package of credit exposures and then sells these on to interested investors. Securitization therefore enabled financial institutions to switch from 'originate and hold' to a new, more market-based model of 'originate and distribute'. The repackaging of loans and receivables into tradable securities can be applied to almost any debt, from mortgages, to consumer and credit card loans, auto credit, or corporate debt (which leads to a veritable "alphabet soup" of acronyms such as ABS, RMBS, CDO, CLO). This combination can be structured in complex ways to produce new payment profiles and exposure hierarchies. To a large extent, this capacity led to the promulgation of a broad array of exotic structured products with little-understood embedded "payment waterfalls," correlations, and counterparty exposures. These product features rested at the heart of the failure of market participants, regulators and academics alike to apprehend the imminent GFC (Wigan, 2009).

In a comprehensive study of trends in global issuances of Asset-Backed Securities (ABS), Schildbach (2008) calculated that between 2000 and 2007, issuance volumes in global ABS markets have grown more than six-fold, from about $500bn to well over $3,000bn. Banks globally saw revenues of almost $30bn from asset-backed securities business in 2006 alone, the year before the crisis, a figure in excess of the revenues generated by cash equities trading that same year. Predictably, Schildbach notes that approximately 77% of ABS issuance originated from the US and US financial institutions accounted for roughly $20bn of global revenues from this business, while their European peers gained approximately $7.5bn. Furthermore, securitization activities in Europe have been extremely concentrated, with four of the top ten institutions seeing revenues of more than $1bn from their ABS businesses. Deutsche Bank was the clear leader, generating more than $2bn in revenue and earning pre-tax profits from that of more than $1bn, which is almost 11% of group profits (Schildbach, 2008).

Thus, looking at securitization, the data seemingly conforms to the narrative of the overwhelming superiority and maturity of American financial markets compared to the limited importance of disintermediation or the shift to market-based financing in Europe, both in terms of scale as well as scope (size of the market and the number of actors involved). Arguably, however, such narrative is based on the fallacy of equivalency between securitisation (a specific technique) and disintermediation (denoting a broader range of transformations in organizational features and strategic practices). Moreover, such an interpretation effectively essentializes the US experience and therefore unduly limits our capacity to conceptualize and analyze alternative institutional trajectories of disintermediation and financialization. Disintermediation has in fact operated on and through a substantively different organizational terrain in Europe, resulting in a reorientation of business models and strategic practices, which nevertheless cannot be captured by notions of convergence.

In the first instance, the secular trend in European banking reflected the institutional complementarities of bank- and market-based financial systems and suggests that the former have been able to “internalize” changes in their clients' borrowing, saving, and investment. The clear distinctions which have been traditionally drawn between the two may no longer be valid. On one hand, European finance remained distinct in its continual reliance on financial intermediaries for regulation and social mediation. On the other hand, innovations in the spectrum of products available to banks in managing their balance sheets and a shift to a portfolio-wide approach to proactive risk management has ensured that even the most “plain vanilla” lending relationship became embedded in complex webs of asset and liability management techniques, largely executed on capital markets proper, or in unregulated parallel spaces.

The innovation most pertinent to European financial institutions was the emergence of a range of Credit Risk Transfer (CRT) instruments, which relied on innovations in the repo and credit derivatives markets. Credit derivatives contracts in particular hinge on the probability that a borrower (the credit, the referenced entity, or the “underlying”) will not be able to meet payment obligations. In the contract, one party sells protection on the underlying credit, promising to make a payment to the buyer on the realization of a credit event (the debtor does not pay). In return, the buyer of said protection pays a periodic fee to the seller over the life of the contract (Wigan, 2009).

Through this technique, what were idiosyncratic exposures to borrowers are rendered tradable, and credit relationships are commoditised. Banks can use credit derivatives to rearticulate their relationships with borrowers. In the simplest of terms, banks are able to lend money, or originate credit, then sell on their exposure to that borrower by buying protection against the borrower’s default. Notably, the borrower will not necessarily be aware that the lender sold on their credit risk, so client relationships are, in theory, left unscathed (Bryan and Rafferty, 2006; Wigan, 2010). This technique is closely related to securitization. In a securitisation deal, however, the underlying asset is removed from the balance sheet of the credit originator, whereas in a credit derivatives contract, the credit originator retains the underlying asset and simply insures against the risk of a credit event.

As Gabor (2012) and Gros argue (2009), CRT instruments such as repo transactions and CDS trading enabled banks to proactively manage their credit risk instead of letting it evolve passively. In principle, the protection buyer – the lender – enters into a CDS agreement with the protection seller – the insurer – to pay a regular premium in exchange for the guarantee to be repaid the insured sum in case the borrower defaults on his debt. Purchasing this insurance contract and hedging the credit risk frees up the regulatory capital banks previously required to back risky assets and makes granting new loans, and therefore an expansion of leverage, possible. The promise on a systemic level is that by making these assets universally tradable, risks previously held statically in the banking system could be managed dynamically through a broader universe of agents (Bryan and Rafferty, 2006; Wigan, 2010).[iii]

The internalization of credit risk transfer strategies by European banks should be understood in direct relation to the prevailing regulatory environment in which they operated. In particular, the Capital Requirements Directive (CRD), transposed the Basel Capital Adequacy rules into EU banking regulation, and set a capital requirement of 8% for the banking book. The amendments of the Basel rules in 2004, so called Basel II, generalized the use of risk weightings in determining capital requirements for externally rated assets, as well as the use of internal models of risk assessment for more advanced financial institutions (BCBS 2004).

Thus, by moving to capital adequacy regulation calculated on the basis of a bank's exposure as the sum of risk management practices, the CRD effectively promoted aggressive expansion of leverage. The differentiation of risk weightings prevented supervisors from noticing the growing degree of leverage in the financial system. Banks could originate more credit on the basis that the regulatory capital charge would not rise so long as the exposures could be either hedged out through derivatives or removed from the balance sheet altogether through securitisations (Wigan, 2009).

Indeed, according to Fitch's annual CDX survey (2007), European banks have made extensive use of such practices in order to facilitate credit growth in the lead up to the GFC. In 2006 according to Fitch, German banks alone accounted for approximately $76bn of net protection bought. The counterparties to these contracts, the net sellers of protection, came predominately from the global insurance and monoline industries, with US registered entities accounting for approximately the equivalent amount of protection sold (Fitch, 16 July, 2007 P. 6). One extreme example for the effects of these techniques on the capacity of European banks to expand their credit books can be witnessed in the case of the Belgian bank Dexia, who at the summer of 2008 still maintained a reported Basel tier 1 capital ratio of 11.4%, but following its collapse was found to hold a core (non-risk adjusted) capital ratio of only 1.6% (Lannoo, 2009).

Thus, the resulting increase in overall leverage in Europe, measured by debt-to-GDP, was broadly comparable to the increase experienced in the US. However, its distribution between the various sectors was markedly different. Table 1 below shows these facts. A first observation is that overall (economy-wide) leverage has always been higher in the Euro Area (EA) than in the US. More importantly, however, the increase between 1999 and (end) 2007 was around 100% of GDP for the EA compared to only 80% in the US. Similarly, leverage ratios in the financial sector were much higher in the EA to begin with and increased at a much faster rate (about 70% of GDP in the EA compared to 40% in the US). As a result, EU average banks' asset growth has far outstripped the overall rates of economic growth as measured by GDP; bank assets expanded by an average of 12.2% p.a. from 1997 to 2006, compared with a rise in nominal GDP of just 4.3% p.a., thus driving up the ratio of banking assets to GDP in the EU from 240% to 333% over the same period (Schildbach, 2008: 9). In contrast, in the US household sector, leverage increased considerably more during the same period, at 40% of GDP, compared to 13% in the EA.

Table 1. Debt-to-GDP ratios

A crucial caveat here is the exclusion of the shadow banking sector from the above statistics on leverage for both the US and Europe. Of course, we have but a rough (and wildly varying) estimation of the size of the global shadow banking sector, its national breakdown, or the individual and aggregate notional and real leverage ratios in the shadow banking sector. Still, there is little doubt that the above-stylized presentation is heavily skewed due to the significance of shadow banking in the US compared to Europe. The NY Fed, for example, has conservatively estimated the US shadow banking system to be roughly 50% larger than its European counterpart in absolute terms ($14.6tn compared with $10.8tn[iv]). Nevertheless, as noted earlier, the velocity of credit expansion, more than its absolute total, is crucial to evaluating systemic stability. Looking at aggregate data on credit expansion, therefore, yields the conclusion that the European economy at the eve of the GFC was by no means "less financialized" than the US economy.

Internationalization – European institutions and the globalization of financial capitalism

A distinctive institutional feature of the environment in which European banks operate is the lack of sufficient domestic supply of assets (as evidenced by the low level of household indebtedness, particularly in the core Eurozone countries). While the globalization of financial flows has been a notable characteristic of finance in general, the absence of domestic assets has forced European banks in particular to enter into a veritable "chase across the globe" (Bryan, 1995). Consequently, European banks assumed the dominant position in global credit markets as primary lenders to the developing world (see data below) as well as accumulated assets in the US.

According to the Bank for International Settlements (BIS, 2008), total cross-border bank lending in the spring of 2008 (just prior to the outbreak of the Eurozone crisis) reached US $36.9 trillion. European banks accounted for a staggering US $25 trillion of this total, compared with only US $1.8 trillion by US banks. And while it is true that intra-European financial flows represent a significant share of this total, European banks nevertheless accounted for 75% of total international bank debt to emerging markets (EM) around the world[v].

Importantly, the internationalization of European banking does not flow purely into EM or indeed strictly along traditional banking lines. Europe has been central to the funding of US capital markets. The US Federal Reserve's flow of funds data shows that in the same year foreigners held 40% of US-originated securitizations. Out of the estimated $10.8 trillion held in the shadow banking universe, about $4.3 trillion were held abroad, mostly in Europe. Therefore, European finance has not only been at the vanguard of financial globalization along the bank lending channel, it has also been a central component in the production and reproduction of ostensibly Anglo-American financial practices.

The dense webs of links forged by innovations across global financial markets have been further exposed by the GFC, demonstrating that thinking of US and European financial systems (both when they are burgeoning and when they are in crisis) in isolation from one another makes little sense. Through CRT for instance, selling protection, or "insuring," bonds and bond-like securities, AIG Financial, an arm of the giant US insurer, was able to turn itself into a virtual investment bank, taking on and managing exposures previously held exclusively in the European banking system (Naked Capitalism, 2008). In theory, this was perceived as desirable - ensuring that risks were more dispersed, held by those most willing and able to manage them, and therefore systematically optimized (Krugman, 2009). In practice, however, the driver of these links has been regulatory arbitrage.

AIG's annual report revealed that it had sold protection on a value of US$ 300bn to European banks (Seeking Alpha, 2008). The company itself has been quite candid about the purpose of these contract; they were written "for the purpose of providing them (the European banks) with regulatory capital relief rather than risk mitigation in exchange for a minimum guaranteed fee" (Henry, Goldstein, and Matlack, 2008). AIG thus helped organize regulatory arbitrage on a gigantic scale. According to Daniel Gros, Director of the Centre for European Policy Studies, Brussels, "A formal default of AIG would have had a devastating impact on banks in Europe" (Gros and Micossi, 2008). This explains why AIG's problems sent shock waves through the share prices of European banks. In rescuing AIG, the US (in the guise of the Treasury) effectively saved, inter alia, the European banking system (Jones, 2008).

Conclusion

The parameters of debate on finance-led restructuring in Europe, both pre- and post-crisis, have been defined by two dominant theoretical approaches, namely, structural political economy on the one hand and institutional political economy on the other. The article has demonstrated the limiting nature of this conceptual bifurcation which has served to obscure the sources of Europe's financial prowess as well as, ultimately, its exceptional vulnerability to the GFC.

European financialization is certainly bounded by structural forces operating in and through global markets. However, notions of institutional flattening and neoliberal convergence fail to adequately capture the nature or extent of the transformations which have occurred in the European financial landscape. Far from capitulating to the "Washington-Wall Street Nexus," European policy makers and private financial institutions have been active participants in reshaping global financial circuits and, in fact, on many gauges prior to the onset of the crisis. European finance has regained a position of ascendancy last seen at the beginning of the twentieth century. Similarly, the emphasis on the role of national and European institutions as bulwarks against the onslaught of global financial markets has served to obscure from view the myriad institutional innovations which were themselves constitutive of the processes of financialization both within Europe as well as further afield.

While the GFC may have started in a specific section of the US housing market, the former was just the trigger not the epicenter of the crisis. Virtually all constitutive elements of the global financial system harboured significant vulnerabilities of their very own alongside exposure to each other. Europe's financial instability was primarily the result of internal problems in the functioning and practices of European financial markets and actors rather than some form of collateral damage from a US made crisis. Therefore, while a globally coordinated policy response is needed, this should not cloud the need to for domestic policy responses to what are ultimately idiosyncratic policy challenges.

The specific sources of financial instability in each national and regional context can and do differ. Just like we can't essentialize the US experience of financialization, nor should we essentialize the US policy response to the crisis of financialization. The High-level Expert Group on reforming the structure of the EU banking sector (the Liikanen Report, 2012) for example, followed remarkably closely the reform agenda encapsulated in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 in the US. Such an approach, attempting to automatically and unproblematically generalise policy measures in the absence of careful consideration for specific circumstances is destined to fall short of its objectives.

The preferred tool for banking regulation under the Basel II accord (formalized in the EU with the Capital Requirement Directive) has been capital Adequacy requirements. the analysis of the proactive risk management strategies employed by European financial institutions has made it clear that this risk weighted approach to capital requirements is ineffective in regulating or even monitoring the solvency let alone liquidity of financial institutions. Furthermore, regulatory arbitrage creates a unique set of challenges for national regulators as evidenced by the case of AIG providing 'regulatory capital relief' to European banks. It also adds an additional complication as not only AIG operated under a different set of national regulations but also it is a non-deposit taking institution, it is not a bank but an insurance company and therefore is not bound by the same regulatory frameworks. In selling CDS contracts to protect European banks from defaulting borrowers AIG did not require any core capital nor did it have access to the central bank funding. The policy lesson here is that regulators should regulate activities not institutions. If AIG is facilitating proactive bank risk management in Germany, it should be subject to German banking regulation.

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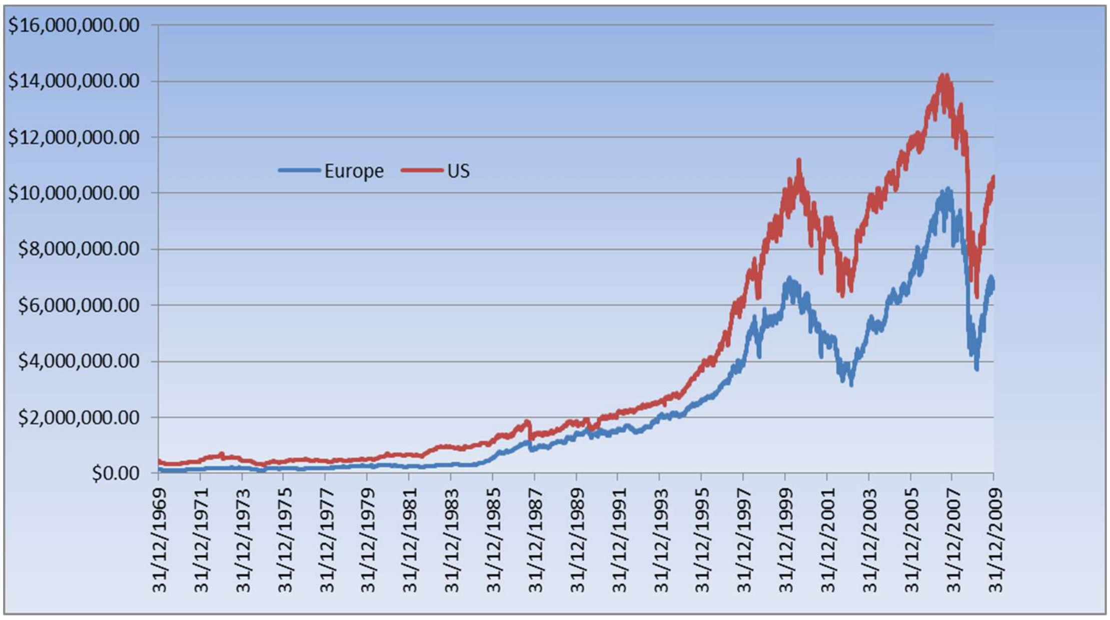
Table 1. Debt-to-GDP ratios[vi]

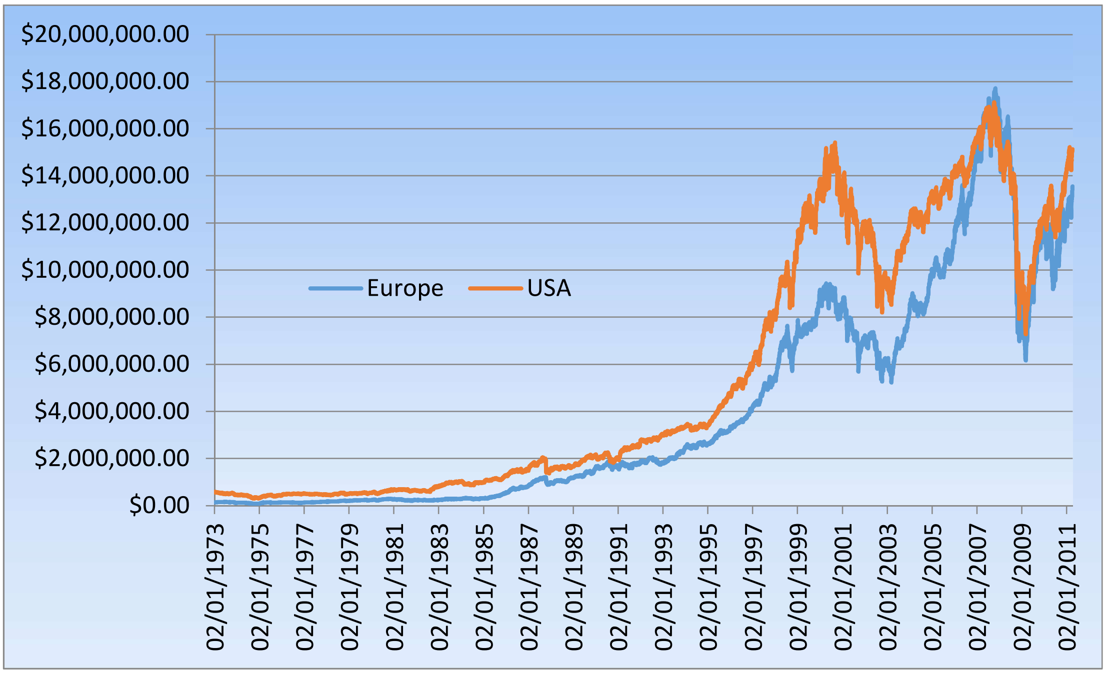
	a) Economy-wide		**b) Non-financial corporate sector**		**c) Financial sector**		**d) Households & small business**	
	EA	US	EA	US	EA	US	EA	US
1999	3.51	2.66	0.67	0.46	1.61	0.79	0.48	0.88
2007	4.54	3.47	0.92	0.49	2.32	1.17	0.61	1.28
2008	4.73	3.46	0.97	0.49	2.42	1.17	0.61	1.24
Change 1999-2007	1.03	0.81	0.25	0.03	0.71	0.38	0.13	0.4

Figure 1. MSCI Indices Europe/US Market Capitalization (US$)



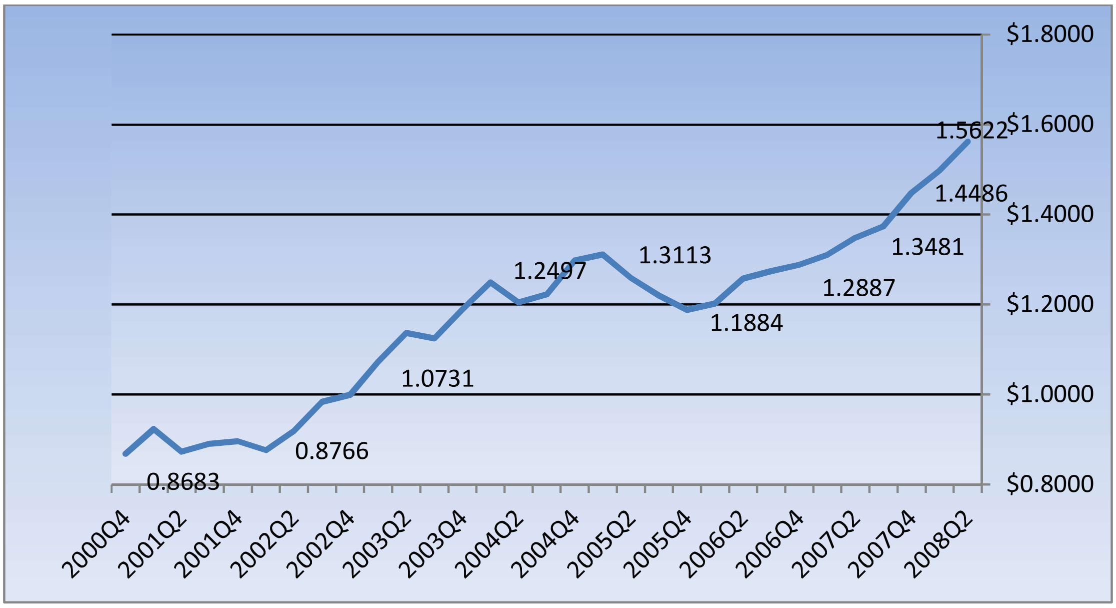
Source: own calculation; data extracted from the Worldscope database.

Figure 2. Thomson Reuters Datastream Indices Europe/US Market Capitalization (US$)



Source: own calculations; data extracted from the Thomson Reuters Datastream.

Figure 3. Euro-USD Quarterly Exchange Rate



Source: own calculation; data extracted from the Eurostat Quarterly Bilateral Exchange Rates dataset.

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[i] See for example, DG Economic & Financial Affairs, European Economy Working Paper 35, March 1988.

[ii] Europe's equity markets' capitalisation continued to rise thereafter, peaking at just over $16,773bn in June 2007, whereupon financial markets on both sides of the Atlantic capitulated to the crises.

[iii] Crucially however, banks do not eliminate risk completely, but rather replace the counterparty risk of their client with that of the protection seller (which should presumably, be considerably lower).

[iv] Sources: Flow of Funds, ICMA, AFME, ECB, ESMA.

[v] $3.5 trillion out of $4.7 trillion, compared to only $0.5 trillion for the US. Cross-border bank lending by European banks to EM amounted to 21% of their home country GDPs, compared to 4% for the US. Thus as a percentage of GDP, European banks were about five times more exposed to EM than US banks.

[vi] *Source*: Centre for European Policy Studies Policy Brief 194/16 July 2009. P. 2.