Banking Without State?

About: Rachel Epstein, *Banking on Markets*, Oxford University Press

By Elsa Massoc

States and banks traditionally work together: states provide banks with protection in exchange for banks financing strategic sectors of the domestic economy and targeted constituents. According to R. Epstein, these ties are loosening, leaving room for the empowerment of market actors.

Political economists have long stressed the traditional *quid pro quo* relationship between banks and states.[1] On one side, banks provide credit to strategic economic sectors, macroeconomic management geared toward political goals, and help in mobilizing targeted political support. In return, states provide banks with regulatory protection from outsider competition, regulatory forbearance and fiscal support in times of crisis. This *quid pro quo* positions banks, more than any other type of firm, at the heart of national sovereignty. Recent scholarship is no exception: many authors have stressed how states and banks have remained closely intertwined during the management of the financial crises that have marked the beginning of the 21st century.[2]

By contrast, in *Banking on Markets*, Epstein stresses that the traditional state-bank *quid pro quo* has faded away. States are no longer able to provide regulatory protection or fiscal

1 See for example, Alexander Gerschenkron, *Economic Backwardness in Historical Perspective: A Book of Essays*, Cambridge, MA, Belknap Press of Harvard University Press, 1962; John Zysman, *Governments, Markets, and Growth: Financial Systems and the Politics of Industrial Change*, Vol. 15. Cornell University Press, 1984.
2 Cornelia Woll, *The Power of Inaction: Bank Bailouts in Comparison*, Cornell University Press, 2014.

support at the national level. And banks are no longer able or willing to support states' industrial policy or public deficit.

> "The transformation [of state-bank ties] refers to the weakening of traditional 20th century bank-state ties in which banks were politically beholden to states because of the raft of benefits bestowed, while states were dependent on banks for a range of economic and political functions." (p9)

Epstein underlines two different mechanisms through which the very incentives for both states and banks to hold on to the traditional *quid pro quo* have been undermined. In Eastern European countries (EEC), Epstein points to the high level of foreign bank ownership. Except for Slovenia, post-communist countries that ultimately joined the EU in 2004 or later sold the bulk of their banking assets to foreign investors. In 2008, 94% of bank assets in Bulgaria, 84% in the Czech Republic and 98% in Estonia, were foreign owned (p18). With such a high level of foreign ownership of banks, the incentive for the state to provide banks with restricted competition and regulatory forbearance, as well as with taxpayer assistance, has disappeared. Banks are, in turn, less prone to comply with state injunctions, as doing so would bring them no benefit. The demise of state-bank ties is less obvious in Western European countries (WEC). Before and after the financial crises, states have repeatedly shown that they were reluctant to relinquish their ties with domestic banks. What radically changed the game, Epstein argues, was the implementation of the European Banking Union (EBU). By 2016, the EBU had centralized bank supervision in the hands of the European Central Bank (ECB) and introduced a single resolution mechanism (SSM). The SSM introduced bail-in rules, providing that certain categories of shareholders would bear the costs first in case of banking insolvency—allegedly sparing taxpayers from doing so. Because supervision now operates at the European level, states are no longer able to provide regulatory protection or forbearance for their domestic banks. Because of bail-in rules, taxpayers are no longer supposed to provide fiscal support to ailing domestic banks. With the EBU, states have lost the "carrots" (p12) necessary to sustain the *quid pro quo*.

Both in Eastern and Western Europe, the traditional state-bank *quid pro quo* has thus been jeopardized:

> "Over the last three decades, Europe […] has been trying to do what long seemed unimaginable: to get national politics out of banking. And yet, to a surprising degree, I argue, despite the enormity of the task, the Europeans have been quite effective in this regard." (p5)

The Demise of the State-Bank *Quid Pro Quo*

Why did states renounce the boons of retaining political influence over banks, either by letting foreign investors in or by implementing the European Banking Union? Building on neo-functionalist theories[3], Epstein argues that in times of financial liberalization, the costs to sustain the traditional *quid pro quo* had become too high. When the costs of sustaining it started exceeding the benefits, states (and banks) became open to changing the rules of the game.

A large part of the book seeks to apply the neo-functionalist argument to WEC. Throughout the euro-crisis, Epstein argues, different types of cost were created by the very discrepancy between a liberalized/globalized banking and the remaining close state-bank ties. These functional costs were enhanced by the budgetary costs of bailing out domestic banks. Both functional and budgetary costs were made more obvious when set in comparison with EECs; the latter had a much smaller banking industry to bail out, thus budgetary costs were much lower. In addition, the threat of cut-and-run (i.e. the repatriation of capital from host to home market) associated with the foreign-owned banking industry did not materialize.

Put simply, economies in which state-bank ties were strong endured the costs of sustaining the *quid pro quo*, but they did not reap the benefits of it. Economies where state-bank ties were weaker not only did not endure the costs of sustaining the *quid pro quo*, but they also somehow benefited—or at least did not pay extra costs—from these looser ties. The traditional trade-off between banks and states was made conspicuously less interesting to both parties. Taking this opportunity, supranational actors, namely the European Central Bank (ECB) and the European Commission (EC) stepped in. Supranational governance of banking would mitigate the costs endured by states during the crisis. For example, "the SSM reduced the incentives for bank-state doom-loops, alleviated the problem of compounded returns, and facilitated monetary transmission" (p132). Because states had become less eager to oppose the demise of ties that proved so costly, the SSM was adopted—even if it represented a clear abdication of sovereignty.

Coherent with the spillover argument first advocated by Haas[4], Epstein argues that the demise of state-bank ties should reinforce the logic of rupture between states and banks; the costs of not conforming to EU governance will keep increasing and overcoming the benefits of maintaining the *quid pro quo*.

What Comes After the State-Bank *Quid Pro Quo*?

Banking on Markets' most exciting contribution is to question the "ineluctability of state-bank relationships" (p6). Epstein reminds us that state-bank ties must be researched, not assumed. Yet, her argument is less compelling when it comes to supporting her alternative

[3] First developed by liberal political economists such as Pauly, Frieden and Rogowski,
4 Ernst B Haas, and Desmond Dinan, *The Uniting of Europe: Political, Social, and Economic Forces, 1950-1957*, Vol. 311, Stanford, Stanford University Press, 1958.

paradigm of state-bank ties' "marketization". Epstein mostly refers to this marketization as the "empowerment of market actors", as opposed to state influence, over banks.

> "Marketization refers to the extent to which the banking sector is privately, as opposed to publicly, held and the degree to which banks' business activities are subject to diminishing home political influence. Diminishing home political influence could stem from foreign strategic ownership or from the loss of national supervisory or regulatory authority" (p15).

"Marketization" is thus defined negatively, as a process resulting from the demise of state-bank *quid pro quo*. In the three cases that Epstein lays out in her definition, market actors spontaneously fill the boots of the receding representatives of the *quid pro quo*. In the first case (privatization of bank ownership), private owners replace public owners. In the second case (rise of foreign investment in banking), foreign private owners replace domestic private owners. In the third case (creation of the EBU), shareholders are empowered to the detriment of state actors and taxpayers.

But the demise of the traditional *quid pro quo* does not give any clear indication about which market actors have been empowered. Ownership does not necessarily equate with control: different institutional arrangements in the corporate governance of firms, which often varies across national lines, determine who controls what in firms. Also, it is not obvious why the demise of the traditional *quid pro quo* should spontaneously give rise to the empowerment of *market* actors. Scholars of corporate governance have argued that the privatization and marketization of firms (including banks) have sometimes empowered top executive managers even more than shareholders. [5] Although the book's title is "*Banking on Markets*", the "marketization" aspect of the argument thus remains under-specified. Epstein focuses more closely on the demise of the traditional state-bank *quid pro quo* that would, according to her, eventually lead to the empowerment of market actors. Yet, her account instead convinces the reader that the relationships between banks, states and markets have become messier and more complex, not that state-bank ties have been broken and markets have been empowered.

First, Epstein's whole argument regarding WEC builds on the fact that states are no longer able to offer banks regulatory forbearance and fiscal support. This statement is empirically problematic. On both accounts, states still have carrots. Highly important reforms have been implemented at the national level. The banking structural reform is a good example of that. When states still have the capacity to (or not to) jeopardize the whole structure of their domestic banking system, it may be a too soon to dismiss the sustainability of the *quid pro quo*. Epstein rightly argues that the assessment of the recent successes and failures of the EBU much resembles an endless "half-full or half-empty" game. The failures and incompleteness of the EBU should not lead us to conclude that nothing has changed in state-bank relationships since

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[5] See for example Adam Goldstein, "Revenge of the Managers: Labor Cost-Cutting and the Paradoxical Resurgence of Managerialism in the Shareholder Value Era, 1984 to 2001", *American Sociological Review* 77.2, 2012, 268-294.

the 1970s. All the same, empirics are not strong enough to support the radical argument of the demise of state-bank ties and the marketization of banking.

Second, Epstein builds on a very narrow vision of state-bank *quid pro quo*. The terms of the *quid pro quo* could be bluntly summed up as: "finance my automotive industry and I'll protect you from competition". Yet, with the financialization of the economy, states' priorities are no longer directed towards financing industrial sectors. States want to promote the growth of their financial sector, which has largely been led, in Europe, by the growth of the banking sector itself. In other words, states want to promote the expansion of their banks.[6] Epstein writes "As globalization has progressed, shielding any sector from increased marketization – including banking – has become more costly and conflictual" (p17). But she forgets that shielding banking from marketization is *not* what states have sought to do. On the contrary, states themselves have driven banking marketization.[7] On the other side, large banks no longer want to be protected from competition at the domestic level; they want to achieve a "level playing field" at the European or global level so that they can take on smaller banks or banks for which it would be costlier to adapt to pro-competitive regulation. In the state-bank *quid pro quo of the financialized era*, states and banks preferences are even more aligned than in the pre-financialization *quid pro quo*.

Finally, Epstein's whole argument builds on a narrowly utilitarian categorization of state-bank ties. The *quid pro quo* between them holds as long as states and banks have "carrots" (p140) to offer. But literatures on the sociology of elites and business power have described a much broader array of relationships between state and banking elites. Processes of elite identification and trust, formal and informal power relations, the practice of the "revolving doors", are just examples of why state-bank ties may remain strong even when narrowly defined "carrots" are lacking.[8] By defining the *quid pro quo* in such minimalist terms, Epstein somehow tilts at windmills, as recent literature already argues that continuous links between banks and states have become more complex and multifaceted than in the pre-financialization era.

The New Relationships Between Banks and States

By underspecifying her concept of marketization and sticking to a narrow definition of *quid pro quo*, Epstein limits her contribution to the scholarship seeking to understand the new complex relationships between states and markets. Paradoxically, she offers great insight to this ongoing scholarship through her empirical work.

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[6] Think of German finance minister Olaf Scholz speaking of industrial policy when he pushes for the merger between DB and CB.

[7] See among others O'Sullivan (2007), Schmidt, Thiemann.

8 Cornelia Woll, *The Power of Inaction: Bank Bailouts in Comparison*, Cornell University Press, 2014.

For example, Chapter 3 explains that during the euro-zone crisis, bank "cut-and-running" did not materialize in EEC. Epstein argues that it is because foreign banking in EEC is mostly operated by banks' subsidiaries. As opposed to branches, subsidiaries are subject to host regulatory and supervisory authorities, which is a major source of "financial friction impeding sudden funding reversals" (p49). Subsidiaries are treated as domestic banks. They must be independently capitalized, they must follow hosts' capital and liquidity requirements, and they participate in national deposit guarantee schemes. Epstein shows that the subsidiary model was actively promoted by host states. They were "careful to limit the extent to which subsidiaries of foreign-owned banks could supply resources to their parents" and added "more legal restrictions on opening of branches than subsidiaries" (p65). Epstein also underlines that subsidiary banks were very careful to please host state regulators. They sometimes refrained from bringing complaints about host regulation to the EU because they did not want to alienate host regulators (p69). In this chapter, Epstein's contribution to the understanding of new kinds of relationships between host states and foreign banks is precious.

Banking on Markets' rich and detailed empirics shed light on how state-banks relationships have been challenged and redefined in a new marketized and globalized context for finance. The book tackles traditional questions in a new and bold way. After reading it, it becomes clear that old paradigms must be rethought if we are to understand state-finance relationships. *Banking on Markets'* is thus a must-read for all those interested in researching the complexity and novelty of state-banks relations in today's capitalism.

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