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# Introduction

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It is almost ten years ago now that, in the wake of the financial crisis of 2007–2008, the European Parliement, European Commission and European Central Bank undertook a dramatic overhaul of European Union (EU) financial regulation. During these years, the EU experienced, along with the regulatory drive, a protracted recession and an apparent powerlessness of economic policies. Both the new legislature and the Commission asked for a pause so that the effects of the new rules could be understood rather better. As the new Commissioner in charge of Financial Stability, Financial Services and Capital Markets Union, Lord Hill declared to the *Financial Times* on 1 October 2015: "when you've done 40 major pieces of legislation in five years (…) common sense tells you that you are unlikely to have been able to work out all the consequences and interconnections. It is sensible to look at it." Two months later, the European Parliament responded with a resolution (2015/2106(INI)) brought by Burkhard Balz "stress[ing] that the impact of individual legislative measures differs from their cumulative impact; call[ing] on the Commission services (…) to conduct a comprehensive quantitative and qualitative assessment every five years of the cumulative impact of EU

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financial services regulation (…); stress[ing] the importance of performing detailed impact assessments and cost-benefit analyses for any future legislation in order to demonstrate the added value of legislation, in particular as regards economic growth and job creation." The last sentence appears especially symptomatic of the shift from an all-out regulatory assault on the financial sector during a crisis to a recession-weary longing for growth.

The concept of this book coalesced a few weeks before these influential political authorities made their voices heard. In January 2015, LabEx REFI and the European Parliament organized a European Finance Forum in Strasbourg, bringing together more than 1,000 students from higher education institutions across Europe to discuss three topics: European financial regulation, European budgetary supervision and financing growth. The links between these themes now appear obvious: while financial institutions funded a growth cycle for most of the 2000s, this came to an end amid bank failures and market breakdowns, with governments sometimes too fragile to rescue their financial sector. Since then a protracted crisis has resulted in economic stagnation and the massive strengthening of financial regulation, with many diverse voices claiming that over-regulation is the *cause* of stagnation. So far, no book has illustrated the big picture: the relationship between microeconomic incentives and macroeconomic growth, between financial regulation, macroeconomic policies and the future of the EU… Until now the path toward a better future together has appeared blurred.

The present book builds on the three workshops that were organized at the European Parliament in Strasbourg. Part 1 covers the supervision of member states' budgets. Since the Maastricht Treaty in 1992, European institutions have strengthened common budgetary rules to break the "deadly embrace" (Farhi and Tirole, 2016) of sovereign and financial sector balance sheets, and to build a steady growth path. Jose Martin Flores recalls this history of *historic compromises*, from the 1997 Stability and Growth Pact, amended in 2005 to the 2011 reforms. Pierre Aldama then elaborates the theory of fiscal sustainability, showing that fiscal rules can achieve debt sustainability together with price stability and remain compatible with the countercyclical motives of fiscal policy. While fiscal consolidation in good times can allow running deficits when needed, recent history has confirmed a serious procyclical bias that has jeopardized both fiscal sustainability objectives and economic growth and stability. Unfortunately, according to macroeconomic research, the recent reforms (six-pack, two-pack and Fiscal Compact) do not seem likely to reduce the procyclical bias of fiscal policy. In order to push the analysis further, Jérôme Creel and Francesco Molteni break down governments' expenses since 2000. They show that countries in the euro area reduced public investment following the tightening of European fiscal rules and the effort to conduct fiscal consolidation. The decline in public investment matches the *public* part of Juncker's Investment Plan. The chapter gives also definite reasons to believe that an investment stimulus implemented at European level could be more effective than one at country level, while a larger issuance of *safe* assets would help improve banking stability and the passing of stress tests. Finally, Christian de Boissieu shows how the banking sector has been strengthened by improvements in situational factors (recapitalization of banks, rupture of the so-called deadly embrace) and more consistently by the progress of the banking union: single rulebook, single supervisory mechanism for systemically significant institutions, single resolution mechanism. This chapter also draws on the LabEx RéFi (Giraud and Kockerols 2015) study that shows how the banking union made the Eurozone more resilient.

In contrast with the macroeconomic perspective, Part 2 aims to understand how the new regulatory framework has impacted the economic models of financial institutions and entities. Discussion of systemic risk might impact on the macroeconomic dimension, though, as bank, insurance and asset management regulation has shown in the recent years. As a prelude, Mathilde Poulain assesses the risks and mitigation of regulatory capture in the contemporary EU. She concludes that *materialist* capture is starting to be overseen, while *non-materialist* capture remains ungoverned, as the difficulty in defining the latter may explain the poor arrangements to control it. Nasser Saber then addresses the topic of derivatives regulation with a transatlantic perspective. Rather than focusing on the last crisis and the product details, he embraces a wide historical panorama to show how derivatives have become necessary to the working of the financial system, and cannot be ruled out without severe consequences. Hence the debate on derivative regulation cannot oppose radical stances but provides informed and pragmatic views that have an incremental impact. The same level of subtle, informed and pragmatic comments are delivered for different regulatory areas: insurance by Arnaud Chneiweiss and Pierre-Charles Pradier, banking business models by Eric Lamarque, banks' market risk measurements by Jean-Paul Laurent and rating agencies by Philippe Raimbourg and Federica Salvadè. All these contributions share a common structure: an overview of the regulatory evolution, assessment and recommendations. The conclusion of this section is that regulation since the late 2000s has imposed not only costs on financial institutions and their customers but also a kind of regulatory uncertainty, which might cause *uncertainty aversion*.

The final section, Part 3, is forward-looking, as the European agenda is full of promising challenges: better securitization and new instruments (under

MIFID II), fine tuning of supervision under delegated acts and regulatory technical standards for AIFMD, CRR-CRD IV and Solvency II will supply long-term funding in lieu of non-conventional monetary policies. At a macroeconomic level, member state policies will be coordinated by the European Fund for Strategic Investments and the European Investment Bank. The funding channels that inflated a bubble having been closed down by the regulatory overhaul, it is time to describe the new architecture of a safer and more efficient European financial system. However, Pierre-Charles Pradier and Hamza el Khalloufi offer a critical view of the current state of implementation of banking regulation: the monetary bazooka surely destroyed the rise in borrowing costs that Basel III was expected to provoke, but even now, when the demand from businesses is picking up after years of slump, banks are not lending enough to fuel economic growth in the EU. The Basel III regulatory package came with so many strings attached that it might be difficult to find the binding constraint, but the authors argue that the regulatory avalanche triggered uncertainty aversion with the banks, which are now expecting strong positive incentives to get back in the game. Fortunately, Daphné Héant, Sophie Vermeille and Yann Coatanlem offer another transatlantic perspective on securitization, which matches the EU Parliament agenda, as a draft directive on this topic was put forward by the Commission in September 2015. The point of the authors is not to sell a miracle drug, but to insist on the benefit of an incremental and piecemeal development of financial markets: in this context, securitization might supply middle-market companies with additional funding (collateralized loan obligations amounted to more than $140bn in 2014 in the USA), while asset-backed vehicles might unload the banks' balance sheet to enable a more dynamical funding of small and medium-sized enterprises (SMEs), in conjunction with the EU SME support factor initiative. The authors show that securitization will not find a healthy business model without a dramatic reform of bankruptcy law in the EU, since investors today face the deterring uncertainty that surrounds bankruptcy procedures, which are common among firms on the technological frontier. Finally, Douady and Antoine Kornprobst recall that funding innovation is not a matter of sending helicopter money into the ether, since institutions are crucial to providing a life-supporting ecosystem. Together they analyse the French and European research and innovation system, which enjoys a convenient state of preparedness: the funnels are well designed; all we need are funds and consumer demand.

So far, no book has given the big picture, the relationship between microeconomic incentives and macroeconomic growth, between financial regulation, macroeconomic policies and the future of the EU. We hope you will enjoy reading about this big picture as much as we enjoyed writing about it. Unfortunately, writing the book was perhaps the easiest task, as recent developments have shown: the recent British referendum adds yet more uncertainty, with the prospect of competition between jurisdictions and regulatory arbitrage. This is just one more challenge to overcome, one more reason to roll up our sleeves and build a better future.

## References

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