Central banking and the infrastructural power of finance

Benjamin Braun
Max-Planck-Institut für Gesellschaftsforschung
1. Financialization and state agency

The feedback loop between financial structure and state agency has been a blind spot in the literatures on...

<table>
<thead>
<tr>
<th>Banks</th>
<th>Central banks</th>
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<tbody>
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<td>New literature does not address feedback effect on state agency:</td>
<td>Literature does not address feedback effect on finance:</td>
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<td>how ‘the structure of finance contributes to the state’s capacity to act in the economy’ (Zysman)</td>
<td>how do central banks shape finance to increase central bank capacity to act in the economy</td>
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2. Market-based state agency

- **Prevalent view** of state-economy interactions: ‘regulation and governance through rule making and rule enforcement’ (Levi-Faur, 2005)

- **However**: State not just regulator, but also *participant* in financial markets

- Difference in *method* of governance:
  - issuing rules & regulations
  - issuing liabilities & purchasing assets

- **Historical dimension**: In the context of 1980s financial liberalisation *shift* from
  - *direct* monetary policy instruments (credit controls, interest rate ceilings)
  - to *indirect* ones (standing facilities, open market operations + reserve requirements)
3. Infrastructural entanglement and power

- **Infrastructural entanglement**: Repo & securitization = infrastructure through which monetary policy is implemented and transmitted

- **Infrastructural power of finance**
  - Manifestation of the ‘two-way street’ nature of infrastructural power as defined by Michael Mann
  - Infrastructural entanglement between financial markets and state agencies that seek to govern through those markets
  - Political leverage of market actors vis-à-vis state actors

- Different from **instrumental power** and **structural power**

- Can explain diverging interests between state actors
  - Example: ECB vs. EU Commission
Securitization = process of creating asset-backed securities (ABSs)

- A bank originates loans, bundles them together, and sells them to a special purpose vehicle (SPV)
- The SPV finances the purchase of the loan pool by issuing (asset-backed) securities, sliced into tranches of different seniority
- The value and interest payments of that ABS are based on and collateralized by the pool of underlying loans

Crucial: Securitization as a mechanism to generate ECB-eligible collateral
The ABS loan-level initiative (2008-12)

- **Origin of infrastructural entanglement**: ECB decision to make ABS eligible collateral

- **Escalation of infrastructural entanglement**: the bankruptcy of Lehman Brothers, which had pledged EUR 8.5 billion of (mostly ABS) collateral

- Beyond Lehman: ECB became the *dealer of last resort* for ABSs

- Twin risk-management problems for the ECB:
  - Inability to value
  - Inability to sell

- Solution: ‘**ABS loan-level information initiative**’
  - Re-vamp of the market infrastructure
  - Pushed through by the ECB against preferences of market actors
  - ‘Hybridity’ built into new market infrastructure
Collateral, quantitative and regulatory easing (2012-17)

- **Basic idea:**
  - Securitization as a means to ‘restore the impaired monetary policy transmission mechanism’ (Cœuré, 2012)
  - Subsequently: Securitization becomes part of the market-based solution to EMU’s risk-sharing problem (Braun/Hübner 2018)

- **Crucial:** Before Juncker Commission, doors in Brussels shut to interests of the securitization industry
4. The ECB and the securitization market

Collateral, quantitative and regulatory easing (2012-17)

- **Collateral easing:**
  - ECB encourages banks to switch ‘from the “originate-to-distribute” model up to the summer of 2007 to some form of “originate-to-repo” model’ (González-Páramo, 2010).
  - Goal of the ECB: to be ‘a great support to this market segment’

- **Quantitative easing:**
  - Ideally: ABSs purchases as targeted support to ailing sectors & regions
  - Reality: collapsed ABS market too small to make a dent
  - Therefore: ABSPP as ‘a signal from the ECB to markets of its belief that this asset class is an important and sound one’ (Bindseil, 2015)
4. The ECB and the securitization market

Regulatory easing

- ECB Executive Board member González-Páramo at a securitization conference in 2010:
  - ‘how do we bring back investors to the securitisation markets?’
  - the ECB’s loan-level data initiative ‘would become an important building block along the path towards standardisation, simpler structures and better post-trade price transparency’

- Warning of the ‘potentially uneven and disproportionate treatment of ABS in forthcoming regulations’ (Mersch, 2013)

- Call to ‘eliminate some of the undue discriminations towards this specific product when this product is simple, real and transparent’ (Draghi, 2014)

- **Result:** Formerly ‘toxic’ asset class became ‘Simple, transparent, and standardized (STS) securitisation’ in 2017 EU legislation
Conclusion

‘It takes a village to maintain a dangerous financial system’ (Admati, 2017)

In the EU, it takes two: Looming defeats for financial-sector interests in Brussels turned into victories thanks to steadfast support from Frankfurt.

‘Although we work through financial markets, our goal is to help Main Street, not Wall Street.’ (Janet Yellen, 2014)

Catch 22 of infrastructural entanglement: More financialization increases capacity of the central bank to act in the economy BUT ALSO its readiness to defend financial interests in the political process. Result: More financialization.

Working “through financial markets” may limit the state’s ability “to help Main Street, not Wall Street”.

‘Financial structures should be the outcome of market forces. ... [C]entral banks should, in principle, play no active role here.’ (Benoit Coeuré, 2018)

‘In principle’...
Further reading

Socio-Economic Review, 2018, Vol. 0, No. 0, 1–24
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Article

Central banking and the infrastructural power of finance: the case of ECB support for repo and securitization markets

Benjamin Braun*

Article

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

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

Governing through financial markets: Towards a critical political economy of Capital Markets Union

Benjamin Braun
Max Planck Institute for the Study of Societies, Cologne, Germany

Daniela Gabor
University of the West of England, Bristol, UK

Marina Hübner
Max Planck Institute for the Study of Societies, Cologne, Germany