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Financial Change and European Society

John Grahl

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John Grahl

A thesis presented in partial fulfilment of the requirements for the award of the degree of Doctor of Philosophy by public works at Middlesex University

January 2014

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Acknowledgements

This thesis comes very late in my academic career and there are simply too many people who have taught me, helped me, encouraged me in my work and debated with me to list here. Only three names will be mentioned.

Over the decade when the submitted works were written I benefited from working closely with Paul Teague and Photis Lysandrou, who are co-authors of some of the pieces. My thanks to these two friends.

Richard Croucher agreed to supervise this more than mature student. I thank him for the interest he has taken in my work and for critical comments on the first draft of the context statement.

Abstract

Financial Change and European Society

The selected works deal with the nature of the financial changes taking place in Europe over recent years and with their social consequences. The approach is critical of many of the financial developments which have taken place, in terms of the dangers they pose to employment relations, to both individual economic security and social security and to economic and employment stability. At the same time, however, it has been argued that many of the most important financial changes have been functionally necessary supports for ongoing developments in the world economy. It is not denied that there are special financial interests which have limited the effective performance of these functions and distorted patterns of economic development; nevertheless it is argued that it is necessary to regard finance primarily as a function and only secondarily as a group of interests. Otherwise the increased power and influence of the financial sector itself becomes hard to understand. Three particular arguments illustrate this general position. Firstly, it is argued that critical and mainstream economists have both failed to understand the relationship between the vast volume of financial transactions today and structural changes in the financial system — misunderstandings which have led to the notion of a "casino economy." In particular, it is incorrect to treat most foreign exchange transactions as speculative. Secondly, it is argued that the very positive assessments that are often made of West European financial systems are out of date, that these systems as historically developed were not well adapted to the emergence of a global economy. Thirdly, and in consequence of the first two assertions, a relatively positive view is taken of the EU's financial integration strategy, a central component of the Lisbon agenda, which is regarded as a necessary response to the emergence of a global financial system centred on the US. On the other hand, a simplistic drive to minimise transactions costs led to the neglect of public goods of great importance to the European social models.

The work so described, like most work related to the financial sector, has to be reassessed in the context of the enormous crisis in global finance which broke out in 2007. Many specific assertions will no doubt have to be revised. Nevertheless, the general view adopted seems confirmed in two basic respects: the

functionality of a globally integrated financial system has not been called into question in either the academic or the policy responses to the crisis; but the social costs — in terms of instability, inequality and inefficiency — arising from its domination by narrow interest groups have been brutally revealed.

List of submitted publications

1. "Money as Sovereignty: the economics of Michel Aglietta", *New Political Economy*, 5, 2, 2000, pp291-316

2. Review of J. Huffschmid, *Politische Ökonomie der Finanzmrkte, International Review of Applied Economics*, 14, 3, 2000, pp 403-7

3. "Globalized Finance: The Challenge to the Euro", *New Left Review*, March/April, 2001

4. Review of Duménil and Lévy, *Crise et Sortie de Crises, New Left Review*, 2001

5. (with Photis Lysandrou) "Sand in the Wheels or Spanner in the Works? The Tobin Tax and Global Finance", *Cambridge Journal of Economics*, vol. 27, no 4, July 2003, pp 597-621, pp 23-46

6. (with Paul Teague) "The Eurozone and Financial Integration: the industrial relations issues", *Industrial Relations Journal*, 34, 5, December 2003, pp 396-410

7. (with Paul Teague) "Problems of Financial Integration in the EU", *Journal of European Public Policy*, December, 2005

8. "Financial Markets and Globalisation", *Soundings*, 2005

9. "Scale and the Political Economy of Financial Change" in Jens Hölscher and Horst Tomann (eds) *Globalization of Capital Markets and Monetary Policy*, Palgrave, London, 2005

10. "Financial Change and European Employment Relations", in James, P. and Wood, G. (eds) *Institutions, Production and Working Life*, OUP, December, 2006

11. "Financial Integration in the EU: Policy Issues and Proposals", *Critical Perspectives on Accounting*, 17, 2006 pp 253-267

12. (with Photis Lysandrou) "Capital Market Trading Volume: an overview and some preliminary conclusions", *Cambridge Journal of Economics*, 2006, 30, pp 955-

13. "Global Finance after the Credit Crisis" *Journal der Entwicklungspolitik* (Vienna), 2009

14. (with Thorsten Block) "The Official Case for Financial Integration" in J. Grahl (ed) *Global Finance and Social Europe*, Edward Elgar, 2009

15. "Lisbon, Finance and the European Social Model" in J. Grahl (ed) *Global Finance and Social Europe*, Edward Elgar, 2009

16. "Financial Markets and Social Security" in J. Grahl (ed) *Global Finance and Social Europe*, Edward Elgar, 2009
17. "Finance and the Household" in J. Grahl (ed) *Global Finance and Social Europe*, Edward Elgar, 2009
18. "The Impact of Financial Change on European Employment Relations" in J. Grahl (ed) *Global Finance and Social Europe*, Edward Elgar, 2009

Declaration

The submitted publications and the context statement are the product of original work by the candidate. In the case of the five jointly authored pieces the candidate's contribution was substantial and is accurately described as follows:

Ad item 5, co-author Photis Lysandrou did much more work than the candidate on the literature surrounding the Tobin tax. However, the candidate was mainly responsible for the analysis of FX swaps.

Ad items 6 and 7, the broad division of labour was that the co-author, Paul Teague, had more expertise than the candidate on employment relations issues while the candidate had more knowledge of financial developments.

Ad item 12, co-author Photis Lysandrou contributed more than the candidate who nevertheless contributed substantially on theories of security trading. Note that this paper is only used here to illustrate certain general problems of scale in contemporary finance.

Ad item 14, co-author, Thorsten Block, had more expertise in econometrics while the candidate contributed more on broader, political-economic questions.

Financial Change and European Society: Context Statement

The submitted work consists of eighteen papers, published between 2000 and 2009, which address the issue of financial changes in Europe, the origins and logic of these changes, their social consequences and some of the policy questions which arise. The economic arguments put forward are broadly heterodox, drawing on post-Keynesian and neo-Marxist themes, but distinguished from much other work in the same traditions by an insistence on the necessary economic functions of finance as well as on the interest groups involved. The social consequences are seen as often, in practice, adverse – from the point of view of employees, retail investors and others – but it is suggested that in a better policy framework, these consequences could be avoided.

The papers are divided into four groups covering: important intellectual influences; financial globalisation; financial integration in the EU; and the implications for employment relations. This context statement deals with each group in turn.

It is recognised that many of the positions taken are open to debate and that some of them are obsolete, especially in the light of the unprecedented crisis which broke out in 2007-8. Even when this is the case, however, the papers might be seen as useful contributions in a complex debate.

I Influences

This first group of papers, all book reviews, illustrate some of the main influences on the following work.

Item 1: "Money as Sovereignty: the economics of Michel Aglietta", *New Political Economy*, 5, 2, 2000

This piece relates to what is the most important influence on these studies – the writings of the French *régulation* school and, in particular, the work of

Michel Aglietta on money and finance. The original interest of the school's work was perhaps that it reintroduced dynamic processes into a theoretical context rendered immobile by a preoccupation with structuralism. The emphasis of the school was on structural change and its notions of accumulation regime and mode of regulation were used to support an *histoire raisonnée* of capitalist development. After the seventies the work of the school became somewhat formulaic: on the one hand it focused increasingly on comparative problems which tended to weaken its grasp of the general features of current capitalist development; on the other the repetitive use of a standardised set of "structural forms" – employment relations; monetary constraint; inter-firm relations and so on – tended to hypostasise these concepts.

Aglietta meanwhile continued to discuss the general evolution of capitalism and made the very correct decision to centre his analysis on monetary and financial issues. His views around 1980, just when the turn to counter-inflationary monetary policy was taking place, were put forward in a celebrated work with André Orléan, *La violence de la monnaie*. The terminology speaks mostly of money rather than of finance but the conceptual structure implicitly includes financial claims because it postulates a hierarchical system of monetary claims in which claims on the lower levels – those most distant from the socially designated money form, such as gold or the money issued by a strong state – can be regarded as financial instruments.

A difficulty many readers had with this work is its use of the French-American writer René Girard. Girard has made fascinating interventions across a wide range of subjects – ancient and modern literature, biblical exegesis, anthropology, psychology and others. But there is a totalizing aspect to his thought which seems to require that a single set of concepts – mimesis, sacrifice, the scapegoat – be recognized as universally valid. Further, their universal validity would have religious implications – Girard advances a specific version of Christianity, although one which does not seem to make major supernatural claims, at least not explicitly. These characteristics could raise suspicions among the typical audience for a *régulationniste* text. The question was avoided in the article reproduced here simply by treating Aglietta and Orléan's use of the Girardian apparatus as figurative. Thus there is seen to be an analogy between two types of monetary crisis – inflationary and deflationary – on the one hand, and two types of religious crisis – excess of immanence, excess of transcendence – on the other.[1]

Another strategy might have been possible: Girard treats human desires as essentially inauthentic; one desires (analogously, regards as money) mimetically

[1] Less grandiose sources might be used; anyone looking for a graphic and detailed account of a mimetic crisis could profitably consult the Dr Seuss story, *The Star-bellied Sneeches*. Girard's oeuvre has recently been superbly debunked by René Pommier (Pommier, 2010). It was impossible to resist the following treatment of Girard's often portentous paradoxes: "Quand on choisit de dire n'importe quoi, il est essentiel de le dire avec le plus d'autorité possible. Malheur à l'ânerie apeurée, à la sottise craintive, à la sornette timorée, à la faribole effarouchée, à la baliverne circonspecte, à la calembredaine précautionneuse. L'ânerie se doit d'être assurée, la sottise suffisante, la sornette résolue, la faribole arrogante, la baliverne intrépide, la calembredaine catégorique."

that which is desired by other people. One could establish a relation between this view of human wants and the notion of alienated individuals who lack authentic social references to help formulate their goals and ambitions.

However, the important point is that Aglietta and Orléan use Girardian notions to establish a qualitative account of monetary/financial crises. The germ of their accounts is the emergence of tensions between suppliers and users of funds at a low hierarchical level. If the problem cannot be resolved at that level it is referred upwards. The basic decision is binary: to refinance or not the deficit unit which is in trouble. Refinance favours the debtor and is – potentially – inflationary. Its refusal implies pressure for a transfer of property rights to creditors. Either strategy can succeed; either can fail; if it fails the problem is again referred upwards where again a binary decision is possible. Eventually critical tensions work up through financial markets and commercial banks to reach the central bank, which stands before the same dilemma. These processes are all characterised by imitative behaviour – thus, for example, one refusal to refinance provokes similar decisions by others. If action at all levels – including that of the central bank, only aggravates the tensions then the entire monetary order is imperiled and the search begins for a new monetary object. The authors used this simple structure to explore the background to the most important monetary event of the present era, the Volcker shock – just beginning as they wrote. They saw the US authorities as threatened with just such a crisis: no one wanted to lend dollars, only to borrow them, and all agents were looking for alternative stores of value.

Thus Aglietta and Orléan used this simple model of financial tensions to build complex and detailed accounts of monetary and financial problems. Both have continued to work in the field, Orléan concentrating on imitative behaviour and related economic phenomena such as asset price bubbles (for example, Orléan, 2009), Aglietta more on monetary theory and policy. They have also worked together again on the origins of money and on the relationship between money and political sovereignty. A recent work by Aglietta, covering the period leading up to the credit crisis of 2008, is discussed in Grahl, 2009b.

The value of this source for the research presented in this context statement is that is made possible a qualitative account of financial processes which was useful in exploring the social impact of financial change. Mainstream accounts of inflation and deflation, because they often postulate a given economic equilibrium independent of monetary factors, minimise the contrast between the restructuring processes associated with each - the contrast between restructuring by refinanced debtors and restructuring by creditors after the property of failed debtors has been transferred. Yet this difference in restructuring patterns is important in interpreting the longer run consequences, and particularly the social consequences, of macroeconomic developments.

Item 2: Review of J. Huffschmid, *Politische Ökonomie der Finanzmärkte, International Review of Applied Economics*, 14, 3, 2000

The influence represented by this review is a different kind. The candidate worked closely with Jörg Huffschmid, founder of the EuroMemorandum group, between 1995 and Jörg's death in 2009 (for an obituary, Grahl, 2010). They collaborated on some 12 issues of the EuroMemo – an annual critique of EU economic policies from a left-wing position (for the work of the EuroMemo group see www.euromemo.eu) – and in the context of two thematic networks sponsored by the European Commission: the first, on EU economic policies in general, coordinated by Huffschmid; the second, on the economic and social implications of financial integration, by the candidate.

These collaborations were based on broad agreement concerning both analysis and policy proposals. However, as this review of Huffschmid's *Politische Ökonomie der Finanzmärkte* indicates there were also points of disagreement which enlivened their work together (a second edition followed, see Huffschmid, 2002).

The convergence of views on analysis relates to a broad agreement on the use of an eclectic range of postkeynesian and neo-Marxist sources; on the adverse consequences of current financial developments; and on the necessity for social control. The differences, as the last page of this item suggests, centre on the degree of interdependence already established in the international financial system and therefore on the appropriate strategies to establish social control. Huffschmid suggested that many aspects of liberalization could be reversed; the review suggests that new control systems were needed at the international level. Behind these differences lies perhaps a difference of opinion on the functionality of the emerging global system.

It has to be acknowledged that following remark in the review, which was written towards the end of the high-tech boom, was hardly prescient: "these two spheres [production and finance] may not be as completely 'uncoupled' as Huffschmid suggests (his treatment of current US conditions, where a deregulated financial system is pouring resources into high-risk enterprises, leaves something to be desired)." The point was made to indicate that deregulated finance did not necessarily lead to stagnation but investors who lost their shirts on that one might be more appreciative of Huffschmid than of his reviewer.

Item 4: Review of Duménil and Lévy, *Crises et Sortie de Crises, New Left Review*, 2001

This work was actually reviewed both in the original French (in *New Left Review*) and in a revised English translation (in the *Political Quarterly*; see Grahl, 2005). The first review has been chosen because it was longer and more considered. It can represent the view taken of the broad current of heterodox literature on current economic developments. Most of the work is accepted but with one or two disagreements and changes in emphasis.

Duménil and Lévy develop their argument from a relatively orthodox Marxist crisis theory: an established pattern of accumulation reaches its limits in an overaccumulation and profitability crisis; this triggers restructuring linked to the devalorisation of existing capital; a new pattern of accumulation eventually results. Finance becomes more important in the restructuring phase because capital in monetary form confers flexibility. The authors find a precedent for the profitability crisis of the 1970s not in the Great Depression of the 1930s but in that of 1873-95. That too resulted in radical changes in the financial system, leading to the formation of the giant trusts. In this new context productivity could be raised through Taylorism and Fordism. The crash of 1929 on the other hand, resulted from the very success of the previous crisis resolution. Demand failed to keep pace with production and when it faltered a large number of smaller enterprises went to the wall. (Duménil and Lévy anticipated very correctly similar problems of success in overcoming the crisis of the 1970s but point out, also correctly, that massive state intervention would be used to prevent a repetition of 1930s slump.)

The applied economics in *Crises et Sortie de Crises* is of a very high order. The objections raised to their work in the review are to do with their over-simplified account of agency. An undifferentiated force, finance, adopts a similarly undifferentiated strategy, neoliberalism. Sometimes this kind of compression might be simply a form of shorthand but it leads to the neglect of important differences and distinctions. The most extreme example is probably the description of the Volcker shock as a "neoliberal coup." Volcker was no neoliberal; he was desperately trying to stabilise the dollar in the face of a reckless refusal by the Bundesbank to intervene in the FX market. The hike in interest rates certainly made neoliberal measures more feasible and the continuation of Keynesian intervention extremely difficult (as events, for instance in France, were to show.) But it was not designed to produce these effects and Volcker himself had expressed his preference for a more organized response to inflation. (See the account in Grahl, 1988).

Such distinctions may be of both practical and theoretical importance. Another more general reservation to such work as that of Duménil and Lévy can be advanced. It is now some thirty years since the turning point marked by the Volcker shock. Yet analysis based on Marxian crisis theory still tends to make the profitability crisis of the 1970s its starting point. All subsequent events are interpreted in the light of that crisis, as either expressing its continuing effects or as potential elements in its resolution. This may tend, quite unintentionally, to give a backward-looking bias to the theories concerned.

Influences: conclusion

It is hoped that these three reviews indicate the positive but critical view that was taken of the main currents in the heterodox economic analysis of financial change. Aglietta and Orléan offer one of the most developed theoretical approach to finance, and one which establishes connections with theories of the state; Huffschmid gives a critique of the then recent functioning of the finan-

cial system up to the East Asian crises of 1998; Duménil and Lévy integrate their account of finance into a periodised account of capitalist development as a whole.

All these accounts are accepted[2] but with the insistence that recent financial developments ("financialisation" - see Toporowski, 2012, for a critique of this notion) have also to be seen as functional. If the major financial crisis of 2007-2009 certainly exhibits the dysfunctions of the financial system, it also, paradoxically reveals its functionality in the high priority given to its preservation by nearly all agents concerned. The suspicion behind much of the submitted work is that globalisation represents, among other things, a new phase in the socialisation of production and that it calls for deep transformations of finance. The same point of view makes for certain reservations about the notion of neoliberalism. There are many economic developments, expressed through markets, which cannot plausibly be attributed to the political strategy or the ideology of neoliberalism.

II Global Finance and the Issue of Scale

This group of papers is concerned with the nature of global finance. The position adopted, shown best in the first paper, has two main distinguishing features: firstly, financial globalisation is seen as a basically functional development, impelled primarily by economic logic rather than by political strategy; secondly, the character of the emergent financial system is interpreted to a large extent in terms of scale, of its immense size. The fact that emergent global financial structures and practices tend to resemble those of the US suggests that scale may be a key determinant of financial change - the size of the US economy, its continent-wide extent and the number of enterprises and households involved in its financial system may help to explain why the US system became a model for financial relations in the global economy.

Item 5: "Sand in the Wheels or Spanner in the Works? The Tobin Tax and Global Finance", *Cambridge Journal of Economics*, vol. 27, no 4, July 2003

This piece, jointly written with Photis Lysandrou of London Metropolitan University, relates to the argument of this context statement in several ways. It was inspired by a certain dissatisfaction with, and suspicion of, the prevailing interpretation of foreign exchange (FX) trading among heterodox economists. This was the view that the enormous scale of FX markets was to be seen as essentially speculative, that this market was an enormous casino. This judgement was based on the fact that the volume of FX trading was far in excess of what might be required to support international trade or even international

[2]In spite of the importance of these heterodox accounts, especially for an exploration of the social consequences of financial change, it is also necessary to draw on mainstream accounts both to understand the details of many financial instruments and procedures and to derive a view of the functioning of the financial system as a whole.

portfolio investment (for example, Arestis and Sawyer, 1997). It amounted to the assertion that one of the most striking aspects of global finance was to be regarded as completely dysfunctional. Lysandrou and the present researcher, on the other hand, because they took a more positive view of global finance, wondered whether a different interpretation of FX trading might be found.

The actual argument of the piece hinges on the nature of a particular financial instrument, the FX swap, which accounts for approximately 50% of FX turnover. The FX swap combines the spot sale of a currency with a forward purchase of the same amount and with the same counter-party. It is important that neither party to the transaction has any exposure to variations in the exchange rate[3] – thus it is difficult (although not absolutely impossible) to see the swap as a speculation. Since, on the other hand, the structure of the FX swap is analogous to that of a repo, it can be interpreted directly as a form of inter-bank credit, where foreign currency (usually dollars) is used as collateral, rather than the treasury securities which are used in a repo. To the extent that FX transactions are looked at in this way, their scale ceases to be paradoxical because of the corresponding scale of the inter-bank money markets.

The authors related their discussion of FX to the policy debate around the Tobin tax, but the most important implication for them concerned the globalisation process. With the emergence of the FX swap, money markets had become globalised in that dollar liquidity could be used to support euro-denominated transactions. This is a very different view from that which sees the same transactions as purely speculative; it points to a deep transformation of financial systems and one which in certain respects must improve their functioning: in particular, the possibility of transferring liquidity from the US banking system to the eurozone was presumably of significant benefit to the latter.

Before the limitations of the piece are discussed, two very different methodological points can be made. The first is that the interpretation of the FX swap which was advanced could only be news to academics and other commentators. Because the change in practice was recent, standard works on the money market did not mention the FX swap, or only mentioned it without a clear account of its function. Two different accounts of the lacuna in academic discussions are suggested in the piece. The over-simplifications in heterodox discussion are explained by commentators jumping to conclusions – financial practices were condemned before they had been examined in detail. It is possible that similar errors have been made elsewhere in the heterodox discussion of "financialisation" and related phenomena.

Why did mainstream economists not put forward a clear interpretation of developments in the FX market? One factor is that mainstream finance experts are usually much more interested in asset prices than in trading turnover –

[3]Such an exposure could emerge in the event of a default by the counter-party; but since the main actors are the very largest banks in the world this is extremely rare and in any case the exposure would usually be very small because the collateral currency is only held for a day or two. To give rise to a loss on an FX swap the counterparty would have to default and, at the same time, the collateral currency depreciate. It is possible that such risks became non-trivial during the credit crisis of 2008, but that was the only occasion when they did so.

indeed it is quite possible to find books on the FX market which concentrate completely on the determination of exchange rates and fail to discuss turnover at all. It is also possible that the "monetary theory of the balance of payments" was an obstacle to a clear understanding. Any explanatory power that this doctrine possessed has today surely been lost – in this it shares the fate of other aspects of the quantity theory of money.

A quite different methodological point concerns an apparently trivial observation which strongly reinforced the authors' confidence in their argument. Looking at the most recent treatise he could find on the money market, Lysandrou came across a note to the effect that, in the big banks involved, the FX swap dealers did not sit on the FX desk but on the money market desk. This makes perfect sense – there is no reason why someone arranging an FX swap should be particularly concerned with the exchange rate. If the interpretation put forward in the piece had been wrong, however, the same simple remark would have been inexplicable. Many types of evidence may prove to be relevant to an inquiry and it is hard to predict such relevance. The present writer had a long discussion with an FX dealer which proved not to be of much help for the research. This was only seen as logical in retrospect – the dealer was focused on spot transactions and hence on exchange rate movements.

A limitation of this article is that, in a sense, it only moves the problem of financial trading back one stage. One can convincingly explain much FX trading by relating it to the money markets – but how do we explain the scale of money market transactions? The only plausible explanation must be in terms of security trading – the big banks which make most active use of the money markets are either trading securities themselves or providing transactions balances to those who are. But the central phenomenon – the immense scale of security trading itself, which is such a prominent feature of recent financial change – still requires explanation. Some further remarks are made on this below.

Nevertheless, this piece made a contribution by arguing for a more complex view of current financial developments and by illustrating – with the example of increasingly internationalized money markets – the global structures which are emerging.

Item 12: "Capital Market Trading Volume: an overview and some preliminary conclusions", *Cambridge Journal of Economics*, 2006

This piece, again jointly written with Photis Lysandrou, can be seen as a sequel to item 5, but a sequel which is much less successful. A central problem of the position developed by the present author and Lysandrou is that the emergence of a global financial system is to be interpreted as a logical economic development. For Lysandrou the logic concerned commodification (see, for example, Lysandrou, 2005); for the present writer it was more a question of a functional development within a new phase of the socialisation of production.

A difficulty with the latter approach is to give some kind of functional eco-

nomic account of the staggering growth in financial transactions, since the switch from bank credit to security-based finance is a central feature of financial globalisation. Now if the very large volume of trading on security markets has no economic rationale – if indeed that trading is largely dysfunctional – then the economic logic of the whole process becomes very questionable.

Thus the search for an account of security trading volumes is an important element of the argument. Some preliminary progress, as regards both FX transactions and money market transactions, is made in item 5: FX turnover can be linked to turnover in the money markets. But money market turnover is itself to be explained in terms of security trading – the big banks must either be trading securities themselves or providing transactions balances to the traders. Here the account of FX markets in item 5 leads to a certain clarification – international money market flows do not just support international security trades. They support security trading in general. There is no reason why the purchase of eurozone securities by a eurozone resident should not be financed from a dollar holding.[4]

It remains to explain the trading of securities themselves. The puzzle is on the demand side – it is easy to see how technical change reduces the costs of transactions – the puzzle is why increased supply meets such enormous demand. Item 12 reviews some of the literature and reaches some very tentative conclusions.

One preliminary point is that there is no clear association between trading turnover and volatility. Normally, the most traded assets display the least volatility, and the same is true for markets – those with the highest aggregate turnover exhibit the most stable prices. Item 12 concentrates on the trading activities of institutional investors. This is for two reasons. Firstly, the period in which the institutional investors became the dominant players on the security markets roughly coincides with the immense acceleration of trading activity. Secondly, their holdings are much larger than those of any other actors. However, the trading necessary to implement a passive, index-tracking investment strategy might be rather limited; in principle, a portfolio which replicates the whole market is self-balancing.

The paper looks at the actual strategies followed by fund managers and perhaps succeeds in showing that their strategies - within a "core-satellite" framework – are some distance away from a 100% passive holding of all the stocks in a given index and that portfolio rebalancing operations might account for a substantial fraction of security transactions.

However, the piece does not go much further. Today, it can certainly be seen as obsolete because, somewhat belatedly, the mainstream finance literature is starting to address the question of trading volume. As the representative agent approach becomes somewhat less dominant, a range of heterogeneities among agents can be taken into account which help to explain security trading.

Portfolio adjustment by institutional investors, in one form at least, can be

[4]Strictly speaking the dollars would be used as collateral for a euro credit but it comes down essentially to the transfer of liquidity across currency zones.

seen as a necessary component of any full explanation of security trading. Nagel (2005) models the trading associated with rule-bound portfolios where the rules relate to such equity characteristics as firm size, value and momentum. He finds that investors following such rules must trade on a substantial scale. Of course, this only drives the problem one stage back. Nagel writes, "one key to explaining trading activity is to understand the forces that make investors specialize into diverse style categories and lead them to follow heterogeneous trading rules. At present neither the agency and industrial organization issues that might drive the specialization into styles, nor the notion of fixed trading rules as heuristics in investment decisions have a natural place in theoretical models of trading volume" (pp 19-20). But his work does indicate that the regular rebalancing operations of institutional investors contribute to the enormous trading volumes observed in security markets today.

Of course, there was never any intention to deny that a great deal of such trading is dysfunctional – purely speculative, or a matter of churning portfolios to swell transactions charges against the interests of retail investors. On the contrary, the goal was a highly critical account of current financial practice. However, it was intended to suggest that the new structures of global finance, including the shift from classical bank intermediation to marketable claims, are not only a reflection of economic decadence or the triumph of special interest groups – that there is also a functional core to the new structures.[5]

Although it is too early to say that this view is justified it is also too early to say that it is wrong.[6] A recent study by Alexander et al. (2010), discussing the issue in the context of transactions taxes, leaves it open:

> Academic opinion, however, is strongly divided over what utility financial transaction taxes have in curbing excessive risk-taking and generating sustainable sources of revenue. Proponents of financial transaction taxes have based their views on certain assumptions about trading and pricing in asset markets: that modern financial markets are characterised by excessive trading activity and short-term speculation, and that such speculation generates volatility not only in short-term asset prices, but also in long-term asset prices marked by persistent and dramatic departures from equilibrium. Keynes observed that this led to the 'predominance of speculation over enterprise' and led to reduced long-term investment and growth. Accordingly, a tax on transactions in securities and other financial instruments would increase the cost of speculative trading, especially for trades with shorter durations, and this would have a stabilising effect on asset prices. Moreover, the tax would generate revenue

[5]The approach adopted also seems to be in the spirit of Marxist theory. Marxism is about what people have to do, rather than what they choose to do. Proletarians have to seek work; capitalists have to accumulate. Modernity does not equal freedom. Similarly, asset managers have to trade.

[6]A recent paper with Lysandrou continues this discussion in the context of the European Commission's proposal for a financial transaction tax (Grahl and Lysandrou, 2014). This piece also gives a fuller survey of theories of security trading.

needed to assist governments with fiscal consolidation, especially during times of crisis. Opponents of transaction taxes generally share the view that the case is flawed because it ignores the fact that a high number of transactions – both short and long-term - are necessary for the price discovery process to work and for the efficient distribution of risk. More transactions lead to a smoothing in asset price movements towards equilibrium, and short-term trading is necessary to allow effective hedging and should not therefore be limited. Any increase in transaction costs (ie., a tax) would limit parties ability to hedge risk, thus reducing liquidity and increasing short-term volatility of asset prices (pp31-32).

Item 8: "Financial Markets and Globalisation", *Soundings* 2005

Item 8 is an expository piece, published in a non-academic journal. This context permitted a wider, but undocumented, account of the issues involved in global finance. Its main weaknesses are that it does not pay sufficient attention to the issue of stability and that it fails to anticipate the massive instabilities from 2007 onwards. However, it brings together most of the elements of the position that was worked out.

Thus the essential nature of finance is derived from disequilibrium Keynesianism: since markets fail to clear, surpluses and deficits are distributed across the market economy; only the recycling of financial resources enables market relations to continue. Adjustment processes in market economies are best seen as resulting from financial pressures, rather than as responses to price signals.[7]

The stylized view of financial history, drawing to some extent on Hicks' (1989) *A Market Theory of Money*, is that early forms of finance tend not to be intermediated and tend to take the form of trade credit. The emergence of a distinct financial sphere is then seen as a consequence of the functional differentiation with structural integration which typifies the modern era as a whole. It is important that finance is interpreted in the first instance as a **function** and only secondarily as an interest group. (This is by no means to deny that finance is also an interest group, one characterised by extreme forms of predatory and parasitic behaviour.)

From a similar point of view, global finance is seen, not as a structure brought into being by political forces, but as a functionally necessary complement of the global economy. This is a difficult issue because virtually all economic developments today require some form of political ratification: legislative or regulatory reform, changes in the nature of property rights, reshaping or redirection of

[7] To avoid misunderstanding, it may be useful to point out that the view here is that, although **savings** follows expenditure, **finance** necessarily precedes it. As Minsky says somewhere, "that which cannot be financed will not occur." The exact source of this quotation has not yet been traced; it occurs in a piece on one of the OPEC oil price hikes. Minsky argued that the right response in the west would be to *increase* the tax on petrol; if people just couldn't afford it the price hike would soon be reversed.

public sector agencies. However, it is still possible to see these political moves as secondary – as driven by economic developments. Thus, one can tell the story of financial internationalization as a sequence of political decisions and interpret that sequence as the expression of a basically political project. This is broadly the position adopted by Gowan, 1999, for example.

The problem with positions such as Gowan's is that they downplay the economic forces at work. The contrasting position taken by the present writer is that the basic political decisions giving rise to the global financial system were determined – not in every detail but in their general direction – by the changing economic context. Thus emphasis would be placed on the link between the activities of US multinationals in Europe and the emergence of the Eurodollar system. Again, in discussing the break-up of Bretton Woods, it would be the preceding growth of international capital flows which would be underlined.

Item 9: "Scale and the Political Economy of Financial Change" in Jens Hölscher and Horst Tomann (eds) *Globalization of Capital Markets and Monetary Policy*, Palgrave, London, 2005

This piece, published in a *Festschrift* for the distinguished German monetary theorist Hajo Riese, returns to this issue of scale and sums up both findings (the money-market nature of much FX trading) and hypotheses (security trading as perhaps a necessary aspect of global finance) before going on to consider financial transformation in Europe, which is discussed below.

The importance of this issue can be brought out by considering current proposals for banking reform. The validity of key proposals would seem to depend on the view one takes of security trading. The largest banks either trade intensively themselves, through their investment banking arms, or provide transactions balances to other traders. The two activities, security trading, and the provision of balances with which to do so, seem to be so closely related in functional terms that it is unclear how meaningful it is to insist on their legal separation. The large banks will be big holders of securities in either case – either through their proprietary trading or as collateral against their loans to the traders. On the other hand, if one took the view that a drastic reduction in such trading was necessary and desirable, then the formal separation of commercial and investment banking could be accompanied by a substantive separation with no great disadvantage.

Similar considerations seem to apply to the notion of banks which are "too big to fail." If the provision of finance for security trading is an essential activity then firstly there may be economies of scale in such provision and secondly a reduction in banking concentration may lead, *pari passu*, to an increase in interconnectedness as the inter-bank credit market takes the strain.[8]

[8] Charles Goodhart refers ironically to these two positions on structural change as the "two mantras." The first is: if it's too big to fail it's too big; the second is: commercial banks typically combine a public utility with a casino and the two should be separated. (Oral

The status of that market itself is also an important issue in the drive for banking reform. Inter-bank credits make it possible to finance vast amounts of security trading with an astonishing economy of monetary resources. If that trading is much reduced so also will be the intensity of inter-bank credit operations (and the flows through wholesale payment systems which reflect them). But monetary policy today works through this market so that its attenuation could raise problems for policy implementation (of which there was a precursor during the recent credit crisis).

The issue is now beginning to attract more attention from finance specialists who admit that it has been neglected in the past. Choridia et al., 2008 write:

> The literature on financial markets has traditionally focused on explaining asset prices, while trading activity has attracted only peripheral attention. Indeed, Rubinstein (1975), Hakannsson, Kunkel and Ohlsen (1982), and Milgrom and Stokey (1982) suggest that there will be no trading in a market consisting of rational agents with identical priors. Empirical investigations of well-known asset pricing models such as the CAPM have also centered only on the determinants of expected returns. Yet trading activity is an inalienable feature of financial markets and, thus, warrants separate examination. Indeed, trading volumes are large in financial markets. For example, the NYSE website indicates that the annual share turnover rate in 2003 on the NYSE was about 99%, amounting to a total volume of about 350 billion shares. Assuming a per share value of $20 and a 50 basis point round-trip cost of transacting, this amounts to a transaction cost of several billion dollars that the investing public paid in 2003 (p3).

The CAPM paradigm tended to suggest that trading would be limited and that buy-and-hold strategies would be widely adopted. A recent theoretical study (O'Hara, 2003) argues to the contrary that a strategy of "holding the market" would involve an impossible amount of trading:

> A simple example can illustrate the problem. Suppose your goal is simply to "hold the market" and you do so by holding shares in the Russell 1000.[9] How much of a portfolio-weighting problem do you really face? Consider the 2002 Russell Reconstitution. The weights of and companies in the index are reconstituted every July 1. On July 1, 2002, 160 companies were added to the Russell 1000 and 113 were deleted. So at a minimum, 273 of the Russell 1000 companies

remarks of Goodhart.) It is necessary to have a clear view of the future balance between security trading and classical bank intermediation to obtain a more useful view of structural reform in the banking sector.

[9] O'Hara herself explains: "The Russell 1000 index measures the performance of the 1,000 largest companies representing approximately 92% of total market capitalization (see `www.russell.com` for index details)." The web-site states that the number, 1000, is itself an approximation, which is why more companies could come in than go out.

> changed weights from positive to zero and conversely. Another approximately 840 companies had their relative weights change. Is it really the case that holding the market is straightforward? Even an equal-weighted strategy of trying to hold one share in every company misses the mark substantially; pursuing a value-weighted strategy is a task worthy of Sisyphus (p130).

Global Finance: Conclusion

The issue of security trading volume is still, at present, open. However, enough has perhaps been said to show that the scale of security trading is an incompletely understood phenomenon, important for monetary policy and banking regulation and that a better understanding is necessary for an accurate characterization of what heterodox economists call "financialisation." The contributions under review have the merit of pointing out the importance of the question within an account of global finance which, unlike many other heterodox accounts, stressed the economic logic and the functionality of many of these developments. Many radical proposals for financial reform seem to be based on the expectation that a lot of genies can be coaxed, or forced, back into their bottles – international capital mobility, the proliferation of derivative instruments, competition between different financial sectors and so on. To the extent that recent developments are functional, such expectations appear somewhat implausible.

III Financial Integration and the Lisbon Agenda

The item just considered ends with reference to the European situation and the rest of the pieces submitted concern European developments. At the end of the 20th century the European Commission formulated an ambitious plan for financial integration, the Financial Services Action Plan (FSAP, complemented by the Venture Capital Action Plan, VCAP). The FSAP soon became a key component of the Lisbon Agenda, a comprehensive strategy for the first decade of the present century which won unanimous support from member state governments.

Item 11: "Financial Integration in the EU: Policy Issues and Proposals", *Critical Perspectives on Accounting*, 17, 2006

Although this piece is dated 2006, it was written before the other articles on the FSAP. It sketches out the main issues as they were perceived at the beginning of the research; these did not change in terms of broad outline, but, as will be seen, each of them was characterised more accurately and in more detail as the research proceeded. The view taken was that financial integration was a rational and indeed indispensable policy in the EU but that it ought to be combined

with flanking policies to secure certain public goods. The reason integration was perceived as necessary relates to the discussion above of security markets: it was thought that the process of globalisation would confirm and intensify the switch from classical bank intermediation to security market based finance. If this were the case then the EU could be disadvantaged. As the point was put more than once in the selected articles, if the EU did not build big, liquid, capital markets, it would simply drive every investor and issuer on the planet into the North American ones. However the dangers of uncontrolled integration were also pointed out. The key issues here remained the same throughout the discussion:

- The impact of the change on corporate strategy and possibly on employment relations within the enterprise. Initially this possibility was understood in a somewhat simplistic way, which identified such consequences of financial change with the shareholder-value model of the enterprise.[10] Today, it seems more accurate to discuss the *economic* pressures on the enterprise in terms of financial market capitalism because, while shareholder interests as such do not seem to play a determining role in corporate strategy, nevertheless capital markets impose more constraints on corporations than in the past. It is also necessary to interpret some aspects of the drive for shareholder value more in ideological than in economic terms (see especially item 10, discussed below).

- Interactions between financial change and social security reform. The central issue here is the transfer of pension provision from the state to the institutional investors and the security markets, although there are pressures for such change also in other fields, such as care for the elderly. Nearly all EU member states have reformed their pension systems in this direction in recent years and were strongly urged by the Commission to do so. There are at least two obvious problems: the risks involved in dependence on the security markets; and the distributional effects of the shift which seems bound to increase inequalities because it will gear pensions to savings rather than to income.

- An obvious issue is that of economic stability. Security markets had displayed considerable instability even in the years before this piece was written and therefore there was a case for regulatory and supervisory measures to limit instability.

- A final issue concerns consumer protection. This gradually came to seem increasingly important over the decade since the FSAP was launched. It concerns not so much the performance of the wholesale markets themselves as that of the institutional investors (often including the big banks) which give households access to diversified portfolios. The Commission

[10] The candidate, together with Paul Teague, had contributed to a symposium on shareholder value published in *Economy and Society* in 2000, but their own paper (Grahl and Teague, 2000) did not deal specifically with financial issues.

adopted a relaxed attitude towards such issues. This raised at least two concerns. Firstly, the Commission seemed to treat the retail finance scene in Britain as a model for the EU as a whole. Now a whole series of reports and enquiries, often by insiders, have demonstrated that retail finance serves British households very badly. Secondly, the Commission took a very different position on regulation in this sphere than elsewhere. In labour market and employment regulation, in environmental protection, in issues of consumer safety it has always been possible for individual member states to adopt higher standards than those promulgated by the EU. The Commission, however, vigorously combated what it now called "gold-plating" in the field of retail finance.

As is shown below, these themes would be further developed, but item 11 was the first of the listed items to raise them. It has to be acknowledged, however, that the key issue of mortgage finance was not addressed until late in the day. The deregulatory moves of the Commission were certainly criticised[11], but the massive implications for stability were not perceived. Many scholars concerned with employment relations shared this blind spot – the interest in corporate finance, which seemed to have more direct implications for employment relations led to neglect of real estate finance although the latter is very much larger and therefore has much greater potential effects on stability

Item 7: "Problems of Financial Integration in the EU", *Journal of European Public Policy*, December, 2005

This piece, jointly written with Paul Teague, makes several points about the financial integration strategy which are also made in some of the other submitted publications. One factor stressed here is the impressive political unity with which the FSAP (Financial Services Action Plan) was adopted. It was unanimously endorsed by both EU level bodies and by member states and this gave unusual impetus to the programme. Even so, the programme ran into trouble in that the early legislation did not bring about much integration on the ground. However, the reaction to these problems once again demonstrated the high priority which all parties attached to the strategy. Alexandre Lamfalussy was brought in to chair a committee of "wise men" charged with reorganising the FSAP. They proposed a very streamlined legislative process, which was in fact agreed and which successfully relaunched the integration drive.

In retrospect, of course, the political unity surrounding the FSAP and other aspects of the Lisbon agenda seems suspect, in that it reflected a common misperception of the US economy and of US financial practices. The paper in question already raises the issues of social policy and of the reconsideration made necessary by the bursting of the high-tech bubble. It is noteworthy that Lamfalussy himself expressed reservations on the issue of stability as early as 2003. The episode is reported in Toporowski's (2009) chapter on financial crises

[11]The candidate did so at a meeting of the European Economic and Social Committee in the Spring of 2007.

in the volume edited by the candidate. The Lamfalussy committee had argued that:

> "... greater efficiency does not necessarily go hand in hand with enhanced stability ... Increased integration of securities markets entails more interconnection between financial intermediaries on a cross-border basis, increasing their exposure to common shocks ... there is an urgent need to strengthen cooperation at the European level between financial market regulators and the institutions in charge of micro and macro prudential regulation" (cited in Lamfalussy, 2003).

This is not what D.-G. Internal Market ("the hooligans" as the Dutch Labour Party MEP, Jan Cremers, has called them) wanted to hear:

> "it was politely but firmly suggested that we drop the subject" (Lamfalussy, 2003).

Item 15: "Lisbon, Finance and the European Social Model" in J. Grahl (ed) *Global Finance and Social Europe*, Edward Elgar, 2009

This piece provides an overview of the Lisbon Agenda and of the place of the FSAP therein. The view taken of the Lisbon Agenda was always critical but gradually became more so as it became clear that there was no prospect of meeting its central employment targets and that the macroeconomic regime which accompanied it was simply inconsistent with those targets. (Some of the material in this piece was used for an even more critical account of the Lisbon Agenda and the way in which the FSAP was implemented. See Grahl, 2011). This was also the era when neoliberal extremism, or hooliganism in Cremers' terms, particularly in the case of the Bolkestein directive (see Grahl, 2007), seemed to gain almost complete control over policy formulation in the EU.

Firstly, the climate in which the agenda was adopted was little short of a moral panic. There was a complete misreading of the US growth performance at the time of the high-tech bubble. It was seen as imperative to imitate some features of the US economic system – although these did not include its strong preference for expansionary macro policies. Secondly, the social dimension of the EU was completely instrumentalised in the strategy; labour market policies were given a supporting role in promoting the "competitiveness and dynamism" of the "knowledge-based economy."

Within the financial sphere itself, the Lisbon Strategy put almost exclusive emphasis on lowering transactions costs, on making Europe, in the notorious words used by the Commisson in its report to the Stockholm Council, "the cheapest and easiest place to do business in the world." Only subsequently was it realised that cheap business is not always good business. The consequence was a neglect of essential public goods linked to finance. The most important of these is certainly economic stability; however, in the research project concerned (see Grahl, 2009a), this was addressed by other scholars: Jörg Huffschmid, Jan

Toporowski and Dominique Plihon. Thus the following five pieces concentrate on other public goods menaced or impaired by a financial integration: well-ordered employment relations; consumer protection; and social protection. The exclusive focus on transactions costs necessarily led to this neglect of public goods. It can also now be seen as a contributory factor in the financial debacle of 2007-8 and the heavy involvement of EU banks in the collapse.

Item 17: "Finance and the Household" in J. Grahl (ed) *Global Finance and Social Europe*, Edward Elgar, 2009

This piece returns to the issue of retail finance. It draws for the most part on British documents because the British scene was most known to the author. This procedure seems justified, however, because market-based finance plays a much bigger role for households in Britain than in other EU member states[12] and it is clear that the Commission was aiming at an expansion of market-based provision throughout the Union. Before the events of 2007 it also adopted a markedly deregulatory approach.

It is extremely easy to document serious malfunctions in British retail finance, using reports from the Treasury (for example, Myners, 2001) and from the Treasury Select Committee of the House of Commons (for example, Treasury Select Committee, 2004). (These are quantitative failings – products and services which do not give value for money. In terms of the form and manner in which services are provided, the lamentable way banks and institutional investors often treat their customers can be seen by glancing at the personal finance columns of any British newspaper.)

In preparing, with two colleagues, a report on financial change for the GUE group in the EP, Grahl et al., 2002, some conclusions had already been reached. Huffschmid summed these up as: *caveat venditor* – the seller is responsible. Regulatory authorities in Britain had already been forced into such a position in some notorious cases of "mis-selling." In our view this should become a general principle in retail finance and is the only effective way in which the asymmetries in both knowledge and power between financial firms and individuals can be addressed: corporate providers of financial services should be required to consult very seriously the interests of their customers; if they fail to do so they should bear most or all of the resulting losses.[13]

The issue relates to broader discussions of financial reform. These usually

[12] The Netherlands is a possible exception, since it also relies on the accumulation of securities to fund its pensions. By most accounts the Dutch pension system outperforms the British one, with a lower charges by the fund managers and a certain pooling of risks among scheme members.

[13] As this context statement is revised for submission yet another example arises in the conduct of Lloyds Bank – after the crisis and in spite of a substantial public share in its ownership. Lloyds employees were offered the carrot of substantial bonuses and threatened with the stick of demotion or dismissal to encourage them to sell unwanted risky investment products to the bank's customers. The Finncial Conduct Authority imposed a fine of 28 million (*Financial Times*: `http://www.ft.com/cms/s/0/567a23a0-6247-11e3-99d1-00144feabdc0.html#axzz2nZnpljq8`)

refer to operations at wholesale level, but one method of reducing the size of the financial sector and lowering the costs of intermediation would be to lower the fees and charges paid by retail customers.

Thinking on how this might be done seems might point to a need for standardisation. Retail finance, especially in Britain, is characterised by extreme forms of product differentiation, with the usual consequences of a failure to achieve scale economies and high marketing costs. Until recently, arguments for product standardisation (as opposed to standardised selling practices) were met with the claim that this would inhibit innovation. Today, a less sanguine view is taken of financial innovation – in reality, most innovations in retail finance involve either spurious product differentiation or scams – and a more effective system of consumer protection may become possible (although one also observes the fierce resistance of established financial interests, for instance in the struggle to reform financial advice in Britain).

Item 17 makes clear that the Commission, until very late in the day, pushed for rapid market-led integration of retail finance even when this menaced consumer protection. The most striking example is the drive by D.-G. internal market (aka "the hooligans") to integrate EU mortgage markets. Since, at the time, there was sufficient integration of wholesale finance to roughly equalise mortgage interest rates across member states, it was impossible to base this policy on the prospect of cost reductions. Instead it was based on the promise of greater consumer "choice." This story is recounted in more detail in Grahl, 2011 where it is shown clearly that the Commission was aiming at the introduction of a sub-prime mortgage market in the EU, a project only abandoned when the corresponding US market collapsed.

The candidate and a colleague who had also participated in the FISC project, in evidence published by the House of Commons Treasury Select Committee, drew some conclusions about the Commission's current attempt to assume control of financial regulation. Nothing in the Commission's past record, which is one of reckless integration at the expense of effective control, justifies such a pretension (Frangakis and Grahl, 2009).

Item 14: "The Official Case for Financial Integration" in J. Grahl (ed) *Global Finance and Social Europe*, Edward Elgar, 2009

This piece, also a product of the FISC research network, addresses another aspect of EU policy-making in general and of the Lisbon strategy in particular. It was jointly written with the young German econometrician, Thorsten Block. Block was primarily responsible for a detailed examination of several technical papers published by the Commission which predicted very great gains from the FSAP. Block's findings were that these studies combined state-of-the-art econometric modeling with heroic assumptions and that their optimistic conclusions depended crucially on the latter. The candidate put Block's assessment into a wider examination of the official case for financial integration and referred to

a previous case of similarly optimistic forecasts in the studies around the 1992 single market programme. The overall conclusion was:

> The European Commission frequently resorts to the purchase of technically sophisticated but basically tendentious studies from commercial research organisations who seem to know very well what their paymaster wants to hear. Over time, this practice can only serve to further undermine public confidence in, and public respect for, the European project (p148).

The case of sub-prime mortgages for the EU, referred to above, provides another sorry illustration of the same practice: Grahl, 2011 documents the massive study commissioned from one of the (most) usual suspects, London Economics (2005), to justify this ill-considered policy.

Item 16: "Financial Markets and Social Security" in J. Grahl (ed) *Global Finance and Social Europe*, Edward Elgar, 2009

As suggested above, the financial integration policies built into the Lisbon agenda tended to downplay all the public goods which might be affected by the market creation process. This piece deals briefly with another example of such public goods, namely social protection. Only old age pensions are discussed although it is suggested that similar forces are at work in the provision of health care. On pensions, the very influential World Bank (1994) Report, *Averting the Old Age Crisis*, crystallised the view that more intense pressures on pension systems resulting from population ageing (or asserted to do so) would be best met by a qualitative change in the nature of these systems. The "first pillar" of provision, state pensions financed on a PAYGO basis, should play a smaller role, focused on minimum standards. The second and third pillars, funded provision on an occupational basis organised by employers and on an individual basis by fund managers, should expand to fill the gap. The switch was justified by the need to strengthen public finances, and, in several countries, to increase the savings rate. Other motives might be a desire to replace public by private provision and to expand the role of the security markets.

In practice a very big obstacle to this kind of reform in countries with significant PAYGO systems is the potential cost of transition which would require one generation to pay both for its parents' pensions and for its own. This might be one reason why reforms in the suggested direction, although they took place throughout the EU, went furthest in the CEECs. The Commission strongly supported this direction of reform although competence for pensions systems remains largely with the member states. However, it is possible to detect an inflection in Commission policy after the stock market crash of 2000/2001 and subsequent scandals in corporate finance. It was still insisted that coming pressures on public finance necessitated deep reforms but now a kind of self-financed funding by governments was also recommended. These should move quickly to

large budget surpluses in order to cover the deficits which would be needed when the bill for population ageing fell due.

The piece in question here has no conceptual originality but records some of the most important factors in the EU's pension policies. It rehearses, with reference to European developments, some of the strongest arguments against the World Bank position. The dimensions of the ageing crisis may be exaggerated, and, in any case, the pressures involved may relate more to a shortage of employment than to an excess of older citizens. An alternative to a changed ratio among the three pillars might be parametric change in state provision (in practice, this has probably been the most important type of reform). The second pillar has been weakened by the degradation of many employer-based systems (by now a virtually universal shift from defined benefit to defined contribution provision among big US and UK companies) while the third depends on both the questionable practices and performance of the fund management industry and the vagaries of the securities markets. There are also major distributional problems with reform in the recommended direction. Funding of pensions on an individual basis through the accumulation of financial assets would tie pensions very closely to wealth rather than to income and this would make pension provision much more unequal.

All these points remain valid but two further considerations can be added. On the one hand, on the basis of the very strong expansion of the fund management sector over recent decades it does seem likely that their role will increase. However, it would be best if this expansion took place without the very large and inequitable tax breaks which the sector currently enjoys and if the main task undertaken was to provide, without subsidies, for individuals with higher incomes who are not satisfied with a state-run system which should become more redistributive and only pay pensions up to the level of average, or perhaps median, pension incomes.

Secondly, a sceptical note can be sounded on projects for transformational pension funds (for instance Blackburn, 2002) which, drawing on the original objectives of the Meidner proposals in Sweden, see the accumulation of equity stakes by workers' funds as a way to change the balance of power between employers and employees. This is a revolution which would depend on a prior restoration. Before equity stakes could be used in this way, it would be necessary to transform the actual relation between top management and shareholders to put the latter back in the saddle. Surely the multiple corporate and financial crises of the last decade have confirmed the dominance of control over ownership. The classic account – amply reaffirmed across the years – of the modern corporation by Berle and Means (1932) describes the Faustian pact by which dispersed shareholders abandoned their putative control rights in exchange for liquidity – for the right to exit quickly from their investments via the organised markets. The weakness of current movements for "activist" shareholding indicate that today's fund managers make the same fundamental choice: they want the companies they invest in to be transparent but will resist any close involvement in corporate decision-making since that would impair their ability to trade on what is now an enormous scale (Aglietta and Rébérioux, 2005).

Item 3: "Globalised Finance and the Challenge to the Euro", *New Left Review*, March/April, 2001

This piece, revised from a professorial lecture, is the earliest attempt to articulate the general argument running through all the papers submitted. The occasion was a substantial depreciation of the euro against the dollar shortly after its introduction. This is attributed to capital flows to the US, a judgement which still seems valid. However, the main thrust of the paper is elsewhere; it attempts to challenge certain views, widespread in heterodox theory, about finance. One way this is done is by suggesting that there are limits to Granovetter's (1985) famous argument on the social embedding of economic relations. It is certainly true that economic transactions may be facilitated by the existence of social affinities between the transacting parties – it might be easier to deal with your brother-in-law than with a complete stranger. However, the rule of US finance ("arms-length" finance, as it is characterised by Rajan and Zingales, 2003) ***that anyone can play***, also has advantages. An arms-length system can expand into the most varied social contexts without difficulty. In contrast the "embedded" systems of Western Europe – based on national or regional identities or on political or confessional allegiancies – may not be able to expand easily beyond the social milieux in which they originated. The various Western European systems were described here as a "cluster of particularisms." No doubt this was somewhat exaggerated – the remark was made to emphasise the possibility of an alternative to the usual view of embeddedness.

Financial Integration and the Lisbon Agenda: Conclusion

The publications discussed here cover the weaknesses of the Lisbon agenda relating to its financial dimension. The discussion is like a performance of *Hamlet* without the Prince of Denmark in that the most important and central weakness, the neglect of financial stability, is not dealt with. This is because, as pointed out above, in the context of the FISC project, that issue was dealt with by others. However, enough has been said to suggest that the FSAP and other financial integration policies were pursued to the neglect of other important public goods: consumer protection and social protection (a third example, the impact of financial integration on employment relations systems, is discussed in the next section).

This neglect can be plausibly attributed to the ideology prevalent in the Commission (and most member state governments) in the first decade of the new century which saw market-based policies as the solution to every problem and radically underestimated the role of regulation, intervention and public institutions. In the financial sphere itself one result can be seen in the extremely high leverage ratios of EU banks prior to 2008 and their massive exposure to the sub-prime debacle. Thus the current banking crisis in the eurozone was, at least to significant extent, made in Brussels.

The same extremism marked other aspects of the Lisbon agenda, especially in the Bolkestein proposals for service sector integration (Grahl, 2007). How

comprehensively the Lisbon strategy failed is perhaps not yet fully appreciated. Consider the central targets for employment growth. Between 2000 and 2007 three quarters of the employment growth achieved in the eurozone was concentrated in five countries – Greece, Ireland, Italy, Spain and Portugal – all of it dependent on unsustainable capital flows and more than all of it subsequently lost. Thus the apparent, very transient and partial, success of the strategy was due not to the good functioning of the monetary union, but to its defects, to the massive misallocation of capital which it engendered.

Since the EU's "2020" strategy for the second decade of the new century quite closely resembles the Lisbon agenda – at least as regards employment – it is difficult to be confident about its prospects of success. At the same time the present discussion might indicate that there is no easy solution in a backward direction. Monetary integration in the EU has accelerated financial integration which, however badly it has been managed, still corresponds to a functional necessity in a global financial system where interdependence has been intensified, not attenuated, by the crisis.

IV Financial Integration and European Employment Relations

The papers grouped here deal, in particular, with the potential impact of financial change on EU employment relations. This is generally seen as negative but it is suggested that this need not necessarily be the case – that the negative impacts relate more to simplistic accompanying measures by the European Commission and member state governments than to financial integration as such. All of this debate, including the candidate's own contributions, focused on corporate finance and neglected the huge imbalances building in real estate.

Item 6: "The Eurozone and Financial Integration: the industrial relations issues", *Industrial Relations Journal*, 34, 5, December 2003

This piece, jointly written with Paul Teague, is only partly centred on financial integration. The first half discusses what was at the time a better-known issue, namely the consequences of monetary union as such, and the consequent loss of macroeconomic instruments at member state level, for wage bargaining and employment relations. One judgement in this section, that there would be no strong move towards international coordination of bargaining, seems to be borne out by subsequent developments, while a second, that monetary union would not fragment and "Americanise" employment relations, proved valid up to the eurozone crisis and the drastic reshaping of labour markets in the worst affected countries.

It is only the second part of this item (published in 2003) which addresses the issue of financial change. The treatment is schematic and, in at least one

respect, simplistic. It is correctly asserted that the FSAP and the drive for financial integration was at the same time a drive for financial transformation and that this transformation involved a decline in the use of classic bank credits by big corporations and their increasing reliance on the security markets. However, the identification of this shift with "shareholder capitalism" certainly needs to be qualified. It is probably more accurate to speak of "financial market capitalism." The increased role of the security markets in corporate finance, and the consequent change in the character of the financial constraints on corporations, are not in doubt. On the other hand, the claim that in the transformed system the interests of shareholders are paramount seems in retrospect to have more to do with corporate publicity than corporate reality. Many things are justified by the need to serve the interests of shareholders, but repeated stock market crashes and a host of "principal-agent problems" in the linkages from the ultimate suppliers of capital to the managements of the corporations which deploy it call into question the actual primacy of shareholder interests.

Nevertheless the piece does point to some indicators of new pressures on employment relations. One of these concerns corporate structure: when finance is supplied through organised security markets the investors tend to put a higher weight on the transparency of corporations closely focused on their central activities and a lower weight on the risk reductions linked to conglomerate form, since effective risk-spreading can be achieved by portfolio diversification. A related pressure concerns employee relations – market-based finance does not abolish stakeholder coalitions, but it tends to narrow them, excluding those employees who have no critical influence on profitability.

This was an early consideration of the theme. The next two items make the account of financial change more concrete and specific.

Item 10: "Financial Change and European Employment Relations", in James, P. and Wood, G. (eds) *Institutions, Production and Working Life*, OUP, December, 2006

This piece, a chapter in a very loosely integrated book of essays, covers a lot of ground and many of its main themes are addressed in the publications discussed above – this is the case for example with the issue of scale in security markets. Here the discussion of trading volumes is dealt with as part of a critical examination of the notion of *financialisation*, which is perhaps invoked too frequently to account for various current socio-economic developments. Likewise, there is an attempt to limit the notion of *neoliberalism*, and to argue that not all market-driven developments can be attributed to neoliberal political strategies.

Although the piece continues to refer to "shareholder capitalism" the account given of financial changes is more precise than in the candidate's earlier work. A critical reading of the work of Michael Jensen had made it clear that certain aspects of corporate finance were linked to specific conjunctures in the US economy. As US corporations in the 1970s and 1980s faced strong challenges from Japanese and German rivals, an increased role for the capital markets was

advanced as a restructuring strategy for US industry[14]. Jensen's earliest formulations did not in fact advocate an active role for dispersed shareholders – he was very much the guru of the leveraged buy-out, by which corporate ownership could be reunited with corporate control in order to eliminate the waste and inefficiency resulting from irresponsible management (seen as a "principal-agent" problem). Only when the drive for unrestricted LBOs reached certain limits (crisis in the junk-bond market, scandals associated with some corporate raiders, reintroduction of legal constraints on takeovers) did Jensen's emphasis fall increasingly on governance issues: dispersed ownership might remain but changes in governance could perhaps reduce conflicts of interest between managements and shareholders. Maximisation of the value of companies (and thus of returns to shareholders) was seen as the key to efficient use of resources.

By the end of the 1990s, and in the wake of the dot-com bubble, this position also became obsolete. A key issue now was the overvaluation of companies on the stock markets. When this happens, the capital markets can no longer be seen as limiting and disciplining corporate leaderships. On the contrary, the ability to issue equity at unrealistically elevated prices eliminates such external discipline and permits all kinds of malfunction and excess. Jensen now became concerned with the quality and authenticity of communication between the corporations and the capital markets. One of his later articles has the title, "Just say no to Wall Street" (Fuller and Jensen, 2002).

Item 10 looks at the response of EU leaders to the evolution of US and global finance. It attempts to distinguish a rational core in EU policy – pursuit of financial integration, recognition of a wider role for securities markets – from the completely uncritical acceptance of any and every US precedent. The mood at the moment when the Lisbon strategy was formulated is described as one of "moral panic." A perceived gap in productivity growth between the EU and the US called every aspect of the European models into question[15]. Breakneck Americanisation, especially of financial processes, was the actual content of the push for the "knowledge-based economy."

As regards employment relations, an important case was the Commission's position on takeovers. D.-G. internal market once again proved worthy of Jan Cremers' epithet as they proposed a complete liberalisation, ignoring the significant problems that had arisen with liberalisation in the US. One Commission document included the staggering sentence: "The disposal of securities concerns only the owner of those securities." This was in the context of corporate restructuring where the purchase of a controlling equity stake can radically affect all the stakeholders in the enterprise involved. By a tied vote the EP rejected the Commission's draft and the legislation actually passed did not make big changes to the status quo.[16]

[14]There are interesting and ironic parallels with some Marxist accounts of capital restructuring presented at roughly the same time.

[15]In retrospect it seems that US productivity performance was greatly exaggerated (Cowen, 2011).

[16]The Commission deplored this decision in the EP. In the Netherlands in 2007 the candidate heard a speaker from D.-G. internal market assert that corporate governance was a matter for

On the basis of the distinction made above, between the rational core of financial integration and the sometimes unbalanced and simplistic way in which it has been pursued, the piece argues that "more ambitious European strategies are possible which would combine the construction of an integrated financial system with effective measures for its social control." This hope remains but recent developments have done nothing to justify it.

Another aspect of this piece is that it makes explicit something which is implicit in most of the publications submitted: a critique of the "varieties of capitalism" position. A general suspicion that this approach exaggerates the importance of differences among advanced economies and, correspondingly, underplays the general forces at work across all of them has been reinforced by the observation of rapid financial change in many cases. The "varieties" approach evokes path-dependence and institutional complementarities to suggest that distinct socio-economic models can coexist over long periods. The rapid transformation of the German financial system in the first years of the present century calls both notions into question. If institutions are complementary to the extent that change in a single sphere would lead to serious problems elsewhere, how was it possible to transform the German financial system virtually overnight, and without provoking obvious malfunctions elsewhere? Likewise, if the shape of institutions is narrowly constrained by their history, how could so much financial history be rapidly written off? It seems that most important players – institutional investors, corporations and banks – were agreed on the need to move to a much more market-oriented financial system. (For a detailed assessment of the move see Streeck and Höpner, 2003.) A key reform to enable them to do so was the abolition of capital gains tax on the cross-holdings of equity among banks and big industrial companies.

If advanced capitalist systems do not preserve their institutional identities in the way sometimes suggested in the "varieties" literature, then the notion of *hybridity* referred to in this item becomes indispensable in comparative studies, as does the recognition of strong general tendencies across systems. It is natural, when general trends seem politically and socially adverse, to search all the harder for exceptions. But exceptions are not necessarily solutions.

Item 18: "The Impact of Financial Change on European Employment Relations" in J. Grahl (ed) *Global Finance and Social Europe*, Edward Elgar, 2009

This item is a slightly later examination of the same theme as in the previous one. The notion of shareholder value is now presented as threefold: new direct financial constraints on the enterprise, arising from the enhanced role of security markets; a corporate ideology, disguising the persistence of managerial capitalism in the assertion that corporate power is exercised in the interests of

member states "provided minority shareholders were protected." The qualification makes the main clause vacuous since minority shareholders are almost bound to profit from unrestricted takeovers. There is no logical basis for such solicitude – minority shareholders presumably know what they are doing when they buy into a closely held company.

proprietors; and, deriving from both of these, standards of conduct and rules of governance.

Once again, a distinction is made between the broad economic pressures for financial change in Europe and the policy response of the Commission, with the takeover directive again the main example of the latter.

The impact of financial change on employment relations is schematic but locates the most negative aspects more to shareholder doctrines than to actual market constraints. The only empirical material referred to relates to the single, but very important, case of Germany. Major changes in share ownership had occurred very recently, with a dissolution of cross-holdings and the entry of foreign investors. However, it was difficult to separate out the effects of these changes from other adverse pressures on employment relations, notably those of the Hartz reforms.

The outbreak of massive financial crisis in 2008, after all the texts above had been drafted, revealed many blind spots. In particular, scholars concerned with employment relations were led to focus on corporate finance, rather than other aspects of financial change simply because corporations, as employers, were central actors on the labour markets and in employment relations. This focus in practice led to the neglect of the theme which was stressed in some of the earlier submitted publications – that of scale. According to Federal Reserve data, at end 2007, on the eve of the crisis, outstanding mortgages in the US totalled $14.46 trillion. This compares with $3.73 trillion in corporate bonds and $5.01 trillion in Treasury securities (Federal Reserve, 2013, Table L2).

North American real estate is the largest financial market in the world. Its scale explains firstly why it could absorb so much speculative capital before the bubble burst (high-tech enterprises could not absorb a fraction of the same sum even with internet entrepreneurs working day and night to organise IPOs). Its scale likewise explains the dimensions of the consequent crisis, of which the impact on employment and employment systems dwarfs any of the direct effects of specifically corporate finance discussed above.

Item 13: "Global Finance after the Credit Crisis" *Journal der Entwicklungspolitik* (Vienna), 2009

This is a slight piece and at one point it was thought better to drop it from the submitted work. It was retained because it is the only submitted text written after the financial collapse of 2008 and because it deals, admittedly in a very simplistic way, with a key conditioning factor in any consideration of financial change: the cost of capital. As Michael Jensen himself now recognises, economic restructuring via capital market pressure depends on capital scarcity. In the 1980s investors could pressure enterprises to either declare very high profits or to return capital because the very high interest rates obtainable on government debt gave them an obvious alternative. This is no longer the case.

In principle a decline in interest rates might be expected to reduce the hurdle rates of return required from productive investments and thus to increase the demand for labour. Established norms and conventions within the financial

sector may have delayed such an adjustment (Plihon, 2002, explores the possible role of such conventions in the high-tech crash of 2000-01).

The reasons for the present abundance of capital are clearly of enormous importance, as is the question of whether such conditions can be expected to continue. There are considerable disagreements, even as to the role of real forces as against monetary ones in the present situation. One view is that a major factor has been Chinese savings and that, as China moves to a more autocentric path of development, capital costs will again rise (McKinsey, 2010).

The issue perhaps indicates the limits of the whole discussion above. Financial structures and mechanisms have their importance, but financial conditions depend more on interest rates and asset prices than on particular structures of intermediation. On the other hand, there are no signs that the process of financial globalisation will be reversed nor that the enhanced role of security markets will be called into question.[17]

Financial Integration and European Employment Relations: Conclusion

The survey here of the impact of financial change on European employment relations does not reach strong conclusions. It is relatively easy to specify some pressures on corporate strategy, such as the preference of investors for outsourcing. It is much more difficult to assess the weight of such pressures in overall changes in employment relations since the latter are over-determined by a host of other factors, notably transformations in the international division of labour, public policy and macroeconomic fluctuations. It is also necessary to take specific national factors into account. The criticism here of the notion of strongly identified varieties of capitalism and the emphasis on general trends in advanced economies certainly does not imply uniform developments across countries – rather it sugests that comparative work explore various forms of hybridity in institutional change.

Overall Conclusion

Financial change has become an important factor in overall socio-economic change in recent decades. The papers grouped here have attempted both to interpret financial change and to make that change more widely understood. The basic view taken was that finance has to be interpreted both as an interest group, or a set of interest groups, and, especially, as a function. Thus the functional aspects of financial globalisation were stressed, with one consequence admittedly being that dysfunctional aspects, although they were repeatedly discussed, were underestimated. On the other hand it could be argued, even after the massive crisis of recent years, that heterodox writers, especially those in

[17] Indeed, it seems likely that higher capital requirements and other constraints on the banks will encourage further securitisation (oral remarks of Charles Goodhart).

the Marxist tradition, are sometimes too ready to privilege the crisis in epistemological terms. Crises are supposed, no doubt correctly, to reveal flaws, inconsistencies and antagonisms concealed by economic upswings. However, it is hard to make full use of the lessons of the crisis unless one is also ready to learn from trends and developments in more "normal", more stable, periods. To call into question the epistemological privilege attached to crises might be one value of the work presented here.

The empirical context of most of the contributions is the European Union and here it was argued that integration was a basically rational strategy, in spite of the many criticisms of the way in which integration was pursued. Today, this central position is open to question. Once again, however, the contrarian view adopted here might not be without value. At present there is a widespread condemnation of the monetary union as illogical in its very foundations. One implication of the arguments summarised above might be that monetary integration and the financial integration it necessarily implies were and remain basically rational strategies, in spite of the debacle resulting from their actual implementation.

Whether or not these judgements are valid, it is hoped that the papers, taken together, can be seen as a useful and in some aspects original contribution to a very necessary debate.

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Chapter 1

Money as Sovereignty: the economics of Michel Aglietta

New Political Economy, Vol. 5, No. 2, 2000

REVIEW ESSAY

Money as Sovereignty: The Economics of Michel Aglietta

JOHN GRAHL

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In 1982, in a work then considered bafflingly unorthodox, Michel Aglietta and André Orléan attempted to use the anthropological speculations of René Girard as a basis for monetary theory (*La violence de la monnaie*, hereafter VM). Sixteen years later they have returned to the scene of the crime in a new attempt to establish such anthropological foundations (*La monnaie souveraine*, hereafter MS).[1] Meanwhile, both authors, but especially Aglietta, have drawn on the original theoretical structure to inform a wide range of monetary studies: on the role and origins of the central bank, on European monetary integration, on instabilities in international finance, on international monetary regimes. This literature can be seen as contributing to a radical Keynesian account of monetary phenomena: firstly, because it adds, to the central Keynesian insight of uncertainty as the determinant of liquidity preference, a corresponding theory of the determination of the monetary object itself, that is, of the birth and death of monetary systems; secondly, because it explores the extra-economic conditions which influence the stability of monetary orders. Largely because much of this material remains untranslated, it is not well known outside France.[2]

This review essay undertakes a critical examination of this body of work. It is organised as follows. There is first a discussion of the origins of Aglietta and Orléan's first theoretical synthesis, which is followed by an examination of their first major work (VM). Then a series of short sections explore the impact of this general orientation on several substantive and methodological questions. Finally, an examination of their most recent joint work (MS) leads into an overall assessment of their approach.

Régulation theory

Although most readers in Britain and the USA know little of Aglietta's monetary studies, he is, of course, very well known as one of the founders of (the best-known variant of) the *régulation* approach to capitalist economic systems, his book, *A Theory of Capitalist Regulation*, being a seminal source for this literature.[3] Although the *régulation* approach is a general theory of contemporary

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capitalism, it does contain some monetary theory, money being seen as one of the canonical institutional or structural forms, through which particular growth models are interpreted (the others are the employment relation, the pattern of enterprise competition and price formation, the structure of state intervention and the international regime). As Aglietta was contributing to the foundation of the regulation school in the 1970s, the key monetary problem was inflation. In general, it is probably valid to see the school's view of inflation as a form of cost-push theory, but certain features distinguish it from other versions of cost-push. In particular, an interesting attempt was made to embrace the problem of capital devalorisation. The destruction of capital values, associated with restructuring of the productive system, is traditionally an aspect of Marxian theories of economic crisis, but devalorisation was classically seen as a function of general deflationary processes. Aglietta suggested that inflation could contain devalorisation processes: if oligopolistic price formation prevented sudden reductions in price following the introduction of new technology, then firms left with obsolete capital equipment could withdraw it gradually from production; if this happened on a widespread basis it would tend to increase inflationary pressure to the extent that the restructuring projects of the laggard enterprises did not turn out, in the event, to be fully successful; in this event, the elimination of obsolete capital would have taken place but have been accompanied by a certain socialisation of losses to all the holders of nominal assets through a rise in the general price level; clearly an accommodating monetary policy was a necessary support of the price formation process which was postulated.[4] This interesting conception contrasted with more orthodox Marxist approaches which tended to see in inflation merely the deferral of an inevitable deflationary crisis and not a process which could be in some ways a functional equivalent to the latter. Subsequent work by Aglietta was increasingly specialised on monetary questions.[5]

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The use of Girard

The appeal to the anthropology of René Girard which was made by Aglietta and Orléan in VM met widespread hostility, partly no doubt because Girard's doctrines of the sacred appeared to be a celebration of irrationality.[6] No attempt will be made here to assess these doctrines.[7] All that will be done is to pick out a few key notions used by Aglietta and Orléan. Human beings are seen as having no intrinsic or naturally authentic desires; their lack of such authentic being impels them to imitate others in the attempt to fill this void; this imitative process, however, if not controlled by institutions, will be reciprocated by the other person chosen as model, who thus becomes a rival, and tends to generate violence between them. The social institutions—at least in early societies, religious institutions—which could control this violence emerge from violence itself as it spreads contagiously just through the originally assumed process of *mimesis* or imitation.[8] This is because, at its paroxysm, violence tends to become focused on a single victim who is destroyed or exiled. The sacralisation of the excluded victim can bring a precarious peace as there now exists a transcendent model of desire removed from everyday life so that the latter can be reoriented

to the pursuit of profane objects without triggering immediate and dangerous rivalries. Rites and rituals endeavour to repeat this sacrificial crisis in a benign form, for instance by using surrogate victims or symbolic representations whose efficacy depends on their being misunderstood by the participants; but the sacred is a fragile institution and can fail either through the desacralisation of the chosen/excluded victim, who thus no longer serves as a model, or through too intense a commitment to rites and rituals which cease to be symbolic representations of the original crisis and become bloody repetitions.

Now some of the shock value of VM arose from the solemnity with which the writers assured us that their use of this colourful narrative was not *figurative*. (The preface to the second edition of VM, however, establishes a certain distance from the Girardian world-view.) It is more practical for present purposes to side-step this perhaps embarrassing claim and to see what features of the Girardian story attracted Aglietta and Orléan as *metaphors* for monetary processes. One can briefly recapitulate the speculative historical schema, inspired by Attali,[9] which leads from ritual to money. Attali's narrative has a Hegelian triadic pattern. Aglietta and Orléan use it as follows. In primitive society, institutionalised by ritual and sacrifice, there is no real money because desires for being are focused not on things but directly on other persons and their conduct. In a second era, the monarch or sovereign emerges as a more stable institutionalised representative of the sacred excluded/elected victim: here money has a secondary status as reflecting the monarch and his sacred prerogatives. Finally, in mercantile society, with the kind of long-distance exchange relations explored by Braudel, money escapes the control of the sovereign and becomes in itself the primary embodiment of wealth.[10]

In Aglietta and Orléan's use of the Girardian image there are clear analogies with Hobbesian politics: sovereignty (a recognised monetary system) emerges to regulate the unlimited struggle to seize wealth (*accaparement*) which would otherwise prevail in modern society. By diverting the keenest desires for wealth on to a special object excluded from everyday production and consumption, the monetary order permits these activities to embrace a host of lesser, profane, objects shielded from the most acute rivalries. The key difference with Hobbes, however, is that the sovereign's peace does not arise from a covenant; the myth of a social covenant is seen from a Girardian point of view as a typical obfuscation of the true, that is, violent, origins of social order; rather do peace and stability emerge from the *bellum omnium contra omnes* itself—through the coalescence of all the feuds and enmities in society into a unanimous attack on an excluded and subsequently sacralised victim. The *analogy* is clear: speculation, as uncontrolled imitative rivalry in the search for authentic wealth, is the violence which menaces modern economies; but it is this speculation itself, when it becomes the unanimous pursuit of a single asset, which gives rise to the monetary order; the latter may then be able to cool speculative passions and divert them into the production of profane, non-monetary goods. This duality might be represented as *contagion/convention*: conventions control and subdue violent speculative contagions, but the origins of convention (misrecognised by those who follow it) are to be found in exactly the same kind of imitative behaviour which produces contagion.[11] The resulting view of the economy is

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radically monetary and in this way connects with other theories inspired by Keynes: there are no intrinsic *use-values* naturally given to the human consciousness; in an inversion of traditional doctrines of a real economy, other goods are regarded as wealth *because* they represent money, the supreme but socially defined object of desire.

In the genesis of the monetary order it is, contrary to standard theory, the unit of account function which is primary—that is, the first step is to define what the sacred, excluded/elected, object is to be. Then comes the store of value function because acquisition of money is now the socially recognised path to wealth; this determines the production of goods for monetary exchange so that the standard derivation of functions is turned on its head.

Monetary orders *conjure* destructive speculation but never eliminate it, so that fundamental crises are always conceivable. These can take two forms. To use the analogy with religion again the god of money can fail either through an excess of immanence (money becomes a banal, omnipresent, object easily obtained and loses its special status—inflationary breakdown) or through an excess of transcendence (money becomes unobtainable, completely removed from concrete economic activity—deflationary crisis). Although these breakdowns have completely opposed forms, they are nevertheless fundamentally unified, alternative expressions of the same inability of the monetary system to absorb changes in the production and distribution of monetary wealth.

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Centralised and fractionated systems

The logic of the Girardian analogy having been summarised, it is possible to lay out in more concrete terms the view of monetary systems which is developed by Aglietta and Orléan in VM. The simplest form would be a homogeneous system within which money consists entirely of claims on a central authority (a useful analogy is perhaps 100 per cent reserve banking).[12] This would be the most direct embodiment of money as an institution—a special asset, excluded from routine production and consumption activities. The form is, however, too pure because it overstabilises the capitalist economy by obstructing the transfer of property. Private debt is absent so that the monetary constraint faced by deficit units is connected directly to the issue of central money which is managed by the central instance. However, when deficits and surpluses swell surplus agents have no immediate claim on the assets of debtors, only a growing holding of central liabilities which may come to seem a simple appropriation if transfers of property are blocked. In this structure the primary form of monetary constraint is the ability of deficit units to settle their balances in central money. The time-horizon over which this constraint must be met is centrally managed. Money here is a pure public good.

At the other extreme, we can consider the fractionated system (*système fractionné*). Here, although a unique central money still exists, it does not play an active role in finance where there are a host of competing private issues (the corresponding analogy might be free banking). In this system, private means of exchange appear in the course of the bilateral transactions among decentralised agents and are thus purely endogenous. Monetary constraints take the form of

the liquidity of private credits—their convertibility into central money—but the time horizon over which this constraint operates is determined by the creditors themselves. It is intrinsically unstable because of the imitative tendencies of the latter and can become impossibly short in times of panic, preventing debtors from clearing their positions with commodity outputs and forcing them either to settle in central money or to cede property. Money here is essentially the basis for private property transfer.

Viable systems, respecting the ambivalence of money as public good and private asset, must be heterogeneous. In the hierarchical system (*système hierarchisé*) we see the coexistence of centralised relations (finance of deficit positions by the issue of central money) and private credits. The two are related through a set of secondary moneys in the stratified form of a pyramid. The convertibility of these into central money guarantees their acceptability within their particular spheres of circulation, where they set the monetary constraint (balance between financing and adjustment of deficits) for agents at a lower level. It is the differentiation of the system which gives scope to private initiatives while its centralised instance, product of, but distinct from, private interests, unifies the space of commodity exchange. Because central money does not enter into all credit relations it is shielded from the mistrust which would otherwise arise whenever a particular deficit position becomes untenable.

The dialectic of homogeneous, fractionated and hierarchical systems seems a well-developed framework in which to approach such questions as the endogeneity of money or the relations between central and commercial banks. It forms the basis of a discussion by Aglietta and Orléan of monetary crises.

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Inflation and deflation

It is an aspect of the monetary concepts elaborated in VM that monetary disorders, whatever their technical complexity, have an inescapable social and political content. Money is a sovereignty, a political structure which constitutes the market system. 'The monetary question is a fully political question.'[13] At stake in the transformation of such systems are the reallocation of property and the nature of restructuring processes.

The text of VM examines, firstly, pure forms of crisis, those in which adaptations fail to restore stability and in consequence lead through cumulative processes to a complete breakdown of the monetary order. It is not, however, suggested that such pure forms are typical of monetary history; more usual are situations where instability is limited and controlled. The difference hinges on whether restructuring initiatives by creditors or debtors succeed in isolating disturbance or whether in contrast the deflationary or inflationary impulses return to their initiators in an aggravated form, beginning a vicious cycle which leads to spreading instability. The mark of inflationary crisis is centralisation: refinance, first by powerful intermediaries but finally by the central bank, shields embarrassed debtors from property transfers to creditors and extends the horizon over which they may attempt to restructure their positions. It is centralising because it protects the economy as a whole from the brutal severance of established exchange relations. The success of such debtor-led restructuring can

lead back to stability and a gradual reorganisation of stable credit relations. Its failure on the other hand will multiply the initial pressures on intermediaries. A study of the hyperinflation in Weimar Germany is used to illustrate this logic: contrary to quantitativist interpretations, the crisis is seen as running through distinct phases with differing macroeconomic characteristics: the functions of the *Reichsmark* are impaired in a specific sequence as it ceases firstly to be a unit of account, then a store of value and only at the very end a means of exchange. It is at the second stage, for instance, that the exchange rate begins to drive the inflationary process much more rapidly than any consideration of money quantities would render plausible. The culmination of the process is a unanimous flight towards hard currency as an alternative form of monetary wealth; throughout the process the division between debtors and creditors forms the basis of an underlying social conflict; the refusal of big industrial debtor interests to bear any large share of the public debt accumulated through the First World War conditions the inability of the authorities to establish a coherent stabilisation project.

The decentralising and deflationary character of creditor-driven restructuring is examined in less detail in VM because it had already received definitive treatment in the works of Keynes and the Keynesian school. In this case the hierarchical structure tends to collapse into the fractionated, rather than the homogeneous, system. Debtors are here exposed to drastic transfers of property under pressure from creditors: correspondingly, investment time horizons are drastically curtailed towards the imperative of immediate settlement. Although pure cases, leading to the breakdown of the monetary order, are rare, a canonical example is offered by the demonetisation of gold as international money during the Great Depression. It is important to note that the two types of crisis are not simple opposites. This is because both centralisation and decentralisation of credit relations are possible responses to the same types of tension between borrowers and lenders. Also, in both cases the cumulative exacerbation of the initial disturbance leads ultimately to the demonetisation of the previously established central money and the definition of a new monetary object through the working out of the crisis itself. In both cases the gradual loss of differentiation among economic agents and the spread of their imitative behaviour as they seek for secure forms of wealth, culminating in the unanimous fixation on a new elected/excluded asset, drives the crisis from one phase to the next.

Money and socialisation

A somewhat later text, uncluttered with Girardian imagery, gives a clear view of the implications of the VM analysis for the socialisation of agents in a commodity economy.[14] Three approaches are contrasted (and represented conveniently in figures). The Walrasian system (see Figure 1), with its well-known requirements, such as the complete transparence of exchange relations, has to suppose that the desires of economic subjects are already given. This naturalist option implies what Aglietta calls the *postulate of nomenclature*.[15] Here 'nomenclature' designates a complete list of commodities, something like an idealised industrial classification, which specifies in advance all the

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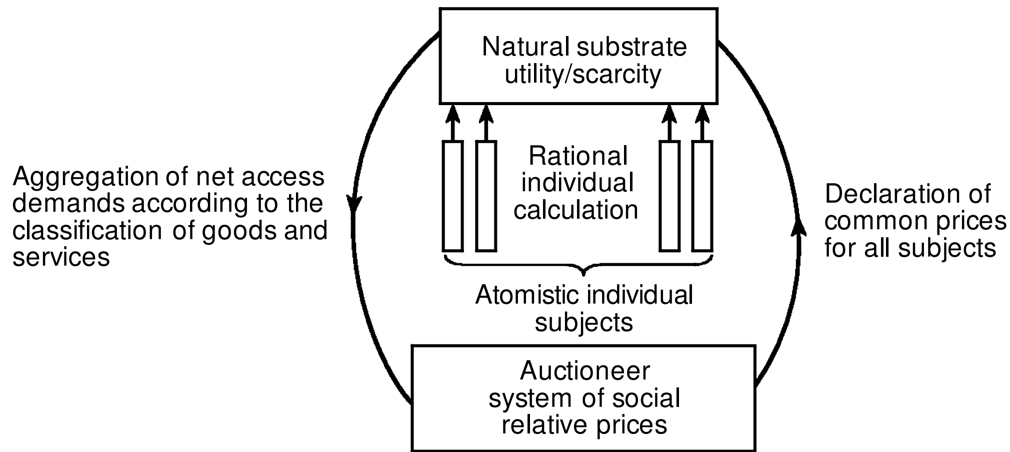

Figure 1. The *naturalist option*: subjects are elements of an objective nature. They do not enter into intersubjective relationships.

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qualities of commodities entering the exchange process, so that only the quantities endowed and exchanged remain to be determined. Thus the very first move in standard General Equilibrium (GE) theory, that is, to write down a vector of goods which is supposed to be known to every agent, already represents a conceptual error from the point of view of monetary theory. To escape from this *a priori* structure and to introduce the problem of intersubjective relations, 'it is necessary to put exchange at the origin: in the beginning there are no subjects already furnished with objective preferences; in the beginning is exchange. Desire is not the desire to overcome the obstacle of natural scarcity; it is the desire to exchange, that is to acquire a subjective economic identity by entering into direct relations with someone else'.[16]

On the other hand, the simple confrontation of two individuals (see Figure 2) does not resolve the problem of socialisation. Conflict (this text no longer says 'violence') is inherent in such a situation because successful exchange depends on the conjectures formed by each agent *vis-à-vis* the other. Since it is illegitimate to *presuppose* that the nature and intensity of individual desires is given as common knowledge, this unmediated exchange leads to an infinite regress, a game of mirrors where each party has to anticipate reactions which themselves depend on the anticipation of his own anticipations. Merely multiplying the number of such parties does not represent a solution unless one returns to the naturalist axioms of GE theory. The historical solution to the problem of socialisation in individualist societies is represented by money as a social institution which breaks the symmetry of the exchange process. 'An agent proposing an object for exchange now only enters into relation with a possessor of money, that is, not a double [model and rival, JG], but an individual who represents for the seller a social reference. For the buyer has in his hands money, the homogeneous mediator of any and all exchanges.'[17] This confrontation admits of a quantitative adjustment between the price assigned by the seller and that accepted by the buyer (see Figure 3).

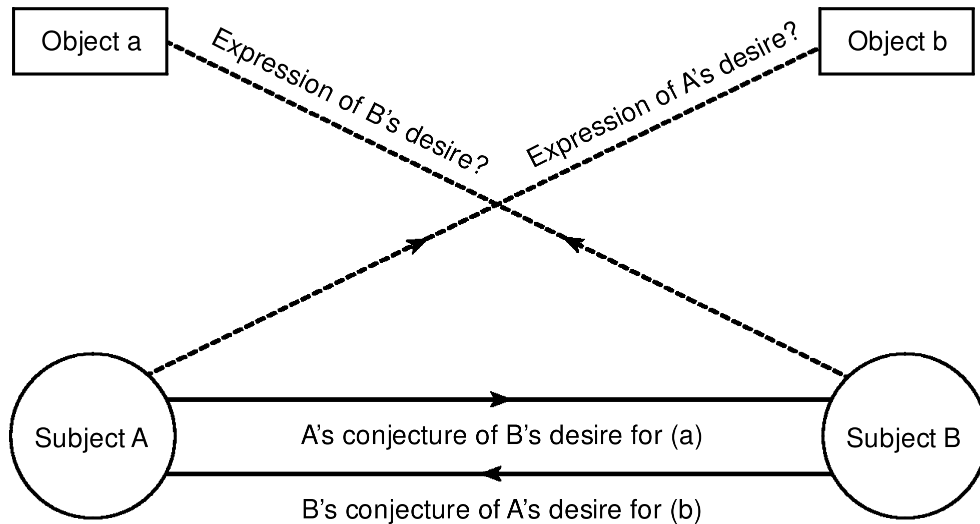

Figure 2. *Failure of socialisation*: individuals, exposed to the 'game of mirrors' of their intersubjectivity, are unable to form a social linkage.

Now financial tension is inscribed in this structure because nothing guarantees that the sums realised in monetary exchange will equilibrate the accounts of the participants. Rather, the emergence at any specified time of deficit and surplus units is inevitable. 'Far from being an appendix of the real economy, finance is the nervous system of the economy as a whole.'[18] Consideration of the recycling problem which emerges then leads to the dialectic of homogeneous, fractionated and hierarchical systems described above. The last of these is the only viable

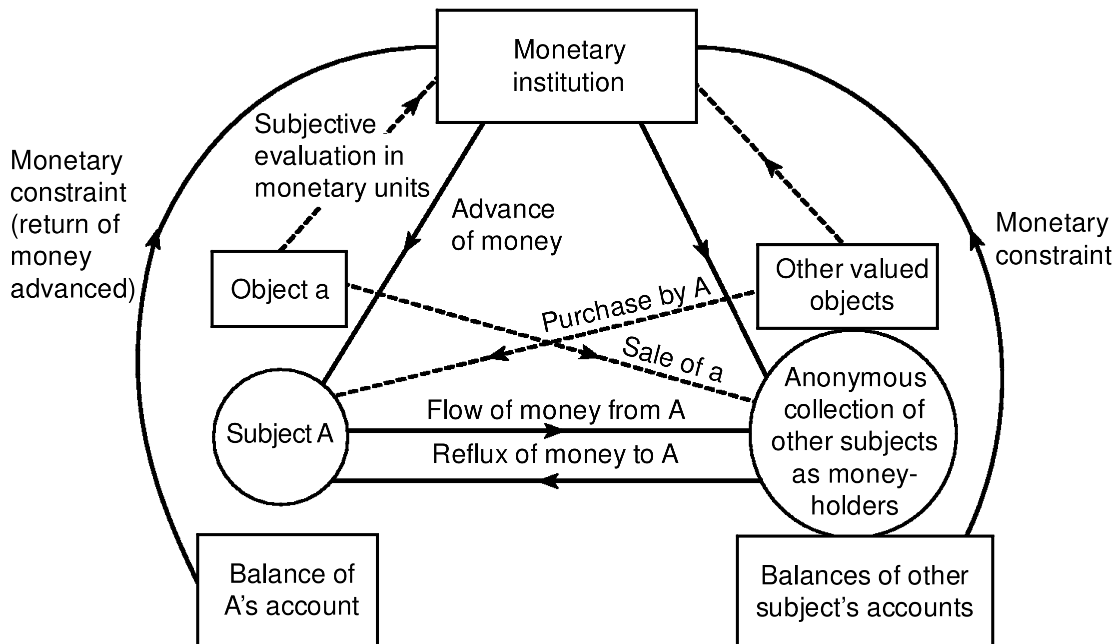

Figure 3. *The monetary option*: through the mediation of the monetary institution (the collective instance) individuals are able to give social expression to their subjective evaluations and to enter into direct relations by payment (exchange of every economic object against money).

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system over time. On the one hand, there must exist collective rules to determine the issue and destruction of money; on the other, these rules are better defended if the central issuing instance is not directly involved in the finance of (or refusal of finance to) individuals in deficit.[19] Thus the decentralised exchange economy becomes possible through the existence of a vertical, monetary, relation alongside horizontal exchange. The confidence in the monetary object which this requires is assured by its symbolic representation of the social totality (although it should be noted that this later text seems to recognise a variety of possible forms for such symbolism, which is no longer traced to sacrificial ritual).

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Applied studies

Following the appearance of VM, a large number of applied studies of monetary questions illustrated how its basic conceptual structure might help to elucidate concrete issues in monetary economics. It should be noted, however, that these studies never simply repeated the original analysis and that they were influenced by the contributions of other writers, especially those in the Keynesian traditions.[20] As responses to emerging questions of monetary policy through the 1980s and 1990s they are also conditioned by particular conjunctures. Nevertheless, it may be useful to examine briefly some of the themes addressed with a view to their relationship with the vision of monetary processes presented in VM.

The Volcker shock

One can begin by addressing a key monetary phenomenon which influences Aglietta's response to most contemporary monetary problems; the dramatic swing in US policy in the autumn of 1979 which is associated with the tenure of Paul Volcker as chair of the Federal Reserve System. US policy is discussed in considerable detail in VM itself and, although this text was too early to incorporate the actual *virage* brought about by Volcker, it gives prescient indications of the issues at stake. The discussion develops through a critique of monetarist doctrine to a heterodox interpretation of the inflationary pressures which precipitated the revolution in central bank doctrine and practice. The inflationary conjuncture of the late 1970s in the USA is presented as the triumph of debtor interests over the formulation of monetary policy.

As debtor-based restructuring failed to restore the bases of the postwar growth model, centralising policies became increasingly inflationary. Differentiation among financial agents and instruments was eroded so that the partially controlled disintermediation by which monetary restriction had been able to slow inflation in the 1960s became an ineffective weapon.[21] The loss of differentiation was also expressed by the increasingly universal indexation of credit instruments on short-run money market interest rates, so that the authorities could no longer use distortions in the spectrum of rates to limit credit expansion and were left only with the crude weapon of a drastic increase in rates as a whole.

However the Volcker shock is evaluated, it took place in a conjuncture where the impairment of the dollar's role as a store of value was tending to produce

uncontrollable waves of speculation in surrogate 'moneys'—real estate, oil reserves, gold and, above all, foreign exchange. Aglietta's analysis of the destruction of confidence confirms the view expressed by Hicks: it is a misunderstanding of Keynesian theory to believe that one can lock agents into productive investments by depriving them of a liquid asset; what rather results is a flight from both real productive assets and from financial assets denominated in terms of the unit of account; a search, increasingly imitative and unanimous, for an alternative money.[22]

The turning of 1979, later characterised by Aglietta as a 'revolt of the creditors', represents a break in postwar monetary and economic history even more significant than the break-up of Bretton Woods in 1971.[23] Governments and private agents are still coming to terms with the regime of high interest rates and creditor-controlled or creditor-sanctioned restructuring which it inaugurated, but the origins and nature of the Volcker shock are still insufficiently explored. It is indicative of the prescience of much of Aglietta's work that he identified so early the scale and significance of this discontinuity.[24]

International monetary regimes

The title of Aglietta's short book, *La fin des devises clés* (The End of Key Currencies), refers, first, to the decline of sterling and dollar hegemonies in monetary history and, second, to the possible disappearance of all such hegemonic structures from the international monetary scene in the future. International monetary systems can be regarded as a privileged field in which to examine the analysis of VM because the absence of a world government means that the monetary object cannot simply be designated; it must rest on the (imitative) interactions of agents. When the monetary object is not given from outside, liquidity depends on *confidence* in the sense of a relation of individual agents to the totality of the exchange economy: 'as with every collective phenomenon which is the result of public opinion, confidence in a particular form of liquidity is extremely changeable if it is not anchored in commonly accepted rules and guaranteed by credible authorities'.[25] 'Confidence in money means postulating that it will be accepted indefinitely and that in consequence it will guarantee the continuous and potentially unlimited realisation of commodity relations … Confidence in money is confidence in the perpetuity of the commodity order beyond the horizons over which individuals calculate.'[26]

The analysis of the sterling-centred international gold standard and of Bretton Woods as dollar hegemony corresponds to most accounts in seeing the former as a system of capital mobility, eventually undermined by monetary nationalism, the latter as a system of national monetary autonomy, destabilised by capital mobility.[27] It is suggested, however, that there is one basic similarity in the crisis of the two hegemonies: 'the key currency only has organising capacity to develop the pattern of international division of labour within which it acquired its hegemonic status, only to diffuse the growth model of the country which issues it, to the extent that this country possesses technical and social conditions of production more advanced than elsewhere'.[28] This historical limitation, however, is not seen as a real 'fundamental' which determines monetary

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developments so much as a source of rivalries which can release the destabilising forces latent in international systems, where the primacy of common rules over competitive arbitrage is always fragile.

Aglietta argues that the reference to gold during the period of sterling hegemony did not involve any calculated assessment of the stability of its purchasing power so much as an unshakeable faith in its intrinsic value, what he calls a religion of money. Thus the long secular price swings of the 19th century were not reflected in variations in long-term interest rates as would be expected if agents were calculating in terms of purchasing power rather than simply accepting the validity of nominal magnitudes. The strength of the monetary order does not result from its capacity to answer every possible challenge of speculative attack but from a confidence, often based on mistaken interpretations, which puts the monetary object beyond question.

As opposed to this religion of the 19th century, monetary nationalism, associated with the assertion of social priorities against the commodity economy, represented a certain desacralisation of money.[29] Convertibility under Bretton Woods became an instrument of macroeconomic policy rather than a respectful tribute to the nominal value of private contracts. However, as with the breakdown of the convertibility rules of the gold standard, market interactions cannot build a new monetary organisation. 'The institution of a new principle of convertibility, on which new rules and new structures arise, is not an economic process. It is an act of sovereignty.'[30]

While the collapse of the gold standard was a classical decentralising crisis, the aftermath of dollar hegemony is characterised as an international debt economy, in which no rules limit the externalities emerging from uncoordinated national policies and in which financial functions and the trade-off of yield and risk are distorted by the absence of a clearly defined international monetary asset. 'When the monetary is reduced to the financial, disorganisation prevails.'[31]

The brief restoration of US hegemony in the early 1980s, when for a few years the US balance of payments again became the main source of international reserves, having failed, the way forward is considered. Aglietta cites Keynes on the desirability of a supranational system, but regards this as only a solution in the very long term. His view is that in the near future a system of *institutionalised cooperation* among the major economic groupings is both possible and desirable.[32] A more recent paper amplifies this argument.[33] Neoliberal interpretations of international monetary phenomena are considered inadequate because they rely on the *a priori* assumption of controlling, 'real', fundamentals and misapply the model of perfect competition to interactions among currencies. 'Imitative behaviour can dominate the influence of any exogenous factors.'[34] In contrast an attempt is made to apply network theory to the pattern of international payments; infrastructural economies of scale can lead to a strong concentration on a single currency, but information structures may tend to a certain regionalisation of payments functions. As in standard theory, each country has to trade off monetary autonomy, exchange rate stability and freedom of capital movements. But it is argued that viable international monetary regimes must display a certain convergence of these national choices in order to reduce the *systemic risks* (see below) to which decentralised structures are exposed.

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Viable regimes must establish rules which are compatible with the national social compromises lying behind the policies of individual countries and lead to predictable, rule-governed, exchange-rate structures. While predictability for individual agents militates in favour of relatively fixed rates, substantial flexibility is needed to allow countries to respond to disturbances. On the other hand, to give complete priority to adjustments at national level would make for an unpredictable overall structure and promote self-fulfilling, destabilising speculation. The most credible international regime would be based on the co-responsibility of leading currency blocs. Cooperation should be more ambitious and wider-ranging than the *ad hoc* agreements of the 1980s and should involve interest rates as well as exchange rates. Some codification of mutual obligations is seen as giving institutional expression to this principle of co-responsibility.

European monetary integration and the parallel currency

Aglietta has returned frequently to the issue of European monetary integration. As the Economic and Monetary Union (EMU) process became increasingly specified by the Maastricht Treaty and the convergence process which followed, some of his earlier work became obsolete in policy terms, but it is still interesting to consider his contribution to the French argument for a parallel currency road to monetary union because this illustrates how the abstract analysis of VM could guide more concrete discussions.[35]

French advocacy of the parallel currency strategy reflected the two enduring interests of France in EMU: to challenge both the global hegemony of the USA and the more local hegemony of Germany over European responses to that global environment. The development of the external role of the ECU could become a preferred path towards closer European integration because it would tend to preserve degrees of freedom in the internal policy of EU member countries while transforming the nature of the external monetary constraint. The general notion was that member states would hold reserves in the form of ECUs issued by a central agency which would be able to define a common policy on the ECU/dollar exchange rate and manage the amount and distribution of ECU reserves. Integration would proceed from outside in, since the first goal would be to articulate a united strategy *vis-à-vis* non-members and then only gradually to harmonise domestic monetary policies.

Aglietta's specific contribution to this debate concerned the line of evolution needed to develop the actual ECU (as of the mid 1980s) into such a reserve asset. It conforms closely to the logic of VM in that it focuses on the interactions between money and finance. In general, the financial function—allocation of capital—requires monetary stability because in the absence of a clearly defined monetary asset as the highest form of liquidity it becomes impossible to define clearly the risk/yield trade-offs necessary to allocate capital resources. This consideration led to the view that the key weakness of the ECU was the separation of its public and private circuits; there existed both a growing market for ECU issues and a distribution of ECU-denominated reserves to member-state central banks in the context of the European Monetary System (EMS), but there

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was no connection of the former to the latter. ECU reserves were necessarily decomposed into national currencies prior to use in forex interventions. Thus no mechanism existed through which an evolving common external monetary policy could impact on intra-European financial flows. Aglietta attempts to define reforms that could overcome this design fault while leaving a measure of autonomy to member states as regards their internal policies. The method envisaged was to promote the private use of the ECU to make payments and the emergence of a spot exchange market for ECUs. The latter would allow a common monetary strategy (on the general level of interest rates and on the average value of European currencies *vis-à-vis* the dollar) to impact on and orient the decisions of private financial agents. Any such reform would be complicated by the absence of strong institutions (the European Monetary Fund, originally seen as a complement to the exchange rate mechanism within the EMS, had not been introduced), but an attempt was made to define a possible approach. Subsequently, of course, the complete dismantling of European forex controls made such proposals obsolete, because the margins for, even merely internal, monetary autonomy in member countries were narrowed drastically; but the reasoning does illustrate the understanding of monetary systems as hierarchical systems which had been laid out in VM.

It can be added that the judgement of the early phase of the EMS to be found in this text is much more severe than the usual conclusion that forex and credit markets were stabilised. This reduction in volatility is recognised, but is seen as relatively superficial; behind it lies the failure of European countries to define a collective response to the Volcker shock and the dramatic appreciation of the dollar; this failure intensified the European recession of the early 1980s.[36]

The independent central bank

An essay appearing in *Annales* considers the origin of central banks and the notion of their independence.[37] The evolution of a dominant private bank to an essentially public role is clearest in England but can also be seen in the USA of the 19th century, where regional banking clubs concentrated reserves and started to take responsibility for both prudential supervision and emergency refinance in times of crisis. The US pattern of development, however, is truncated, since the decisive step of abstracting the emergent central bank from the usual rules of competition was not taken before legislation established the Federal Reserve System. Aglietta relates his historical account to a theorised move from 'free banking' to the modern two-tier structure—which reflects the dialectic of fractionated and hierarchical systems in VM. Although similar readings of this evolution can be found elsewhere,[38] Aglietta insists on the political nature of the completed process, most apparent in the central bank's role as lender of last resort. 'This is an operation outside the scope of the rules of competition. There is a violation of the market since private engagements are not respected; but the sanction for this is suspended for an indeterminate period by a sovereign decision, not delayed by contractual means.'[39]

These historical reflections lead into a discussion of the meaning of central bank independence today. The disappearance of the 'sacred' reference to gold

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does, it is suggested, introduce the need for a nominal anchor as the basis for confidence in the monetary unit, although it is not claimed that securing this anchoring must be the only, or even the predominant, objective of monetary policy. 'The principle of price stability, which legitimises the independence of central banks, is a reference framework for decision-making, not a rule which is substituted for decisions. This reference expresses a representation of the monetary constraint which is commonly accepted in contemporary economies and which is institutionalised.'[40] Protection of finance and credit against systemic risk, and hence the functions of prudential supervision and lender of last resort, thus remain central to the role of the central bank. It follows that two types of discretionary action have to be possible—on the one hand, a strategic change in the nominal anchor deployed (for example, the adoption or abandonment of an exchange rate peg); on the other, the scope and duration of tactical departures from the rules of emission implied by a given anchor. *Independence*, in Aglietta's account, *is not an institutional separation of the central bank from the executive but rather a guarantee that these indispensable discretionary powers will be exercised in the general interest and not in that of particular debtor or creditor groups*. He contrasts the form of this guarantee in Germany, where the wide contact of the Bundesbank with regional financial and economic developments and with savers' associations and regional authorities makes for a certain control over public opinion, and in Britain, where the basis of independence (prior to the recent reforms, it must be noted) was the permanent interrogation of central bank policy by both parliament and the press. Both structures are seen as compatible with democracy, but the suggestion remains that confidence in the monetary unit escapes, to some extent, from rational analysis:

> The central bank furnishes a guarantee against the arbitrary nature of the monetary sign, a rampart against nominalism. This guarantee must be an intimate belief of private agents, while, however, modern economic culture forbids us to give this guarantee the symbolic form of a 'natural' reality. It is nevertheless sure that a unanimous belief, if it is to be solid and persistent in those crisis situations where the central bank is led to adopt policies very far from its habitual behaviour, can only function in the manner of a myth. From this stems its symbolic character. It is not an exchange with individuals but a pact with society. *Confidence is not established by a contract but enacted through a ritual.* The myth consists in the belief that the institution is outside the conflicts which run through society; which gives to it the status of an impartial mediator.[41]

This insistence on a certain necessary misrecognition of monetary phenomena is a central difficulty of Aglietta's thought and is discussed again in the concluding section.

Systemic risk and financial globalisation

In recent years a growing number of Aglietta's concrete studies have concerned

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the process of financial globalisation. These include, for example, detailed studies of Russia and Japan which it is impossible to review here.[42] But one can characterise briefly a more abstract account of the problem of systemic risk in globalised finance.[43] The initial discussion of systemic risk in general, with its heavy emphasis on imitative behaviour, recapitulates some of the analysis discussed above. The position coincides most closely with the line of post-Keynesian theory developed by Minsky, including the latter's account of an endogenous tendency towards increasing financial fragility. However, use is also made of several more formal accounts of financial disturbance, such as 'rational bubbles', the 'peso problem' and 'sunspot cycles'. These models are seen as offering particular 'patterns' of imitative–speculative behaviour (*figures de la spécularité*); their use requires a reference to a more fundamental level of theory which makes the unreadability of macroeconomic constraints by individual agents the basis of an account of cumulative, imitative, destabilisation. The derivation of central bank responsibilities—regulation, prudential supervision, emergency refinance—from this instability follows both in theory and in evolutionary practice.

However, it is argued that, in industrialised countries today, 'the violence of financial crises has been attenuated to give place to "systemic risk" … if all the elementary sources of past crises—imitative/speculative behaviour, blindness to system-wide disasters, contagious loss of confidence—continue to be omnipresent in our economies, their working has not led, for a period of now several decades, to the appearance of chain reactions with consequences comparable to those observed only half a century ago … systemic risk is the form taken by financial catastrophe when some control over it is successfully maintained'.[44] These risks, nevertheless, are seen as increasing both because of more intense financial relations as such and because of growing interconnections among financial systems. In this context, Aglietta, writing here with Anton Brender, develops a typology of systemic risks.

First, *breakdowns* (*pannes*) are system failures intrinsic to the financial system as such, arising as a consequence of failures in the functioning of the payments system or of important market-makers, both of which are limited in capacity and procedures. Both payments and market-making mechanisms can come under increasing pressure from the volume of transactions effected by institutional investors and from a phase of intense competition among markets and financial centres. Some of the phenomena of the 1987 stock-market crash—programme trading, 'triple-witching hours'—are offered as examples.

Accidents, on the other hand, are seen as the consequences of localised (sectoral, regional) economic failures for a financial system which has not succeeded in adequate diversification (there is, as is pointed out, an unavoidable tension between such diversification and the specialisation of intermediaries needed for local efficiency). On a limited scale, widespread bank failures in agricultural states of the USA in the 1980s illustrate this kind of accident; but the crisis of Latin American debt, following the rise of US interest rates in 1979 and the recessions of 1980–82, is also placed in this category. The previous credit expansion towards these same countries is also seen as having involved

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speculative imitation: 'a reading of available testimony shows indeed that in numerous, or even in most, cases, banks extended their loans to the South, not because they had analysed the growth prospects of each of these countries, but because they had the idea that their predecessors in this lending had done so and had concluded that these were promising markets'.[45] The possibility that these first lenders were mistaken was ruled out, even though the downturn in the international cycle showed how delicate a matter such country risk could be; similarly, those joining the rush into sovereign debt ruled out the possibility that such imitation would itself subvert the premises on which earlier loans had been made.

Finally, a *drift* (*dérive*) is not a crisis within the financial system, but a persistent failure of the latter to regulate the real economy. Examples are the distortions which can be produced by a rapid growth of consumer credit or in the credit available for take-overs, even if the banks and credit markets which supply these borrowers with funds are never put at risk. A more structural example of a drift arises from the impact of the portfolio preferences of institutional investors on the relative prices of assets. In the context of globalisation, such drifts had a clearly inflationary tendency in the 1970s, but today they seem more likely to slow down the supply of bank credits to private agents.

The general conclusion of Aglietta and Brender is that the 'cognitive resources' of the financial system depend almost exclusively on the analysis of past regularities, but that these regularities are impossible without the action of a centralised agency which can assess the macroeconomic impact of financial developments and supply necessary guidelines to financial agents. In present circumstances, such an agency would have to operate on an international scale.

The scene of the crime

La monnaie souveraine (MS), published in 1998, can properly be regarded as a collective and not merely a collected work. It is the fruit of a long interdisciplinary inquiry, bringing together economists, anthropologists, historians and psychologists over several years. It rests on the elaboration of a common set of concepts and their deployment in order to account for the monetary phenomenon.[46]

Such an interdisciplinary approach is necessitated by the basic logic of a monetary theory of markets and by the rejection of the standard attempt to derive money from the exchange process. If money lies at the origin of the commodity-producing economy as a distinct sphere, then, from the point of view of economic theory itself, money must be *presupposed* and only a widening of the inquiry to other social sciences can account for its emergence. As Aglietta and Cartelier put it, 'money is logically prior to market relations' and 'money is a social tie more fundamental than the market'.[47]

At the same time, MS seeks to provide more secure anthropological foundations than those of VM. In this respect the later work involves an attempt to substitute a solid, empirically grounded anthropology for the speculative anthropology of Girard.[48] Thus the discussion of monetary phenomena in pre-modern societies is extremely detailed and recognises a very wide variety of both social

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practice and symbolic interpretation. Nevertheless, a unified account does emerge. The starting point is the notion of *debt*, understood as a debt of the individual to the social totality. This totality is not to be seen simply as a power structure but, in essence, as defined by a hierarchy of shared values. These values may well sanction a marked differentiation of social positions, but, since they are values, their acceptance is a matter of *authority*, not of power. Since the perception of such a debt is commonly an aspect of a religious world-view, there is a link to Durkheim's anthropology.

Money in general, then, becomes the means, the specific rules and practices, by which the obligations stemming from this social debt are discharged. Only a few illustrative points will be taken to indicate the kind of interpretation to which this leads. The study of a Melanesian society by Daniel de Coppet reveals a complex monetary system of considerable sophistication.[49] Flows and counterflows of money (beads made from shells) are subject to precise laws: at times, for example, during funerary rites, there is a centralisation of money; at others, a wide dispersion. What differs most clearly from modern societies is the significance of the monetary phenomenon which is here essentially ritualistic—monetary concentrations enact the cult of ancestors while dispersions then link the other spheres of social life, such as cultivation, to the rites which are seen as the highest form of existence. Charles Malamoud examines the use of money in the sacrificial rituals of Vedic India.[50] This Indo–European example perhaps comes closest to the sacrificial structures postulated by Girard since there is a clear substitution of monetary payments for more primitive and bloody offerings. The census of ancient Rome, analysed by Jean Andreau, moves us much closer to modernity since one can now detect the emergence of distinct political and even economic spheres in society, not tied essentially to the 'domain of the sacred'.[51] Here again, however, the claims of the social whole remain primary: monetary assessments are part of a more general process which assigns to each citizen his place in the polity, including his military rank; in the monetary aspect of the census fiscal obligations have primacy over any market-based evaluation of social status.

Finally, Jean-Michel Servet discusses the transformation of monetary processes brought about by Western colonisation in Equatorial and West Africa.[52] His analysis includes an interesting account of the myth of barter in European thought which he sees as a blindness towards the forms of social organisation dislocated or even suppressed by the colonialists:

> The barter by which African exchange systems have often been characterised is not, as is generally claimed, a primitive, pre-monetary stage revealed by the presence of the West. This expansion of barter exchanges is a consequence of the demonetisation of the previous systems by the colonial states and the result of the monetary development of colonised societies subject to constraints or beginning with the specific dynamic of 'commoditised' activities.[53]

No attempt is made in MS to construct an overarching or universal social theory. The social whole to which reference is made is, in every case, defined by a

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specific hierarchy of values. But there is a kind of second order universalism in that, within each society, money is seen as having a general relation to the social totality. Contributions by Jean-Marie Thiveaud and Mark Rogin Ansprach attempt to elaborate these general relations and to prepare the way for the analysis of modern monetary systems.[54] The first insists on the primacy of the financial over the monetary in the sense that the discharge of obligations to society as a whole is the basic datum; the evolution of monetary practices is then a means by which these obligations can be codified and organised. At the same time, money, like the development of writing or of science generally, does represent a certain secularisation and rationalisation of social organisation. 'The use of struck coins, in the distant eras of antiquity, represents one of those phases of human evolution when knowledge and technique advance together.'[55]

Ansprach insists on the element of continuity between pre-modern and modern monetary systems. This is the *vertical* relationship of human beings to the sovereign social totality:

> Even if we have lost sight of the sacrificial stake, the vertical axis remains. It is still the relation to the community as a whole which is expressed by money. But, instead of being displayed in broad daylight, like the bead curtains [of the Melanesians] … this relation is henceforth hidden as by a veil. The monetary veil is interposed between exchangers and allows them to act as isolated individuals, outside any traditional social ties. Nevertheless, it is only by virtue of this very particular relation to the community as a totality that individuals can behave as though the relation to the totality did not exist.[56]

How are we to see modern monetary relations in the light of this revised anthropological model? The task is undertaken in the introduction to MS and three of its chapters. Firstly, the vertical relation, the debt to society, is profoundly modified. Financial obligations are now broken into a multiplicity of debts to other individual agents, even though honouring these debts remains a social rule and one that can only be expressed through the social institution of money. Meanwhile, the directly vertical relation between the whole and the parts is inverted. Political structures, especially welfare states, become the debtors of individual citizens.[57] Now if these two changes were complete, then monetary relations would indeed have become purely instrumental, tools in the hands of autonomous individuals for whom society is merely the sum of their interactions. The values involved, both individual liberty *and* equality, are individualistic.

> What, however, distinguishes our analyses from the views which predominate in economic theory, is the recognition that it is impossible to complete these two developments. We consider, in effect, that this impossibility expresses the fundamental constraints which every human collectivity must respect. In other words, the growing autonomy of the economic sphere, the instrumentalisation of collective institutions and the primacy of power relations over relations of authority do not delineate a coherent

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> social model. On the contrary, the latter presupposes the subordination of power relations to a principle of authority.[58]

In consequence, money does not arise as, but only becomes, an *economic* object and this transformation is never completed; a social authority (not merely a power centre) is required to establish and maintain its economic status. At this point the economists make their contribution to the work as a whole.

The argument of Orléan is essentially critical.[59] He chooses the overlapping generations (OG) model of money as encapsulating the attempt to account for monetary phenomena on the basis of purely individualist behaviour. In the OG model, intrinsically useless monetary units are accepted simply because they are accepted; this is described as a purely self-referring (*autoréferentielle*) explanation. 'No form of symbolic guarantee is required. Agents perceive each other as rational subjects moved only by the search for maximum profits.'[60] Orléan's argument, both theoretical and empirical, is that this reasoning is a *reductio ad absurdum* of its individualist premises—because of the fragility and instability of the equilibrium which has to be assumed.

Aglietta himself, in a joint paper with Jean Cartelier, attempts a positive characterisation of the modern monetary system, starting from the view that money, socially given, is historically and logically prior to market relations.[61] The basic task is the classical one of reconciling the decentralisation of market economies with the economy-wide interdependence which is necessary for their coherence. Abstracting completely from the 'real' commodities and assets which enter into exchange,[62] the writers seek this reconciliation in the monetary sphere, specifically in the workings of the payments system. Their stylised account of payments systems is laid out in three steps.

First, the specification of a common unit of account; Keynes' *Treatise on Money* is cited in defence of the primacy of this concept. 'It is through it that relations among individuals can take a quantitative form.'[63] This in turn requires both a sovereign instance to define the unit and a nominal anchor to secure its permanence. Second, the process of primary monetary issue (*monnayage*); it is access to means of payment which gives, to those agents who enjoy it, their economic autonomy. Although we can envisage this process as the coining of specie in an idealised metallic system, in contemporary systems such access is a question of capital. 'In a credit system, it is the amount of capital and its liquidity which will determine the capacity for action which individuals have in the market.'[64] Nevertheless, we find here also a vertical dimension: the means of payment reveals 'a super-individual element, or if one prefers, a vertical relation of individuals to an organising principle', embodied in a clearing house or central bank.[65] Third, a viable payments system requires a principle of settlement: just as was indicated above in the discussion of socialisation, financial tensions are implicit in a monetary economy since there is no reason why the closing balances at the end of any period should correspond to its initial monetary issues. The principle of equivalence is violated by these non-zero balances. Their settlement, or the general acceptance of their being carried forward, thus becomes the third component of the payments system and the only

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actual means by which the 'sanction of the markets' and the rule of equivalence is enforced. Since the question is one of reabsorbing tensions in the payments system or matrix, here again vertical relations are involved.[66]

Although MS, unlike its Girardian predecessor VM, does not develop an elaborate theory of monetary processes themselves, the indications are that it leads to a very similar account of monetary instability and of centralising and decentralising crises—now denoted, in more orthodox terms, as a loss of nominal anchorage on the one hand and systemic risk on the other. What is attempted is an account of the general condition of *confidence* which holds critical factors at bay. Confidence is seen as having three key forms.[67] *Hierarchical* confidence is the most familiar of these since it can be identified with confidence in the central bank as a sovereign authority, in its competence and reliability. *Methodical* confidence applies to the level of market agents themselves and derives largely from the routine and repetitive nature of transactions. It can perhaps be related to the notion of *trust* among economic agents. The term 'methodical' is used because this trust rests on 'suspicion, scepticism, mistrust, infinite procedures of assurance and reassurance, the work of inquiry and supervision'[68]—thus counterparties are trusted because methodical procedures hold them to their undertakings. Once again, breakdowns in confidence can propagate rapidly through imitative processes, just as imitation spreads confidence and tends to promote it from the individual to the collective plane. Finally, *ethical* confidence results from the perceived conformity of monetary institutions to the (individualist) ethic which prevails in market societies; it corresponds to the belief that the authority of the central bank will be used to reinforce and not to threaten the continuity of contracts through time.

The independence of central banks is seen, by Aglietta and Cartelier, as closely linked to globalisation. The sets of agents linked by payments systems correspond less and less with the populations of states: 'the independence of central banks is the institutional form of a monetary legitimacy which transcends the national framework'.[69] The dangers of such developments are well expressed in the introduction to MS:

> These [national] principles of economic organisation express the higher values by which European societies sought to establish their unity at a certain period of their history: a constitutional order protecting the mission of the central bank in Germany, the general interest incarnated by the state in France. These forms of sovereign authority have been subjected to the test of the international expansion of the markets. While the constraints of economic integration unbalanced national governance systems, economic liberalism destroyed the policy doctrines by which the same systems were legitimised. The hour had come of the only correct thinking. Indeed, the globalisation of finance has given decisive force to transnational financial opinion so that national economic policies are no longer judged according to the hierarchies of value which used to legitimise them. Conflicts between national principles of economic governance and the vagaries of

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> financial opinion have, for more than fifteen years, punctuated the alternations of confidence and mistrust in national economic policies.[70]

Whether the advent of the euro can do anything to resolve such problems is, very wisely, left as an open question.[71]

Conclusion

This essay serves its purpose if it suggests the interest and contemporary relevance of a neglected body of monetary theory. To conclude, a few remarks will be made on Aglietta's work as, first, a research agenda and, second, a set of substantive propositions.

At least since the contribution of Patinkin,[72] the monetary research programme of mainstream economics has been to reconcile, within formal models, the theory of money with the Walrasian, general equilibrium, version of the theory of value. This programme is surely degenerate. It has given rise to some plausible accounts of specific monetary effects, but these invariably rest on a *petitio principii* (money as an argument of preference functions, or a 'cash-in-advance' rule to exclude barter). Where any degree of generality is attempted, definite results are impossible to obtain; one simply gets the result that anything can happen.[73] Although some 'new Keynesian' writers have tried to advance the same research agenda by emphasising certain aspects of Keynesian theory, it is hard to say that they have been rewarded with any greater degree of success. Where interesting results are obtained they rest on some form of untheorised assumption, such as the non-clearing prices postulated by Benassy, for example.[74]

Aglietta, together with Cartelier and Orléan, invites us to draw the logical conclusion of this failure. Monetary theory and value theory are alternatives, not complements.[75] To develop the first, one should begin with the radical rejection of the second. Certainly, much of the work of the post-Keynesian school tends in this direction, but rarely with the decisiveness and clarity of these French writers. Some results of this alternative programme have already been displayed. Two examples discussed above are a reconsideration of the significance of money as a unit of account and the need, once one has adopted the position that markets rest on money and not the reverse, to conduct an interdisciplinary investigation of the origins and social supports of monetary relations. Of course, this radicalism (some may see it as nihilism) presents its own difficulties. In some way one must reintegrate, even in a subordinate place, notions of resource constraints, preferences and so on. Some of Aglietta's writings give hints as to how this might be done. The notion of a relatively stable growth path indicates the circumstances which best reconcile a developing division of labour with confidence in the monetary order. But now this reconciliation has a different meaning: it is not a question of a pre-given 'real' equilibrium, still less of social optimality, but rather of a condition of existence, a constraint, on the primary monetary phenomenon.

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When one moves from this metatheoretical level back down to the more prosaic plane of substantive analysis, the work of Aglietta is more heterogeneous, but it always illuminates the specific topic under examination and can frequently lay claim to conceptual originality. If a few interesting aspects of this, by now voluminous, body of work are to be emphasised the list might include, first, the incorporation of the notion of liquidity into a wider notion of confidence—agents are concerned not only with the convertibility of their assets into money, but with the reliability of the monetary unit itself and the perpetuation of the exchange economy as a whole. All of these are seen as social constructs. Second, this is related to the key issue of imitation, which can certainly be explored by orthodox game theoretical methods but which takes on its full significance when one avoids the over-strong postulates which game theory makes about both motivation and interactions. Third, Aglietta's work has important implications for the debate on the endogeneity or exogeneity of money in both theory and practice and proposes a complex synthesis of the conflicting positions involved.

Finally, one can return to the argument, somewhat surprisingly repeated in *La monnaie souveraine*, that economic agents fail to understand the monetary system in which they act, that they are necessarily victims of a misunderstanding (*méconnaissance*) with respect to this central and determinant institution. In the Girardian phase this cognitive failure was the direct consequence of a metaphysical ontology, a lack of authenticity in all human beings. If this metaphysics is discarded, why is it still claimed[76] that there is 'an irreducible opacity of the social totality for the individuals who act according to the fundamental rules of money'? In the premodern cases this is simply the result of the sacralisation of society as a whole. But why do the agents of the market economy, having desacralised all relations and accustomed to interrogate every institution from an instrumental point of view, continue to depend on such myths as that of the independent central bank?

The answer appears to lie in the hierarchy of values which governs the economic relations of modernity. In different ways both egalitarian and liberal ethics accord absolute primacy to the development of the individual. It is an ethical myopia which blinds us to the social constitution of the individual and perpetuates the claims of an unrecognised community in the form of the 'malignant power of money'.

Notes

1. Michel Aglietta & André Orléan, *La violence de la monnaie* (PUF, 1982); and Michel Aglietta & André Orléan (Eds), *La monnaie souveraine* (Odile Jacob, 1998).
2. The only accounts known to the present writer are Michel De Vroey, 'A Non-monetarist Monetary Theory of Inflation', *Cambridge Journal of Economics*, Vol. 8, No. 4 (1984), pp. 381–99, which lays out a similar view of inflation to that of Aglietta, but which is focused on this single analytical issue; and Robert Guttmann, *How Credit-money Shapes the Economy: The United States in a Global System* (M.E. Sharpe, 1994). See also John Grahl, 'Economies Out of Control', *New Left Review*, No. 185 (1991), pp. 170–83, which attempted to apply some of these monetary concepts to the existing conjuncture.
3. Michel Aglietta, *A Theory of Capitalist Regulation: The US Experience* (New Left Books, 1979). For a recent reappraisal, see the postface to the new edition of *A Theory of Capitalist Regulation* (Verso, 2000) which appeared in shortened form as Michel Aglietta, 'Capitalism at the Turn of the

Century: Regulation Theory and the Challenge of Social Change', *New Left Review*, No. 232 (1998), pp. 41–90.

4. Compare Michel Aglietta, 'Monnaie et inflation: quelques leçons de l'expérience américaine des dix dernières années', *Economie et Statistique*, No. 77 (1976), pp. 49–71.
5. This essay will not explore Aglietta's precursors in any detail. They include what are known as the 'circuit theorists', such as Bernard Schmitt, who in turn influenced the work of Cartelier (see note 62, below). A comprehensive survey of 'non-conformity' in French economics can be found in Jean Weiler & Bruno Carrier, *L'Économie non-conformiste en France au XXe siècle* (PUF, 1994) which includes references to publications, frequently in English, by many of the most prominent figures.
6. See especially René Girard, *La violence et le sacré* (Grasset, 1972).
7. For an anthology of positive and negative reactions, see Paul Dumouchel, *Violence and Truth: On the Work of René Girard* (Athlone, 1987); for a sympathetic but rigorous critique, which measures Girardian hypotheses against a wide range of evidence, see Paisley Livingston, *Models of Desire: René Girard and the Psychology of Mimesis* (The Johns Hopkins University Press, 1992).
8. Classically, the term *mimesis* refers to artistic representations and thus to the imitation of nature. The Girardian term refers rather to imitation of some other person, taken as a model. There is an overlap, however, in the art of Greek tragedy which Girard interprets as a partially secularised ritual. The rest of the present essay simply uses the term 'imitation'.
9. The work of Attali cited by Aglietta & Orléan, *La violence de la monnaie*, is Jacques Attali, *Les trois mondes* (Fayard, 1981).
10. See, for example, Fernand Braudel, *Économie et capitalisme, Vol. 2: Civilisation matérielle* (Colin, 1979).
11. In this context a contrasting influence in VM to that of Girard can be mentioned—Prigogine's attack on reductionism in the natural sciences (for example, Ilya Prigogine, *From Being to Becoming: Time and Complexity in the Physical Sciences* (W. H. Freeman, 1980)). Reductionism (of all sciences to physics) can be refuted by the demonstration of self-organising processes which, on the basis of given physical laws, themselves can lead to new, higher-order systems. This becomes an analogy, in VM, for the emergence of more or less stable conventions out of chaotic imitative behaviour.
12. The critique of Friedmanite doctrines in VM associates them with the *a priori* assumption of a homogeneous monetary system. This seems to correspond well with the oral tradition in Chicago, associated with the name of Henry Simons, which had indeed been tempted by the notion of 100 per cent reserve banking in the wake of the 1930s depression.
13. Aglietta & Orléan, *La violence de la monnaie*, ch. 1.
14. Michel Aglietta, 'L'ambivalence de l'argent', *Revue Française d'Economie*, Vol. 3, No. 3 (1988), pp. 87–133.
15. In this he follows Jean Cartelier; see, for example, Jean Cartelier, 'Théorie de la valeur ou héterodoxie monétaire: les termes d'un choix', *Economie Appliquée*, Vol. 38, No. 1 (1985), pp. 63–82.
16. Aglietta, 'L'ambivalence de l'argent', p. 95.
17. *Ibid.*, p. 97.
18. *Ibid.*, p. 113.
19. The relation between this derivation of money as a form of socialisation and the famous Marxist derivation of money in the first chapter of *Capital* may be of interest. In fact, there is an attempt, in VM, to establish a close relation between the two, but this is hardly convincing because it is reasonably clear that Marx regards barter as representing an incomplete or undeveloped form of value rather than an impossible structure leading inevitably to conflict. A recent contribution by Jean Cartelier, 'Marx's Theory of Value, Exchange and Surplus Value: A Suggested Reformulation', *Cambridge Journal of Economics*, Vol. 15, No. 3 (1992), pp. 257–69, calls into question the internal consistency of the Marxist dialectic of value forms. Another leading member of the regulation school has tried to integrate monetary and financial processes into the theory while remaining closer to classical Marxism. This essentially involves a restatement of the theory of commodity and money *fetishism*; see Alain Lipietz, *The Enchanted World: Inflation, Credit and the World Crisis* (Verso, 1985).
20. In terms of analytical tools, perhaps the most important influence on Aglietta's subsequent work has been the application of asymmetric information models to credit relations. See, for example, Joseph Stiglitz & Andrew Weiss, 'Credit Rationing in Markets with Imperfect Information', *American Economic Review*, Vol. 71 (1981), pp. 393–410.
21. Compare, for example, Hyman Minsky, *Stabilising an Unstable Economy* (Yale University Press, 1986) on credit crunches.

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22. John Hicks, *The Crisis in Keynesian Economics* (Blackwell, 1974). On the necessity of a liquid asset, Hicks writes: 'once one accepts that one form of investment is not as good as another, it follows that it is socially productive that the form of investment should be wisely chosen. It cannot be wisely chosen if it is too much hurried. *The social function of liquidity is that it gives time to think*' (p. 57, emphasis added).
23. Michel Aglietta, *La fin des devises clés* (La Découverte, 1986), p. 85.
24. Michel Aglietta, 'World Capitalism in the Eighties', *New Left Review*, No. 136 (1982), pp. 5–41, gives a *régulationniste* interpretation of the conjuncture of the early 1980s. Readers are warned that the expression, *inflation rampante* (creeping inflation), is horrifyingly mistranslated as 'rampant inflation' throughout this text. The article draws on a more technical paper: M. Aglietta, P. Ewenczyk & G. Oudiz, 'L'Europe dans l'affrontement international des années 80', Ministère du Plan/CEPPII working paper, presented to the conference, *Western Europe in the 1980s*, Cambridge, May 1982.
25. Aglietta, *La fin des devises clés*, p. 21.
26. *Ibid.*, p. 35.
27. Compare, for example, Barry Eichengreen, *Globalising Capital: A History of the International Monetary System* (Princeton University Press, 1996).
28. Aglietta, *La fin des devises clés*, p. 44.
29. Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (Beacon Press, 1944), although not mentioned in this particular text, can be seen as the theorist of this social revolt and of the transformation of capitalist systems which it brought about.
30. Aglietta, *La fin des devises clés*, p. 66.
31. *Ibid.*, p. 33.
32. Compare the short text, in English, Michel Aglietta, 'The creation of international liquidity', in: Loukas Tsoukalis (Ed.), *The Political Economy of International Money* (Sage/RIIA, 1985), ch. 6, pp. 171–202. 'The world economy needs an official monetary control compatible with the degree of financial interdependence which it has attained' (p. 199). In more recent discussion, Aglietta indicates that, in practice, a concert of independent central banks may be the closest feasible approach to this requirement.
33. M. Aglietta & P. Deusy-Fournier, 'Internationalisation des monnaies et organisation du système monétaire', *Economie Internationale*, No. 59 (1994), pp 71–106.
34. *Ibid.*, p. 77.
35. Michel Aglietta (Ed.), *L'ecu et la vieille dame: un levier pour l'Europe* (Economica, 1986).
36. Many subsequent texts return to European monetary integration. In particular, one can mention the clear warning given about the coming crisis of the ERM: Michel Aglietta, 'Stabilité dynamique et transformations des régimes monétaires internationales', in: Robert Boyer, Bernard Chavance & Olivier Godard (Eds), *Les figures de l'irréversibilité en économie* (Editions de l'École des Hautes Études en Sciences Sociales, 1991), pp. 311–34. See, for details, John Grahl, *After Maastricht: A Guide to European Monetary Union* (Lawrence & Wishart, 1997), pp. 105–6.
37. Michel Aglietta, 'Genèse des banques centrales et légitimité de la monnaie', *Annales: Économies, Sociétés, Civilisations*, No. 3 (1992), pp. 675–98.
38. See, especially, Charles Goodhart, *The Evolution of Central Banks* (MIT Press, 1988).
39. Aglietta, 'Genèse des banques centrales', p. 686.
40. *Ibid.*, p. 695.
41. *Ibid.*, p. 696; emphasis added.
42. On Russia, see Michel Aglietta & Philippe Moutot, 'Redéployer les réformes', *Économie Internationale* (1993), pp. 67–103; on Japan, see Michel Aglietta, 'Les dérapages de la finance japonaise', *Économie Prospective Internationale* (1992), pp. 9–29.
43. Michel Aglietta & Anton Brender, 'Globalisation financière et risque de système', *Cahiers Économiques et Monétaires* (Banque de France), No. 37 (1990), pp. 37–81; this is based on ch. 5 of a longer study: Michel Aglietta, Anton Brender & Virginie Coudert, *Globalisation financière: l'aventure obligée* (Economica, 1990), pp. 223–70. Much of the analysis discussed here is summarised in Michel Aglietta, *Macroéconomie financière* (La Découverte, 1998). Although this is designed as a pedagogic text it does contain much original material, notably on the stability of national banking systems.
44. Aglietta & Brender, 'Globalisation financière et risque de système', p. 54.
45. *Ibid.*, p. 63.
46. An earlier group of studies from the same project appeared as Michel Aglietta & André Orléan (Eds), *Souveraineté, légitimité de la monnaie* (Association d'économie financière, 1995).
47. Aglietta & Orléan, *La monnaie souveraine*, p 131.

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48. The repudiation of Girard is too total and too silent. Although the index to MS contains 26 references to ‘sacrifice’, 29 to ‘the sacred’ and 20 to ‘violence’, there is not a single mention of Girard’s name, *passim* in VM. It seems that the theoretician of the *bouc émissaire* has himself become a scapegoat, sacrificial victim of an unacknowledged exclusion. The totalising, even imperialist, nature of Girard’s thought certainly makes it difficult to combine his insights with those drawn from other theorists. Nevertheless, it may be going too far to abandon completely the notion of a hidden or suppressed violence behind the world of free exchange.
49. Aglietta & Orléan, *La monnaie souveraine*, pp 159–211.
50. *Ibid.*, pp. 35–52.
51. *Ibid.*, pp. 213–50, 249.
52. *Ibid.*, pp. 289–324.
53. *Ibid.*, p. 294.
54. *Ibid.*, pp. 85–126, 53–83.
55. *Ibid.*, p. 109.
56. *Ibid.*, p. 83.
57. It is stressed by Bruno Théret (MS, pp. 253–87) that money in contemporary society serves not only to unify the economic sphere of commodity exchange, but also to unite the political and economic spheres through taxation and public spending.
58. Aglietta & Orléan, *La monnaie souveraine*, p. 11.
59. *Ibid.*, pp. 359–86.
60. *Ibid.*, p. 380.
61. *Ibid.*, pp. 129–56.
62. This daring strategy can be traced back to the earlier work of Cartelier, in particular, Carlo Benetti & Jean Cartelier, *Marchands, salariat et capitalistes* (Maspero, 1980). The original motivation of this work was perhaps its critique of the Marxist theory of social classes: for the authors the asymmetry between proletarians and the bourgeoisie is essentially a matter of their differential access to monetised credit, rather than to the means of production as such. Although it is difficult at present to attach a great deal of importance to this point, Benetti and Cartelier can also be seen as developing a critique of general equilibrium theory as in their identification, mentioned above, of the ‘postulate of nomenclature’.
63. Aglietta & Orléan, *La monnaie souveraine*, p. 135.
64. *Ibid.*, p. 136.
65. *Ibid.*, p. 137.
66. A serious problem arises with this tripartite account of monetary systems. On the basis of the distinction between primary monetary allocations and rules of settlement Aglietta and Cartelier problematise the Keynesian concept of liquidity (MS, p. 140). They wish to distinguish the marketability of assets (liquidity) from their ability to act as the basis of primary issue or *monnayage*. To the present writer this seems to be a distinction without a difference; as soon as one makes capital valuations the basis of access to the means of payment this access becomes a market process. Here the simplicity of conceptual structure is bought at too high a price in terms of descriptive accuracy. The anthropological foundations of MS are no doubt much more solid than those of VM but the promotion of the concept of debt over that of money weakens its economics. Credit requires collateral; if we apply Cartelier’s own logical fork, assets can act as collateral either through their ‘real’ properties (utility, productivity) or by virtue of their monetary values. If one makes the second choice one is surely back in a completely Keynesian world.
67. In an extension of the interdisciplinary approach of MS, Jacques Birouste develops (pp. 323–56) a psychological account of confidence. In this context one can report the repeated references of both Aglietta and Orléan to the work of Georg Simmel, *The Philosophy of Money*, trans. by Tom Bottomore & David Frisby (Routledge & Kegan Paul, 1978) [first German edition 1907], whom they regard as providing the most developed account of the impact of modern monetary relations on the perceptions and motivations of the individual. The essay by Frederic Jameson, ‘The brick and the balloon: architecture, idealism and land speculation’, in: *The Cultural Turn: Selected Writings on the Post-modern 1983–1998* (Verso, 1998) pp. 162–89 brings out well the nature of Simmel’s contribution:

> Any discussion of money as a mediation needs to confront the work of Georg Simmel, whose massive *Philosophy of Money* pioneered what we would today call a phenomenological analysis of this peculiar reality (p. 165).

To illustrate the pertinence of Simmel's analysis, we can cite a passage suggesting how money can lower the conflict intrinsic to exchange:

> Money transactions erect a barrier between persons, in that only one of the two parties to the transaction receives what he *actually* wants … In this way an inner barrier develops between people, a barrier, however that is indispensable for the modern form of life. For the jostling crowdedness and the motley disorder of metropolitan communication would be simply unbearable without such psychological distance (*The Philosophy of Money*, p. 477).

Orléan has made frequent reference to this work; see, for example, André Orléan, 'La monnaie comme lien social; étude de Philosophie de l'Argent de Georg Simmel', *Genèses* (June 1992), pp. 86–107.

68. Aglietta & Orléan, *La monnaie souveraine*, p. 26.
69. *Ibid.*, p. 157.
70. *Ibid.*, p. 30. The expression, '*la pensée unique*', is currently used by heterodox economists in France to stigmatise the closed intolerance of neoliberal orthodoxy.
71. Two brief papers by Aglietta and Christian de Boissieu have recently discussed the starting position of the European Central Bank (ECB): Michel Aglietta & Christian de Boissieu, 'La responsabilité de la future Banque centrale européenne' and 'Problèmes prudentiels', both in Conseil d'Analyse Économique, *Coordination européenne des politiques économiques* (Documentation Française, 1998), pp. 49–59, 63–70. One aspect of this discussion is the pertinence of the US model of central banking, as opposed to the Bundesbank model which was actually used as a blueprint for the ECB.
72. Don Patinkin, *Money, Interest and Prices* (Harper & Row, 1956) [2nd edn 1965].
73. This argument is made in more detail in Grahl, *After Maastricht*, ch. 1, which uses, as a summary of the current state of play within the mainstream, Benjamin Friedman & Frank Hahn (Eds), *Handbook of Monetary Economics*, 2 Vols (North-Holland, 1990). Compare the position repeatedly adopted by Cartelier, for instance in his recent popular essay: Jean Cartelier, *La monnaie* (Flammarion, 1996).
74. Jean-Pascal Benassy, *Macroeconomics: An Introduction to the Non-Walrasian Approach* (Academic Press, 1986).
75. This assertion is made most strikingly in Cartelier, 'Théorie de la valeur ou héterodoxie monétaire'.
76. Aglietta & Orléan, *La monnaie souveraine*, p. 147.

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Chapter 2

Review of J. Huffschmid, *Politische Ökonomie der Finanzmärkte*

International Review of Applied Economics, Vol. 14, No. 3, 2000

REVIEW ARTICLE

Among the Vultures

JOHN GRAHL*

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Jörg Huffschmid (1999)
Politische Ökonomie der Finanzmärkte
(Hamburg, VSA-Verlag)
246pp, ISBN 3-87975-736-4

The primary aims of this book are to develop an analysis of globalised finance and to arrive at policy measures that could reassert social control over the financial sphere. However, it is also designed as a tool for teaching and as an introduction to the study of financial relations. It is a partisan work: its actual, dry and descriptive, title (*The Political Economy of the Financial Markets*) was insisted on by the publishers, who rejected Huffschmid's more colourful suggestion, *Among the Vultures*.

The first chapter presents the explosive growth of international financial transactions. There is a paradox here, in that the needs of enterprises for external finance have fallen as a consequence of higher levels of profitability and slower rates of investment; governmental requirements for credit have also been falling as public sector deficits have narrowed in many industrialised countries. The result is that transactions have grown much faster than the volume of outstanding financial claims. It is, in addition, only a very limited spectrum of assets that are traded on an international scale: some bond issues, some of the shares quoted on a handful of stock exchanges, above all currencies—together with derivative claims on these same assets. (Thus, a second, closely related, paradox is that most countries continue to meet most of their financial needs from domestic resources.) Huffschmid interprets the continuously accelerated volume of international transactions in this limited range of liquid assets as a response of financial agents to the lack of profitable investment opportunities in real economic activities. This acceleration and increased liquidity of financial placements, together with their abstraction from the productive economy, have become the basis for huge waves of speculation.

Huffschmid then examines the actors behind the financial markets—the big banks, insurance companies and institutional investors. In this sector, increased

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competitive pressures have led to drastic rationalisation and concentration and he takes this as consistent with his view that there is a superfluity of financial resources. At the same time, these big players have altered the nature of their business towards investment banking and dealing on the financial markets—a reorientation encouraged by the privatisations of the 1980s and by the rapid growth of public sector debt at that time. The increased influence of financial companies, however, does not rest on a massive internationalisation of their balance sheets, which are still dominated by domestic assets: their threat to move capital abroad, without their actually doing so, is enough to reinforce their power over national developments.

The next chapter examines the historical background to financial globalisation. Tight regulation of finance with controls on international capital mobility was an essential element of the reformed capitalism of the era after World War II, and of the long upswing that followed. The exhaustion of this phase of accumulation posed the alternative of further democratic reforms or the rollback of previous ones. The move to floating exchange rates was an essential precondition for the victory of the neoliberal counter-reform agenda. The US authorities, no longer able to assert their hegemony within the Bretton Woods system, opted for currency competition rather than a new, multilateral regime for world money and finance. However, currency competition did not permit the formulation of expansion-oriented national economic policies. Rather, it instituted an international competition among countries to reinforce the stability and the yields of the financial assets that they issued. This pressure was a key lever of the wave of internal counter-reforms (privatisations, labour market deregulation, public spending reductions, and so on) which followed. The Bundesbank is heavily criticised for its role in this process: it promoted capital mobility in Europe as a way of putting additional pressure on the economic policies of neighbouring countries.

The next chapter traces the economic and social consequences of the neoliberal turn in economic policies as the new exit-options available to financial capital were used to help push disinflation to the top of the agenda. These consequences are different in the different regions of advanced capitalism: in the US, despite a drastic increase in social inequalities, and despite a whole array of financial crises and malfunctions, the new financial regime has been compatible with rapid economic growth and rising employment. There is a stark contrast with developments in Japan, where financial liberalisation led first to an unchecked speculative stock market and real estate boom, and then to a disastrous crash. The persistent stagnation of the Japanese economy through the 1990s is characterised by Huffschmid as a liquidity trap: even unprecedentedly low interest rates have not been able to relaunch investment. In Europe, the unfolding of the neoliberal agenda was dominated by the 'stability' policies of the Bundesbank, which determined a restrictive monetary and fiscal path towards monetary union. The US, Japan and Europe, however, are all marked by increasing inequalities and by a growth of insecurity. The international conjuncture resulting from these asymmetric developments in the main industrial regions is unstable—huge US balance of payments deficits as against Japanese and European surpluses—and there exists the danger of a general deflation.

Huffschmid now turns to the theoretical analysis of financial crises. In examining the course of financial crisis, he draws on the writings of Minsky and the notion of an endogenous tendency towards fragility in financial structures. However, Minsky's theory is worked out for an economy in which real production and investment are growing without basic problems. To account for the origins of

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contemporary crises, Huffschmid prefers to use the analysis of the French economist, François Chesnais, who invokes the obstacles to real economic development to explain a superfluity of funds in the hands of creditors and their search for safe, short-run, returns. The pattern of crisis in East Asia is interpreted in these terms as the result of overliquid, under-regulated international finance: 'First come the bankers with their credits or the investment funds with their placement strategy and start to raise the temperature. Then come the speculators and if the situation becomes risky the bankers draw back and the speculators finally wreck the markets.'

The last and longest chapter deals with policies to re-establish social control over financial processes. Huffschmid notes that the brief official readiness to contemplate a new global financial 'architecture' that followed the crises of 1997 has now subsided into a mere call for more transparency in debtor–creditor relations and a tendency to blame the victim countries and exculpate the international lenders. His proposals for crisis-management are relatively conventional, being focused on a rapid response of national and international authorities to brake the self-reinforcing process of currency depreciation, falling asset prices and defaults. In this context, however, it is a cause for concern that the European Central Bank does not dispose of a full range of instruments with which to intervene in conditions of crisis.

Going beyond the immediate response to crises, Huffschmid's proposals for medium-term reform are radical, based on constraining, slowing down and stabilising financial processes and on reintroducing institutional barriers between the different components of the financial system. He argues for a whole range of controls—fiscal, supervisory, administrative—to be operated at every level—national, regional (for example within the EU), and international. Controls over international capital movements are given a prominent place in this set of proposals; they are seen as making possible a move back to relatively fixed exchange rates. Although, in principle, a new global financial order is desirable, it is not seen as politically realistic at the present time because of US commitment to continuing liberalisation. This makes regional monetary cooperation all the more important. With capital controls, regional systems of fixed but adaptable exchange rates can be constructed. Huffschmid believes that the EMS, despite its dislocation in 1992–93 (which he attributes largely to the 'perversion' of the system by German policy), can act as a model for these. He suggests that the EU can become the core of a sheltered financial space that could not only reconnect the productive and financial spheres within Europe, but also demonstrate, worldwide, the advantages of regulated finance. In the long run, the subordination of finance to social priorities requires differentiated credit policies and a new segmentation of the financial sector, so that, for example, a bank specialised in housing finance would concentrate on that function and not be dragged into competition with every other financial intermediary. It is admitted that such a reform programme may seem 'very authoritarian and restrictive'. Huffschmid, however, argues that the necessity for very strict measures against speculation would be transitional because, over time, the reforms would work to encourage real investment and to eliminate the actual surplus of financial resources.

The book as a whole is an extremely lucid and comprehensive account of financial globalisation and it presents a persuasive version of the left-wing case for radical reform. The reviewer sees some problems with the latter, but will begin with a certain difficulty in Huffschmid's historical argument. It seems to be quite correct

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to trace the introduction of the neoliberal counter-reforms to the exhaustion of the postwar phase of accumulation and to the tendency, released at that point, to divert investible resources into liquid financial assets. This drive into the financial sphere then became, as Huffschmid argues, a key weapon in the assault on the postwar compromise.

However, even at the start of the 1980s, it may have been too late to meet these developments with a national economic programme. Huffschmid (citing two left-wing French sources) suggests that the Mitterrand experiment of 1981–83 was half-hearted and that it retreated in fear before a confrontation with German policy. This may be too simple: the left-wing coalition, which came to power in June 1981 had, by January 1982, carried out a nationalisation programme of unprecedented scale—which included, significantly, the entire financial sector. It is true that macro-economic conditions elsewhere—in Germany and the US—were not propitious for the attempted expansion, but the expansion was not the only thing that went wrong. By 1983, the big industrial groups, nationalised with a view to a wider presence of France in leading sectors, were all haemorrhaging red ink. The political tasks assigned to them were beyond their capacities and their future development required more complete internationalisation.

Several points follow: as long as two decades ago, national Keynesian strategies were problematic—even in the world's fourth industrial power; the inter-dependencies which constrain national strategies pertain to production as well as to finance; and these two spheres may not be as completely 'uncoupled' as Huffschmid suggests (his treatment of current US conditions, where a deregulated financial system is pouring resources into high-risk enterprises, leaves something to be desired).

Turning to the policy recommendations, no objections will be made to much closer and more detailed supervision of financial markets and agents, to international agencies which attempt to preserve stability rather than to drive forward the free market agenda in new industrial countries and to 'bail in' rather than bail out the creditors responsible for speculative boom and bust in emerging economies. Nor will the right of these countries (or, *in extremis*, any country) to tax and control both capital inflows and outflows be called into question. Similarly, there is no objection here to the democratisation of such bodies as the IMF or to closer and more effective policy coordination among the leading powers to replace the present free-for-all.

However, the battery of measures that Huffschmid proposes to delay, obstruct and segment financial processes seem to the reviewer to be fundamentally misconceived. On Huffschmid's own analysis, it is a key task of contemporary economic development to transform the potential investment resources, which now flow ceaselessly from one liquid placement to another, into genuine productive investment. We are faced with the paradox of superabundant capital together with exceptionally high profit rates and an ongoing movement ('shareholder value') to drive these profit rates even higher.

In such a situation, it is hardly useful to erect a host of barriers to financial transactions. These barriers will lead to as many points of tension in credit relations and as many targets for liquid capital in search of arbitrage profits. The rapidity and fluidity of financial transactions today make possible (in the contemporary US, even actual) an unprecedented diversification of risks, turning innovative projects, by aggregation, into secure assets; it is important to harness this potential rather than destroy it.

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The crisis-ridden process of financial globalisation can only be fought with its own weapons: scale, comprehensiveness, standardisation. The best choice for Europe, if it wishes to establish some influence over global finance, is to accelerate the integration of the European financial space, to enforce rigorous rules of competition and accountability, and to protect both savers and borrowers from the market power of intermediaries by a thoroughgoing standardisation of financial products.

It should be added that Huffschmid's book, besides its merits as an analysis, is an excellent working tool. Financial institutions, agents and markets are carefully explained; up-to-date data are marshalled to support every stage of the argument; there is complete documentation, including the web addresses of important institutions. This material will be useful even to students with an imperfect knowledge of the German language. In spite of the objections raised above, it is, perhaps, the most complete and rigorous exposition of the case for fundamental reform.

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Chapter 3

Globalized Finance - The Challenge to the Euro

JOHN GRAHL

GLOBALIZED FINANCE

The Challenge to the Euro

The European project is widely seen to be floundering, politically and economically, in the face of US global dominance.[1] While the long depreciation of the euro—from its initial $1.16 in January 1999 to a record low of 82 cents in October 2000—may now have been checked, the underlying market scepticism about European economic prospects that accompanied its fall has not disappeared. The euro's decline was not, after all, a commercial phenomenon—Euroland was posting big current account surpluses at the start of EMU—but a financial one, the consequence of big capital outflows. Since December 2000, the euro has benefited to a certain extent from investors fleeing the troubled American economy; but whether this rising tide can float such a leaky ship remains to be seen.

The present conjuncture has highlighted two key weaknesses in the design of Europe's monetary institutions. There is, firstly, the weakness of their external policy: the Council of Ministers has some responsibility but no real power in this sphere. Given the present imbalances in the world economy, this carries the risk that a serious slowdown in the US will not be compensated for by a decisive relaxation of Euroland's macro stance. Secondly, there is the problem of the 'policy-mix'—the balance between the monetary and budgetary components of the macroeconomic stance.[2] Fiscal policy is both fragmented and uncoordinated. In a situation (undervalued currency, sluggish internal economy) where (now standard) Mundell-Fleming theory would call for a less restrictive fiscal stance, there is no clear mechanism for effective

budgetary coordination; nor is it clear how such a relaxation could avoid destabilizing long-run interest rates in the weaker countries.

In this context, the European Central Bank's sole response to the falling euro—repeatedly raising interest rates towards US levels, while the contradictory statements of Bank officials, EU Commissioners and national political leaders betrayed their growing anxiety—risked being both damaging and self-defeating: damaging, because unemployment is still very high in the core Euroland economies and the recovery fragile; self-defeating, because a slowdown in Western Europe might provoke further capital outflows towards other more rapidly developing economies. The weakness of the euro does not result from inflation—lower in Euroland than in the US—nor is it a mere function of interest-rate differentials, since much of the capital outflow is through FDI and not simply placements in the US banking system.[3] Rather, it was fast economic development in the US that gave rise to (real or perceived) investment opportunities, and thus attracted European financial resources.

It might be said that Europe is producing plenty of exports but not enough assets: its capital markets are fragmented and illiquid, compared to their US counterparts. And though Europe's security markets are now starting to expand and integrate, this involves a long, conflictual move away from its traditional financial institutions, based on various forms of 'relational' banking within specific countries and regions. Thus to address the weakness of the euro by simple monetary restriction runs the risk of exacerbating Europe's financial

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[1] This article draws heavily on discussions with two colleagues at the University of North London Business School, Stuart Archbold (now at the University of Kingston) and Photis Lysandrou.

[2] For a full analysis, see Robert Boyer, *Le Gouvernement économique de la zone euro*, CGP, Documentation Française, 1999.

[3] Martin Feldman observes: 'In the past year . . . [v]irtually all of the net equity capital that came to the United States was in the form of FDI, including mergers and acquisitions as well as new investments and outright purchases of existing businesses' ('Aspects of Global Economic Integration', NBER working paper 7899, September 2000). The point is important because it suggests that euro weakness is the result of the extent to which European companies, both industrial and financial, were participating in the US expansion. This participation was itself facilitated by the sophistication of US financial mechanisms—both as regards securities (portfolio capital) and mergers and acquisitions (FDI).

weaknesses—the underdevelopment of its financial markets, and the survival of obsolete financial structures—which, together, subordinate the European economy to US practices and priorities.

There is still a great deal of scepticism about the extent and the implications of globalized finance for European economic development. A strong statement would be:

> So long as governments continue to target their current accounts, retain some sovereignty within their borders (so that at least the threat of government intervention in cross-border capital movements remains) and differentially regulate their financial systems, investors cannot think about domestic and foreign assets in the same way. Different national financial systems are made up of different institutions and arrangements, with different conceptions of the future and assessments of past experience, and thus operate with different modalities of calculation. All these features factor into a continued diversity of expectations and outlooks which cannot all be reduced to a single global marketplace or logic.[4]

Two arguments, in particular, are advanced to back the sceptics' case. Firstly, it is often suggested that today's high levels of financial interaction are not unprecedented—that something very comparable can be found in *la belle époque,* with the monetary nationalism that broke up the mechanisms of the Atlantic economy and the gold standard being seen as inseparably linked to the revolt of the masses and the assertion of democratic controls over the free market.[5] The second objection rests on the prevalence of self-finance: any account of globalized finance as a dominant force in today's economic life must confront the fact that the majority of investment is financed domestically.

A standard way of representing this is to show that, across countries, the ratio of savings to output is highly correlated with the ratio of investment to output. Countries finance nearly all their investment from their own savings—investment processes do not generally draw on external sources of capital. Why do they self-finance? Part of the answer must be that virtually all agents in capitalist economies rely heavily on this form.

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[4] Paul Hirst and Grahame Thompson, *Globalization in Question*, Cambridge 1999.
[5] Of course, the classic account of this process is that of Karl Polanyi, *The Great Transformation*, Boston 1957 (1st edition 1944).

Corporations, to take the most important case for the present argument, draw predominantly on internal funds when they undertake investment (see Fig. 1).

Figure 1 *Sources of corporate finance (percentages)*

	Retained Earnings		Equities		Debt		Bank Credit	
	1975–80	*1991–95*	*1975–80*	*1991–95*	*1975–80*	*1991–95*	*1975–80*	*1991–95*
US	63.5	81.1	4.4	1.1	13.2	10.4	6.6	-1.3
Japan	35.2	54.5	4.9	4.6	2.3	4.3	33.6	39.8
Germany	58.8	64.7	2.2	2.0	-0.1	0.7	25.3	23.2
France	42.6	71.5	4.0	18.3	0.0	0.2	12.6	12.2

Source: Jörg Huffschmid, *Die politische Ökonomie der Finantzmärkte*, Hamburg 1999.[6]

Note the following characteristics: self-finance predominates; it is becoming more, not less, important in a quantitative sense; US corporations make more, not less, use of self-finance than those of Japan or Western Europe; the latter rely significantly more on bank credit and less on marketable credit instruments (commercial paper/corporate bonds); in general, equity makes a nugatory net contribution to business investment. This kind of evidence has been used to suggest that Japanese or German financial mechanisms—privileging 'insiders', such as house-banks—outperform those of the US—based on 'outsider' finance traded by anonymous creditors on organized capital markets; and that, in any case, accumulation processes must be relatively independent. These conclusions may be obsolete.

There are many detailed hypotheses about national self-finance. But it would follow from the use of self-finance by most corporations and

[6] For an English language review, see John Grahl, 'Among the Vultures', *International Review of Applied Economics*, vol. 14, no. 3, 2000, pp. 403–7. An examination of current account figures, it must be noted, reveals a single exception to the rule that countries self-finance: the US. Since this country is usually seen as lying at the centre of global financial networks, the exception is extremely important.

other economic agents that international capital flows would be small relative to the total of global investment activity. If we want to argue that globalized finance is important—is dominant—then we have to assert that the tail of external finance can wag the dog of internally generated funds. In what follows, there is an attempt to suggest that this is indeed the case.

Information asymmetries and the problem of agency

The standard account of debtor–creditor relations draws on ideas of a structural information asymmetry between borrower and lender, first developed in the context of the used-car market.[7] The seller may have a better idea than the buyer about the quality of the car on offer, while the buyer may not be able to distinguish a good car from a 'lemon'. The problem is that markets can break down in such circumstances: if the buyer simply lowers the price to take into account the existence of 'lemons' on the supply-side, the owners of the best cars may withdraw (known as 'adverse selection'). The same considerations apply to credit. Borrowers differ with respect to their reliability and efficiency, yet it is the borrower who has the most concrete idea of how borrowed funds will be deployed. A simple increase in interest rates may not be an effective way of dealing with this problem: borrowers with sound investment projects may be deterred, leaving the credit market to those with risky prospects, or even those who simply intend to default. The widespread phenomenon of credit-rationing (limiting credit supply without raising interest rates) flows from this.

The 'principal–agent' problem has a very similar structure. In this case, information asymmetries obstruct relations between an employer and an employee or—more directly relevant here—between the proprietor of an enterprise and its management: bad prospects will be represented as good. Thus both equity and debt finance are sources of potential conflict and market breakdown. Hence the key slogan of *transparency*: creditors and shareholders want the procedures and motives of company managements to be visible to them. We do not have to take such (essentially neoclassical) models too literally. What is important is that they testify to the inherent difficulties in debtor–creditor relations, a

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[7] George Akerlof, 'The Market for Lemons', *Quarterly Journal of Economics*, 89, 1970.

key explanation for the prevalence of self-finance throughout capitalist systems. With self-finance the difference between principal and agent vanishes, as does the information asymmetry between creditor and debtor. The problem is that the capital market disappears at the same time: in a world of universal self-finance, there are no mechanisms for the reallocation of investible resources. And not only the capital market: since virtually all monetary exchange results in surpluses on the one hand and deficits on the other, a world without finance would be a world without markets as such.[8] It is the recycling of monetary resources—that is to say, finance—which permits the continuity of market relations by accommodating debtors; at the same time, the financial pressure to which debtors are subjected is a central component in bringing about market adjustment. Dimensions of the latter—intervals between assessments, thresholds triggering policy change, required speed of adjustment, balance between rationalization and expansion—all obviously have a financial aspect.[9]

Voice versus exit

Now, if the inadequacy of generalized self-finance is recognized, then there are a variety of institutions which might structure debtor–creditor relations and thus make it possible for accumulation to be compatible with economy-wide restructuring and with the reallocation of capital. In extremely stylized terms two types of institution can be envisaged: following Hirschman's classic text, we can distinguish between the voice-based and the exit-based approach.[10] The former establishes close, long-term relations between particular counterparties who will gain, over time, specific and accurate knowledge of each other's motives and capacities. They may even come to develop 'loyalty'—a certain identification of their interests, so that the coalition concerned actually works to mitigate the initial conflicts between them. This is closely connected to the notion of a 'stakeholding' enterprise, knitted to its creditors, its employees, its suppliers and customers, to the local community and so on. As this happens, interactions within the coalition

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[8] See the work of Jean Cartelier, for instance *La Monnaie*, Paris 1996.

[9] The view that finance is a kind of *superstructure* on the base of 'production' or 'industry' is responsible for many errors in critical political economy.

[10] Albert Hirschman, *Exit, Voice, and Loyalty: responses to decline in firms, organizations and states*, Cambridge, MA 1970.

become smoother and less costly. Frequently, this kind of structure will be socially embedded, in Granovetter's sense—economic relations will coincide with social relationships, based on kinship or other affinities.[11] In the case of credit-relations, lenders are reassured by their close, individual knowledge of borrowers.

Voice-based structures depart in two key ways from the logic of competitive credit markets. Firstly, they are particularist—they privilege insiders, those interests belonging to the coalition, against outsiders; secondly—and as a consequence—they may be extremely opaque to outside scrutiny. Comparativists, of course, will insist that voice-based systems are different in different places: the German use of house-banks and interlocking directorships is not the same as the Japanese *keiretsu*, while the Korean *chaebol* are different again; systems vary across continental Europe, and so on. This variation is nevertheless a *general* feature of voice-based financial systems: they are all particularist structures, often embedded in specific social relations. Being different is what makes them the same.

The exit-based approach, on the other hand, controls economic relations by the threat of departure—which depends on the existence of alternatives provided by the market. In the case of credit relations, exit means that one can sell one's claim on a debtor. Thus, exit-based structures want to make competitive markets more efficient, to impose sharper and more immediate sanctions on poorly performing debtors, to render the activities of corporate borrowers more transparent and to reform incentive systems in ways that align agents with the interests of principals. And because exit, in this case, depends on the ability to sell one's holding or credit instrument, it becomes easier as the corresponding asset-markets become deeper and more liquid.

All this is extremely stylized: few, if any, relations between creditors and debtors are pure representations of either approach. Even within the most highly organized competitive asset-markets, one will always find networks of dealers linked by voice, even exhibiting loyalty. Similarly, there are no completely closed stakeholding structures—however particularist these may be, the conditions of outside credit markets will

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[11] Mark Granovetter, 'Economic Action and Social Structures: The Problem of Embeddedness', *American Journal of Sociology*, vol. 91, no. 3, 1985.

always impact on their decisions. Nevertheless, it seems legitimate to interpret some of the most important current financial developments as a transition from voice-based to exit-based disciplines. The shift is historical: everywhere corporate managements are more subject to financial market pressures. It is also hegemonic: the actual process of financial restructuring has taken the form of the deregulation and internationalization of dollar finance.

It seems to be the case that, for all their fluidity and sophistication, voice-based structures have one fatal flaw—their particularism. However crude the market-based mechanisms of dollar-based global finance, they have the decisive advantage of being reproducible. These techniques, taught in business schools all over the world, can be generalized through the extension of US financial markets and practices. The financial regimes to which they give rise can expand without limit to obtain a truly staggering scale. This, in turn, is based on the imposition of universal standards. However efficient, on a local basis, the voice-based structures of Germany (or in the days of *encadrement de crédit*, those of France) may have been, they remain imprisoned in their specific social environments and are unable to extend their operations to the international level. While aspects of Japanese industrial practice—lean production, total quality, flat hierarchies and so on—have been enthusiastically adopted by Western corporations, these have been completely divorced from the ethic and sense of community which may, arguably, have given them a certain social value; lifetime employment, of course, stayed at home. What could not be exported (as is now clear from the debacle in East Asia) was Japan's opaque, 'relational' system of corporate finance.

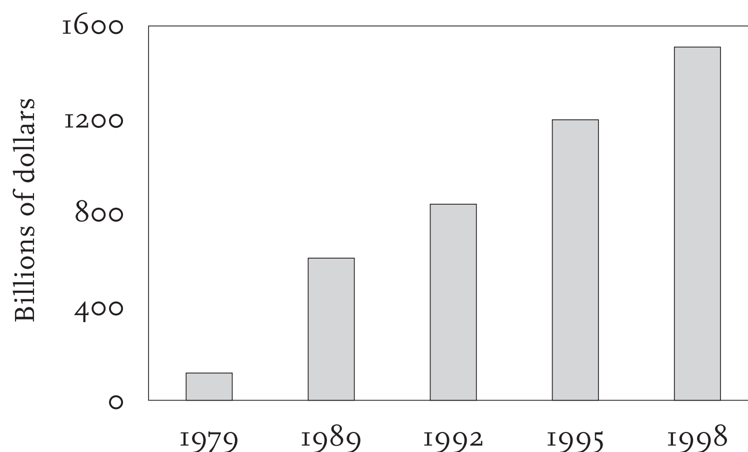
A key battleground for this confrontation between voice and exit has been corporate governance. It seems to this writer that the battle is already lost and won. The precise ways in which flows of external finance—still the smaller part of investment—can profoundly reshape corporate behaviour will be examined through the workings of three, more or less fully globalized structures: foreign exchange markets, government bonds and independent central banks.

Foreign exchange

The astonishing growth of foreign exchange transactions over the last two decades (see Fig. 2) has often been noted, but its interpretation

has sometimes been misconceived. Because there is clearly no relationship between foreign-exchange trading and either international trade or international investment-flow, these transactions are sometimes characterized as dysfunctional or purely speculative. If, however, we adopt a global rather than an international perspective, what we observe is simply the imbrication of national banking systems, almost the emergence of a unified payments system. The vast bulk of foreign-exchange transactions are completely analogous to displacements of liquidity within national payments systems—they simply recycle monetary resources, only now on a global basis. Fluctuations in exchange rates are not the occasion of this recycling but, on the contrary, an obstacle to it: when they are eliminated, the volume of cross-border monetary flows increases. (This can be seen in the rapid growth of cross-border payments within the EU's TARGET system. Although the total volume and value of inter-bank payments recorded by TARGET are stagnant, cross-border payments are expanding rapidly at the expense of domestic ones, as monetary and banking integration within Euroland proceed.)[12]

Figure 2 *Daily Foreign Exchange Transactions*



Source: BIS, cited by Huffschmid

[12] ECB data shows that total daily payments through TARGET were 1,042 bn euros in January 1999 and 1,035 bn in October 2000; within this total, cross-border payments, that is, new flows induced by integration, rose from 355 bn to 429 bn.

Money doesn't actually cost anything. There are, nevertheless, good reasons why it should be scarce. In a market economy, the allocation of these artificial symbols of wealth must be subject to the same logic as that of 'real' resources, otherwise the equivalence of money and commodities would be impossible. In every industrialized country the creation of money today is strictly limited. The reverse side of this is the astonishing acceleration of monetary transfers—an integral part of the emergence of global capital markets. Large banks draw short-term credit from any other point in the world system and, similarly, place any surpluses where they please. In consequence, one of the basic conditions of bank functioning—the ability of a bank to finance imbalances in its position—is determined not by national but by global circumstances, and on terms which are increasingly homogeneous. This can hardly fail to have repercussions on the strategies of any commercial bank embedded in these circuits. At the very least, any agent seeking short-term accommodation from such a bank must match the terms which prevail on the (global) inter-bank market. And longer-term credit is affected by short-run terms, since the two are always to some extent substitutes.

In the previously vaunted stakeholder systems of Germany and Japan, it should be remembered, 'relational' banking played a pivotal role. What has been said here by no means implies that banks will immediately abandon their long-term, stakeholding relationships with important corporate clients. But such relationships are being reassessed in a quite different context, and by quite different criteria.

Government bonds

Deposits with large banks are not very risky placements: this transparency and liquidity is what permits the rapid penetration of globalized relations in this sector. The same applies to the liabilities issued by the stable governments of wealthy countries. Bonds are backed, as the American expression has it, by the 'full faith and credit' of the national government, and default would imply an immense disruption of political life. That is to say, agency and information problems are minimal. It is clear that, with regard to the bond market, the standardization of terms and prices does not always require immense cross-border flows. This is still, nevertheless, a unified market. It would be crudely empiricist to insist on actual phenomena as a measure of globalization; virtual

movements are equally important—the *possibility* of a switch out of one government's debt and a flight to 'quality' in that of another, held to be more reliable, or more respectful of the rules of the game.

Governments cannot be expected to trumpet the loss of their sovereignty. There are, however, two closely related reasons why they will do a lot to maintain the presence of their liabilities within globalized markets. Firstly, the relegation of their bonds to secondary status would impose immense costs in terms of the risk premium that would have to be paid to their creditors. To put things the other way round: the Italian government faces greatly relaxed budget constraints—to the tune of 3.5 per cent of GDP—now that the Maastricht agenda and EMU have promoted its bonds to international class. Secondly, government bonds occupy a key position in national financial systems. Since they are, conventionally, risk-free (perhaps, more accurately, minimum-risk) instruments—which would fail to perform only after a massive upheaval had already called other obligations into question—they act as benchmarks for the issue of debt by all other agents in the economy, according to relatively well-defined (and globally scrutinized) trade-offs between risk and yield.[13] Public credit remains the basis of private credit. Even non-standardized, non-classified junk bonds are marketable only according to a comparison with the more reliable forms of debt. Equity finance is also—although in a somewhat looser way—tied to bond yields: any dramatic rise in the latter is highly likely to knock the equity market for six. On the other hand, even a major stock-market collapse may be managed into a 'soft landing' if the bond market holds firm, as this will avoid any complete break in the flow of monetary resources to the largest borrowers.

Thus the relegation of a country's government debt from a globally enforced standard to the status of a high-risk instrument threatens the economy as a whole with financial disruption. People do what they have to do—even in free countries. The Maastricht process explicitly made the convergence of bond yields a condition of participation in EMU. The standard rationale for this is that bond yields embody expectations of inflation—which is completely true, but the expectations, the judgement, involved are *external*, as is the sanction. The Maastricht

[13] The increasingly globalized role of US credit-rating agencies is of importance in this regard.

convergence process did immense damage to European employment and to the European social models. But if one wants to assert that the policy choices made in this context were the wrong ones, one must also recognize the pressures bearing on these choices.

If the world status of its bonds is an important consideration for any government, it is also true that the globalized bond-market is a sword of Damocles suspended over domestic policy-makers' heads. If any domestic development—monetary or fiscal, political or industrial—is read as threatening the solidity of a country's financial structure, globalized markets will exercise an immediate sanction. The demotion of a country's bonds, the emergence of a significant risk premium vis-à-vis the obligations of other states, will result in an immediate deflation of the economy concerned as bond yields rise, and with them the required rate of return on all medium-to-long-term credit instruments. Thus the monetary authorities of advanced capitalist states are not, as in the past, choosing between more or less expansionary or contractionary policy stances. Frequently, they are trying to *forestall* a spontaneous, market-led deflation of the domestic economy through a bond sell-off. This leads us into the new role of the central bank.

Independent central banks

A question:

> Let me now raise a curmudgeonly thought. When you think deeply about the reasons for removing monetary-policy decisions from the 'political thicket', you realise that the reasons apply just as well to many other aspects of economic policy—and indeed to non-economic policy as well. Consider tax policy for example . . . Yet, while many democratic societies have independent central banks, every one leaves tax policy in the hands of elected politicians. Why?[14]

And an answer:

> The independence of central banks is the institutional form of a monetary legitimacy which transcends the national framework.[15]

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[14] Alan Blinder, *Central Banking in Theory and Practice*, Cambridge, MA 1998, p. 59.
[15] Michel Aglietta and Jean Cartelier, 'Ordre monétaire des économies de marché' in Aglietta and André Orléan, eds, *La Monnaie Souveraine*, Paris 1998.

A transformation of monetary policy has taken place—on a truly global scale—over the last ten years. This cannot be examined in detail here. But one can offer, as a token of an argument to be developed at greater length on another occasion, a brief characterization of the situation of national monetary authorities in industrial countries.

One can read through virtually the entire literature on central bank independence without coming across a single reference to external economic relations. There are plenty of international comparisons—on the one hand good, independent, credible central banks and on the other weak, politically vulnerable, inflation-prone central banks—but these are simply contestants in a beauty competition, not elements in a single system. Why then do we observe a huge wave of reform in nearly all industrial countries, always in the same direction? There is, of course, the pervasive influence of ideology; independent central banks emerge as a tribute to such eminent economists as Lucas, Barro and Grossman, Rogoff. No objections will be made here to the logic of their accounts (although some objections are certainly possible). Rather it can simply be pointed out that these accounts are abstract because, in portraying monetary policy as a game between politicians, central bank and private sector, they neglect the possibly important distinction between external and domestic agents. For example, the concern with inflation: domestic players might be worried by inflation as such—by the rise in consumer prices, for instance; external agents are more likely to be preoccupied by the risk of currency depreciation. In the most abstract accounts of market systems the distinction does not matter because the two variables—the internal and the external value of a particular currency—move in parallel. In practice, things are a little more complex. Exchange rates do reflect price differentials, but they do not do so immediately or exactly: in this context, the price of assets is as important as that of consumer goods.

The situation of the central bank places it between the globalized markets for money and for bonds. As regards the first, central bankers can still—just—control the price of monetary accommodation in the currencies they issue, but they do so in a world where the terms of accommodation, and the elasticity of its supply, are set on the foreign-exchange market. The sterilization exercises that once divorced these two constraints seem to have become a thing of the past, at least for small countries—and possibly even for the ECB itself. (Standard theory

suggests that sterilization becomes less feasible as the degree of international capital mobility increases.) The price of money is thus set by a trade-off between short-term interest rates and foreign-exchange rates, to which central banks respond—but which, in itself, is beyond the authorities' control.

The globalization of bond markets constrains every deliberation of the Bank of England's Monetary Policy Committee or of the ECB Council. It is no longer a question of making a judgement between an expansionary or contractionary stance: as we have seen, a sell-off of government bonds is a permanent contractionary threat which central banks *must* attempt to forestall. An effective monetary policy is increasingly seen as one without major implications for bond yields; the central bank thus operates not on the cost of capital as such, but on the term structure of interest rates, trying to accelerate or decelerate immediate expenditures without compromising the value of financial assets or the investment programmes linked to them. To assess the actions of the central bank as if this were not the case—as if comprehensive control over domestic credit conditions were still possible—is only another example of the anachronism that can be seen in many current debates.[16]

Effects on corporate finance

Thus far, we have seen three key components of the credit system in a global context. Banks draw and place funds within an essentially globalized payments system, and the terms on which they do so are externally determined. Central banks certainly have some influence on the day-to-day price of these funds, but this influence is tightly constrained and has to be exercised in a way that does not threaten the stability of bond yields. Bonds are not only globally traded but also glo-

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[16] The position of the US central bank is exceptional in that the global dominance of dollar-based finance reduces the impact of external constraints on its policies. The constitution and functioning of the Fed are relatively unaffected by the monetary reforms of the last two decades; specifically, the Fed's broad mandate allows it to give considerable weight to the stabilization of output and employment as against the suppression of inflation. A growth-oriented macroeconomic stance can thus remain a key component of the US social contract. People have to live and die in the marketplace but they do at least insist that markets function, and the electorate still sanctions governments that accept lengthy recessions.

bally priced, and bond yields establish a key reference point, for all marketed credit instruments. Where does this leave the corporation?

It was pointed out at the start that external finance still provides only a relatively small fraction of corporate investment resources. Can the tail wag the dog? This depends on whether external finance is merely a residual element of an essentially internal process, or whether the terms on which it is available have started to define opportunity costs for both lenders and borrowers. Once industrial borrowers begin to take the external cost of capital as the key hurdle for investment projects, and their customary creditors start to regard yields on organized asset markets as a base-line rate of return, then market terms and costs will inevitably start to be internalized—even if insider finance continues to prevail in a quantitative sense. Increasingly, to the extent that external finance is determined on the market, these terms and costs will be a matter of global forces.[17]

It seems that market-determined finance does have decisive advantages over the voice-based mechanisms of relatively closed industrial groups. Firstly, it is able to diversify risks over a vast number of companies and investment projects. Secondly, market-based disciplines can reduce agency and information costs, by no means completely but, on aggregate, more effectively than the more precise but isolated inspection and monitoring procedures used in stakeholding models. The globalization of equity markets has therefore tended to reduce the cost of capital to borrowers in ways which raise returns to lenders.[18] Much of the evidence adduced to the contrary ignores the costs of cross-subsidy within stakeholder models: the weaker firms in a Japanese 'convoy' certainly have access to cheap finance but only at the expense of the stronger firms, or of the 'relational' banker. Nor are microeconomic data conclu-

[17] To put the same point in more general terms: in the global market, the volume of trade in *financial* commodities (claims on income streams) now predominates over the volume of trade in *real* commodities (goods and services). See Photis Lysandrou, 'Globalization as Commodification', University of North London Business School Discussion Paper, forthcoming.
[18] René M. Stulz, 'Globalization of Equity Markets and the Costs of Capital', NBER Working Paper 7021, March 1999. Stulz finds a significant reduction of capital costs, but not as great as he expected; he may have underestimated the efficacy of the voice-based mechanisms being displaced.

sive here: a German enterprise may be better managed, physically more productive, committed to higher standards of design and so on than its US counterpart; but if the enterprise as such represents a misdirection of capital resources, then it becomes a weakness in the competition between national economies.

Shareholder value

Beyond these pressures, there is now a drive in equity markets towards challenging, at the limit even eliminating, the very notion of a distinction between external and internal finance, through the demands of shareholder value. Legally, the shareholders of an enterprise are not its creditors but its owners. By the logic of financial markets, however, the main sanction they possess is not a proprietorial but a purely market act—to sell; to exit. Companies care about their share price: it determines the cost they pay for risk-bearing capital. Managements may also fear that too low a share-price will lead to their own dismissal. In this context, the fact that stock markets do not provide significant net amounts of industrial finance is irrelevant.[19] The role of equity is not simply to supply finance for companies, but to exercise control over the totality of corporate finance—including the use that is made of retained earnings.

It is not necessary to idealize here the so-called 'market in corporate control'—in fact, there is every reason to question this supposedly efficient Darwinian mechanism for the natural selection of managements. Takeovers and mergers may as often be an expression of agency problems as their solution, reflecting the opportunism and empire-building of acquiring managements. The point is that this does not, in general, absolve the management of the *acquired* enterprise of the sanction of a devalued share price.[20] Then there is the capacity of relatively powerful shareholders, such as fund-managers, to intervene in corporate governance. Beyond the consequences that flow simply from flotation on the largest stock markets—accounting procedures and reporting conventions—shareholders may seek to impose incentive systems on

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[19] Gross flows, which include funds extracted *from* quoted companies, are a different matter.

[20] Stuart Archbold, 'An Examination of Managerial Strategies and Motives in UK Mergers and Acquisitions', British Academy of Management Conference, 2000.

management, tying them into maximization of profits and share appreciation through equity or stock options.

To summarize the shareholder-value agenda, one can look at matters from the point of view of the capital market itself—that is, in terms of the reallocation of capital resources. This market would see, on the one hand, over-capitalized enterprises situated in slow-growth sectors, perhaps with high earnings streams but with relatively limited possibilities of accumulation. To the extent that they escape pressure from shareholders as principals, these 'cash-cows' may have acquired complex networks of insider coalition partners, representing stakeholder interests. To such a company, the shareholder-value agenda is all too familiar: pressures for productive reorganization will involve downsizing, disposal of peripheral or under-performing divisions, stripping-out of cushioned, managerial layers and so forth. Financial reorganization will include higher distribution ratios, equity buy-backs and increased gearing through the bond finance of assets that provide adequate collateral. In effect, the shareholders are saying: 'There is no such thing as internal resources; everything is ours.' Companies on which this programme has been imposed will provide higher returns on a possibly diminished equity base. This will correspond to higher risks for equity holders, but today's fund managers are confident that they can diversify those risks. They certainly do not want the companies themselves undertaking asset diversification if this lowers their rate of return. On the other hand, shareholders would look for undercapitalized, high-growth enterprises. Capital liberated from the cash-cows will be poured into a wide range of start-up, innovative, hi-tech projects. The realization of profits in this case may lie far in an uncertain future, but the potential gains are immediately capitalized into equity prices.[21]

Aspects of the shareholder-value agenda are common to both growing and established enterprises. Operational decisions are not supervised; instead, there is an imposition of standardized reporting and accounting procedures (compare the capitulation of Metallgesellschaft to the

[21] Thus it is by no means accurate to identify the advantages of US financial mechanisms only with phases of rationalization and disinvestment; they display a clear superiority in growth sectors such as biotech, where the capitalization of US enterprises at $320 bn is some ten times greater than that of their EU counterparts. *Financial Times*, 27 September 2000, p. 29.

requirements of the NYSE); incentive structures are introduced to eliminate, in principle, any conflict of interests between shareholders and management.[22] The premise of this kind of development is an enhanced capacity (real or perceived) on the part of proprietors to diversify risks across wide portfolios—a development closely associated with the increasing weight of collective fund managers among equity-holders.

Of course, the idea that this pattern of accumulation is moving us towards a world free from agent–principal conflicts is absurd. Managements threatened with this kind of colonization are fighting back every day—by diversifying, for example, perhaps in blatant contradiction of shareholder logic, into the promised land of the new hi-tech paradigm, or by anticipating the called-for restructurings, or by loading themselves with so much debt that even the most gung ho acquirers will think twice before launching a bid. But many of these defensive moves simply accelerate the reordering of productive relations and investment programmes promoted by the shareholder-value drive. The high degree of instability inherent in such developments goes without saying: the press is full of dire warnings about a coming decline in the yield of equity capital, a decline which in itself must imply big falls in equity prices. Most of what these Cassandras predict must be right; but part of the needed correction has already happened, and even a big stock-market decline could be absorbed by the US corporate sector, provided that other channels of finance—bonds, above all—can be kept open.

It remains the case that shareholder-value is not—or not only—an ideology, but a real consequence of financial globalization. It represents a

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[22] Standard measures of financial flows neglect this pattern. Thus the data cited from Huffschmid above suggest that German corporations have more access to outside funds than do their US counterparts. This neglects, firstly, the extent to which US corporations have been made to finance each other through such stock-market mechanisms as equity buy-backs and, secondly, the fact that the German and Japanese flows often represent what are in fact internal resources—internal, that is, to an industrial-financial grouping—and not funds drawn from the capital market. Nor are simple comparisons of investment volumes always pertinent: it is important to know how effectively these investment resources are deployed. Michel Aglietta presents data indicating that the productivity of corporate investment in the US (that is, the ability of this investment to raise output) has increased by 40 per cent over the period 1982–97. The corresponding figure for Germany is 12.7 per cent, for France, 6.8 per cent ('Shareholder Value and Corporate Governance: some tricky questions', *Economy and Society*, vol. 29, no. 1, February 2000).

new balance of forces between proprietors and managers, very much in favour of the former. And it is driven not only by the as yet very limited cross-border market in equities, but also by the global transformation of currency and debt markets in ways which universalize these pressures, even in economies where equity itself is traded predominantly among domestic agents. The visible effect is to reinforce, in the most powerful way, the familiar drive towards more complete and immediate market disciplines in other areas, in labour and output markets. Trade liberalization or labour market 'flexibilization' alone would only sharpen pressures on *some* product markets, some categories of labour and so on. The shareholder-value drive, in contrast, tends to eliminate the notion of a sheltered sector by imposing the same norms of cost, price and profit as prevail elsewhere.

Defensive measures

What are the implications of this for voice-based systems? From the point of view of the competitive capital market, stakeholder systems are not a solution to the problem of agency but rather the same problem writ large. Not only has a management established some autonomy from proprietorial interests; that management is embedded in a distributional coalition where a host of other interests can enforce their own priorities. For market-oriented shareholders in general (though not necessarily for privileged groups of insiders), opacity reigns. Particular, non-standard relations govern all transactions. In a confrontation between the two types of arrangement, general considerations would suggest that voice-based systems have three possible lines of defence. All of them are visibly failing in the context of an ongoing financial revolution.

The first line of defence might be to erect regulatory or other barriers, rendering exit options difficult, costly or even impossible, with the voice-based structures of 'Rhenish capitalism' or classical European social democracy being an imposed alternative to free capital markets. But the increasing interdependence of economies (in general) and financial liberalization (in particular) have been eliminating these restrictions for a generation. As early as the 1960s, to give one significant example, big German companies realized that they had an escape from the possibly irksome discipline of housebanks as suppliers of credit: they could simply go to the Eurocurrency markets. Exit options have never ceased

to multiply in the intervening years (although to different extents, of course, for different agents). If voice-based systems are to prevail, it must, increasingly, be through successful competition with the market-oriented forms.

A second line of defence might be to outperform the market-oriented approach, by reduced transactions costs, longer time-horizons, lower levels of conflict and so on. The efficiency of the particular, voice-based arrangements may overcome the general conditions of the market. This is always to some extent the case: no economic interactions will ever be purely contractual. But for the viability of a given voice-based system this efficiency condition (itself increasingly difficult to meet as market alternatives expand and develop) is necessary without being sufficient. There is also a *distributional* condition: the efficiency premium must make every member of a given coalition better off. Otherwise, that party may defect, and return to the market. The history of West European economies over the last two decades is littered with such defections at every level: skilled workers opting for individualized contracts with their employers; the severance of customary ties between suppliers and purchasers; giant enterprises delocalizing vast productive systems or abandoning their customary sources of finance for quotation on international stock markets. The pressure on all agents to do likewise goes on increasing.

Thirdly, as Hirschman argues, a voice-based system may mobilize the loyalty of its agents: an allegiance that rejects purely individual perceptions of interest. Of course this is an invaluable resource, and only the deep-rootedness of such loyalties can account for the resistance so far of many European social structures. But it is hardly necessary to point out the pressures. 'Those who deplore the cynicism of the men and women of our time', writes Pierre Bourdieu, 'should not omit to relate it to the economic and social conditions which favour or demand it and which reward it.'[23]

New developments

The question of efficiency, however, is not a neutral criterion in judging between the two systems. As financial market disciplines become

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[23] *Acts of Resistance: Against the New Myths of our Time*, Cambridge 1998, p. 84.

more intense, different metrics are applied to company performance. The scope of such an assessment, moreover, is a function of the approach adopted—individual enterprises are more likely to fail under a shareholder-value regime, but the economy as a whole may produce higher returns. The outcome of the competition between the two approaches may also depend on the type of economic development that is taking place. Colin Mayer, formerly an influential proponent of 'insider' finance, now writes:

> Outsider systems may . . . be particularly well placed to respond to the commercial opportunities created by the emergence of new technologies and new international markets. These require rapid adaptation which may be impeded by the complex webs of inter-relations between firms and other stakeholders which exist in insider systems.[24]

Finally, one has to take into account the sheer scale of the financial resources now being deployed to crack open the insider systems of Germany or Japan, made possible by the (practically) integrated world-payments system. The pace of this change varies: fast in France; slow, until very recently, in Germany. But this is a wheel that only turns one way: already the complex, interlocking shareholder patterns of Federal Germany are being dissolved as the big universal banks transform their equity holdings, from supports for reciprocal relations with industrial companies into asset-managing funds *à l'américaine*. In every sphere of European finance, agents are transforming markets, procedures and mechanisms to bring them into line with US practice. Only a few years ago, many transactions with derivatives ran foul of German gambling laws; today the German *Terminbörs* is a leading European market for derivatives. Whatever the balance of factors in the rivalry, the established European systems are losing. The cause is their financial weakness: their inability to mobilize and deploy capital resources rapidly, efficiently

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[24] 'Corporate Governance, Competition and Performance', in Simon Deakin and Alan Hughes, eds, *Enterprise and Community: new directions in corporate governance*, Oxford 1997, p. 171. See also Colin Mayer, 'The City and Corporate Performance: condemned or exonerated?', *Cambridge Journal of Economics*, vol. 21, no. 2, 1997. Mayer fails, in particular, to find evidence that insider systems lower the cost of capital: 'it is difficult to believe that the international integration of the past two decades has not brought costs of capital closely into line, at least for large companies which are able to raise funds in markets around the world.' He now argues only for a permissive policy: firms should be permitted to have concentrated, insider, ownership if they wish.

and on a large scale. It is a weakness which may yet begin to compromise the EMU project itself.

Models of resistance?

The argument so far has been that globalized finance, based on the deregulation and internationalization of the US financial system, is neither a myth nor even an alarming tendency, but a reality. A recent article by Ronald Dore calls into question the triumph of 'Anglo-Saxon' capitalism; most of the evidence Dore presents, however, is quite compatible with the position expressed above.[25] The stubborn resistance of Japanese society to the shareholder-value agenda is itself evidence of the immense external pressures on inherited patterns of economic organization. Dore, like many of those attracted to 'stakeholder' forms of enterprise, seems to regard finance as a superstructure—subject, in the last instance, to determination by the 'base' of Japan's industrial system. Yet his own account of the long Japanese stagnation through the 1990s shows how potent financial factors have been. The banking crisis, seen as a major cause of retardation, was 'more or less' resolved by 1996. Since that date, pressures on public finance are recognized as having played a negative role. Thus indebtedness, private and public, has put the recovery of Japanese industry into disarray for a full decade—this in the world's largest creditor country, awash with unmobilizable assets.[26]

If Dore downplays the impact of financial forces, he may, by the same token, exaggerate that of ideologies. He records elsewhere a conver-

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[25] 'Will Global Capitalism be Anglo-Saxon Capitalism?', NLR 6, November–December 2000. See also his *Stock Market Capitalism: Welfare Capitalism. Japan and Germany versus the Anglo-Saxons*, London 2000.

[26] Similarly, Taggart Murphy ('Japan's Economic Crisis', NLR 1, January–February 2000) gives a graphic account of the painstaking political negotiations that are slowly untangling the web of bad and dubious debts in the Japanese banking system—but Murphy writes as if this process were of little importance, a secondary phenomenon. Compare, to take a notorious counterexample, the rescue of LTCM, whose insolvency is widely seen as displaying the instability, even the irrationality, of trade in financial derivatives. Its recapitalization (strictly, a 'bail-in' rather than a bail-out since the resources came from its own creditors, not from the Fed) was complete within days. For a more developed version of this point see Photis Lysandrou, 'Globalization and the Euro: lessons and policy implications of the Asian crisis', University of North London Business School Discussion Paper 28, October 2000.

sation with a Japanese manager who thought that 'a global company should have global ownership', as though to imply a surrender to the fashionable managerial nostrums of the hour.[27] But banking insolvency, a narrow, illiquid securities market, the opacity of interlocking industrial groups where one cannot be sure who owns or owes what, have become quite tangible constraints on the reorientation of Japanese production, and the manager's viewpoint—one more decision to exit—may be more logical than he would like. As for the German stakeholder model, Dore's pessimistic assessment hardly differs from the view presented here. Over decades, large companies and banks have built up huge cross-holdings in each other's equity, supporting dense networks of reciprocity and cooperation, both financial and industrial. A key component of last summer's tax reform was the removal of fiscal barriers to the dissolution of this structure. With capital gains tax on the disposal of these holdings simply eliminated, they can be transferred painlessly to fund-holding institutions (often yesterday's 'relational' bankers) who will henceforth manage them not as the supports of insider finance, but as so many items in their portfolios. The consequence, accepted by both borrowers and lenders in Germany, if not yet by the European Parliament, is to put a trillion dollars of corporate assets into play.[28] Only a few years ago it was generally taken for granted that one could not buy a German company. That was then.

A crash will make no difference

There are many commentators who assert that the dollar-based financial system is riding for a fall. They have some telling arguments on their side. Even on the most optimistic assumptions of 'new paradigm' economics, it is hard to envisage a surge of profits that could justify

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[27] 'Asian Crisis and the Future of the Japanese Model', *Cambridge Journal of Economics*, vol. 22, no. 6, November 1998.

[28] Peter Gowan has suggested that this transformation of German finance was a *quid pro quo* for the participation of German companies in the US economy (personal communication). This is surely correct, but the desire to attract US FDI into Germany was also an important motive. More generally, Gowan's insistence on the political force used to extend what he calls the 'Wall Street-dollar system' across the globe can be accepted without denying that the resulting economic structure has an intrinsic logic of development or believing that the economic changes involved are reversible. See Peter Gowan, *The Global Gamble: Washington's Faustian Bid for World Dominance*, London 1999.

current equity prices, if equities are to maintain anything like their historic yields. If, on the other hand, these yields are due to be lower in future—itself an implication of the financial revolution—then prices are already too high.[29] It is clear that this concern is shared by the guardians of the dollar-financial system itself, including Greenspan. Other major disequilibria characterize the present situation: the huge commercial deficit of the US and the related shortage of savings, with American consumers relying heavily on asset-market appreciation to maintain their wealth. We already have bitter experience of the instability of asset-based growth in the outcome of the worldwide property boom of 1987–90.

The writer shares the *Schadenfreude* which accompanies every disruption of the dominant, dollar-based financial mechanism. But the days are gone when any real reversal of present trends could be expected from conjunctural developments. As an examination of the pattern of cyclical development over the past thirty years will show, globalized finance is driven forward not by any particular phase but by the cyclical mechanism itself (see Fig. 3). Crises, buffered and absorbed in the huge dollarized economy essentially through adjustments of US macro-policy instruments, have provoked massive regime shifts in Western Europe.[30] Of course, one key factor in this has been the lack of unity among the European states—their inability to define a common response. But, in this respect, are things really very different today?

A slowdown in the US would involve the immediate devalorization of US assets held in other countries; a turn-round of US current account and deterioration of European/Japanese competitiveness; pressure on Europe to expand by the most inappropriate means—big tax cuts, the sacrifice of financial stability; and, to the extent that the US bond market was implicated, equal pressure on long interest rates in Europe.

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[29] For an attempt to calibrate the overvaluation of US equities, see Sushil Wadhwani, 'The US Stock Market and the Global Economic Crisis', *National Institute Economic Review*, 167, January 1999, pp. 86–105. Also, Robert Shiller, *Irrational Exuberance*, Princeton 2000 (reviewed by Andrew Glyn in NLR 5, September–October 2000).

[30] Robert Brenner ('The Boom and the Bubble', NLR 6, November–December 2000) may understate the ability of the US to manage a stock market crash, with its threat of a 'hard landing'. He considers the constraints on monetary policy but does not discuss the vigorous fiscal expansion which will certainly meet any significant downturn. US public finance is healthy enough to permit this response, which would work to limit dollar depreciation.

Figure 3 *Some crises*

	Crisis	US response	Consequence
1971–73	US balance of payments	Dollar devaluation, break-up of Bretton Woods	Monetary policy becomes key macro instrument in European countries
1979–82	US inflation	Volcker shock: drastic rise in US interest rates	Huge and persistent rise in unemployment in European countries; fiscal crisis of the welfare state
1987–90	US stock market crash, recession	Turn to monetary expansion in US in climate of capital liberalization	Worldwide property boom and bust; tensions in EMS; end of full employment in Sweden

The weakness and subordinate status of the EMU project can be read in the increasingly alarmed and disunited statements of the ECB leadership. They seem to feel less and less able to deploy the classic US response to such difficulties: 'benign neglect.' There are serious dangers here. Specifically, to defend the euro or the price of euro bonds, monetary conditions might be tightened, and this in a context where the forced march of member-state governments towards fiscal balance continues, or even accelerates. Here, then, there exists the possibility of a vicious cycle, with stagnation and weak profitability further undermining the strength and organization of euro finance, exposing all the European systems to continued external pressure. The institutional mechanisms which could block such a process are weak: the concertation of national budgetary policies—to the extent that it exists—remains focused on the goals of the Stability Pact, and there is no fiscal policy of overall macroeconomic significance at Union level. The truth is that Europe is not generating enough assets, either 'real' or 'financial'. The deep-rooted preoccupation with *les grands équilibres* has held back development for twenty years (relative to a perpetually disequilibrated US economy). What is needed, on both economic and social grounds, is a relaunch of economic development, supported by a huge financial mechanism; but one which functions with different standards to those of globalized US finance.

Chapter 4

Review of Duménil and Lévy, *Crise et Sortie de Crises*

Gérard Duménil and Dominique Lévy, *Crise et sortie de crise: ordre et désordres néolibéraux*
Presses Universitaires de France: Paris 2001, 128 FF, paperback
286 pp, 9 782130 513445

John Grahl

THE SWAY OF FINANCE?

How are we to understand the new phase of capitalism that has emerged, over the last half-decade or so, from the long downturn that followed the postwar boom? A decisive resolution, at last, of a twenty-year period of crisis, with the deep restructuring that took place from the mid-seventies to the mid-nineties now clearing the way for sustained capital accumulation? Or as a more troubled exit into a new stage marked by further financial instability? *Crise et sortie de crise* reminds us that this is not the first time that modern capitalism has transformed itself in the course of a profound structural crisis. In this view from Paris, the emergence of the neoliberal order is set in a century-long perspective: what can the solutions of the Great Depression that beset the final decades of the nineteenth century tell us about the trajectories of today?

Duménil and Lévy begin with an analysis of the slowdown of the seventies, following *les trente glorieuses*—the 30 glorious postwar years. The rate of profit is taken as the key variable here, in a quite classical sense. They postulate a 'Marxian trajectory' in which, at a certain point, the established pattern of economic advance was no longer able to deliver rapid gains in labour productivity without the cost of fixed-capital investment soaring. On both sides of the Atlantic, the attempt to restore conditions for profitable expansion by using Keynesian methods to maintain activity failed, yielding only a brief stay of execution for the postwar model. It was at this stage, they argue, that finance capital began a decisive intervention to reassert—for the first time since the early thirties—its own hegemonic control.

It was this finance-led turn to neoliberal policies at the beginning of the eighties that released all the classic mechanisms of crisis. Recession and monetary

restriction forced reorganization of the productive system, while unemployment restored labour-market discipline. In fact, argue Duménil and Lévy, the claims of labour soon ceased to be the main barrier to profitable investment. Instead, the instability and the relatively poor growth-rates of Western economies over the following decades are traced to policies imposed by finance capital which, in practice, prolonged the crisis. The leap in interest rates after 1979 inhibited productive investment, despite the recovery in gross rates of profit. Deregulation of capital flows on a world scale resulted in sharper and more frequent fluctuations of the business cycle—'disorders' of neoliberalism triggering devastating disruptions in the developing world, from the debt crisis in Mexico at the beginning of the period to the East Asian crises at its close. As income was steadily transferred from producers to shareholders, capitalism's inherent tendency to 'reproduce and exacerbate inequalities and injustice' intensified.

Duménil and Lévy situate financial globalization within the context of American hegemony, but they see developments on both sides of the Atlantic as broadly similar. In an analysis darkened, perhaps, by the spectre of three million out of work in France—and in contrast to much Anglo-Saxon writing—the role of mass unemployment during the long downturn is a central theme of *Crise et sortie de crise*. Mainstream accounts of Europe's supposed labour-market rigidities are dismissed, and the greater persistence of European unemployment explained by a somewhat less advantageous balance between expansion and rationalization—giving rise to slightly faster growth of labour productivity, at the cost of job-creation.

This weakness, in turn, is traced to macroeconomic policies in the EU, which Duménil and Lévy view as excessively restrictive, even when the new financial constraints on governments are taken into account. Had economic growth been only 0.2 per cent per annum higher, growth of labour productivity only 0.2 per cent slower and the effective work week reduced by 0.1 per cent a year, unemployment rates could have been contained. 'It was not a miracle that was needed but a little improvement (*un petit mieux*) or slightly less of a deterioration.' They fail to add that lack of effective, Europe-wide coordination of macroeconomic policies also contributed to stubbornly high levels of unemployment. The severe monetary contractions of the early eighties, and again at the beginning of the nineties, were both marked by unusual disarray among EU states.

Crise et sortie de crise draws some striking comparisons between the last quarter of the twentieth century and the Great Depression of 1875–93. Duménil and Lévy read the Victorian downturn, too, as the outcome of a 'Marxian trajectory'—that is, a major structural crisis precipitated by a failure to build enough innovations into established investment patterns. A fundamental restructuring of productive relations and financial mechanisms—the rise of the massive corporations and investment banks supporting them, above all in the US—eventually restored the yield on new investments, through the breakthrough in labour pro-

ductivity associated with the assembly line and scientific management. This is a precedent that suggests a new phase of sustained economic dynamism is a real possibility today. But the rise of big business also made for dangerous imbalances in the turn-of-the-century productive system. The giant firms existed alongside very large numbers of smaller and less efficient enterprises, often in the same sectors; only very buoyant market conditions made it possible, for a time, to run old and new orders in parallel. Another source of instability lay in the extreme fragility of the financial structures—dominated by investment banking—that had promoted the rise of the big companies. Duménil and Lévy thus define the crash of 1929 and the worldwide depression that followed it as 'the crisis stemming from the resolution of the crisis of the late nineteenth century'. The collapse expressed a failure by the dominant economic groups to move beyond orthodox prescriptions and to adapt institutional frameworks and policies to new conditions.

The authors make no apocalyptic predictions. The very fact that 1929 took place, they argue, makes it unlikely to happen again: any disturbance serious enough to trouble the centre will immediately meet with statist intervention. The lessons of *fin-de-siècle* restructuring yield a more sober verdict: the technical and economic conditions for a new expansionary phase of capitalist growth do indeed exist, but may be undermined by serious imbalances in rates of development and unstable systems of financial control. Finance capital may wish to move to a new, more centralized stage of neoliberalism; but, the authors point out, it is not the only actor here.

Two readings of capitalism's future trajectory are presented in conclusion. In part, these are complementary; in part, they widely diverge. Firstly, a 'Keynesian' chapter traces the economic dysfunctions resulting from the liberalization and worldwide penetration of dollar-based finance: chronic imbalances in international payments, repeated foreign-exchange disturbances and banking crises, especially in the developing countries. Reforms aimed at stabilizing the current order would call for strong global institutions to regulate the world economy, both taming and sustaining potentially dangerous capital markets.

The second reading—characterized as 'Marxist', but a Marxism combining 'fundamentalism and revisionism'—attempts to look beyond these limits. It detects, in the emergence of globalized economic relations, a new and higher stage in the socialization of production. The giant fund-managing companies which dominate private insurance and pension provision open the way to a further 'mutation of property relations', the latest evolution of the process that saw, at the beginning of the twentieth century, the birth of the giant corporations financed by share capital. If the authors do not see in such developments any clear path to social control over economic life they still feel able to claim that, 'sooner or later private ownership of the means of production will belong to the past, whatever the steps of this dissolution may be'.

Crise et sortie de crise is a clear-minded and trenchant work, which we must hope will find an English-language edition soon. What is its originality within the literature of a radical political economy today? Duménil and Lévy share the underlying idea of an overaccumulation of capital with a good many economists in the Marxist tradition. But they differ in significant ways from other bodies of theory in the field. Criticizing their compatriots in the Regulation School, for example, Duménil and Lévy argue persuasively that the regulationists mistake some of the consequences of the long postwar boom—regularly rising wages, the prominence of organized collective bargaining—for its preconditions. The 'institutional forms' of the fifties and sixties, on which writers like Michel Aglietta have insisted, were not as important as the regulationists have claimed. The distinctive emphasis of Duménil and Lévy falls, by contrast, on the central role they attribute to finance in the history of capital over the past three decades.

Here *Crise et sortie de crise* adopts a highly intentionalist position. For Duménil and Lévy, the term 'finance' designates a class fraction capable of acting with collective determination in pursuit of clear-cut objectives. Since the seventies, its success in securing these has—according to their account—been so great that we can speak of the 'autonomization' of finance, in determining policy outcomes over this period. The increased salience of capital markets, the higher costs of credit, not to speak of changes in the pattern of public expenditure, are all interpreted as expressions of the triumph of this class fraction over productive sectors of capital and labour alike. Likewise, the dynamic of financial globalization is viewed as the result of energetic initiatives by a well-defined set of economic interests.

This vision of the workings of latter-day capitalism is too voluntaristic. Finance is not so much a fraction of capital with a collective subjectivity, as an objective function for the reallocation of liquidity in any market economy. Temporarily, there do exist conjunctures in which the growth of financial wealth may become dissociated from production: the recent stock-market bubble in the United States is a case in point. But, as Duménil and Lévy themselves point out, any continuing income stream from financial assets must be a deduction from profits or wages. Moreover, it is always necessary to distinguish intermediaries from holders of financial assets; although the two roles can be played by the same agents, this is the exception rather than the rule. The liberalization of capital markets is treated by Duménil and Lévy as if it simply reflected the interests of intermediaries and creditors, whom they assimilate. But some debtors, particularly but not only in the US, have been major beneficiaries of the process as well.

Thus the detailed record of the downturn does not bear out the kind of decisional model on which Duménil and Lévy rely. The most important single turning-point in the move away from Keynesian crisis-management was the

drastic tightening of US monetary policy in 1979—the so-called Volcker shock. Can this policy shift be traced back to an organized group of private-sector agents? Hardly. Some commentators have spoken of it as a 'revolt of the lenders', and so far as it goes, this is not incorrect. But the monetary malfunctions of that time were so severe that the very distinction between borrowers and lenders was breaking down; everyone wanted to borrow, leaving the Federal Reserve itself as the only continuing lender. The American middle classes can move a lot of money. The kind of pressure-cooker Keynesianism that attempts to eliminate the rentier by eroding the value of monetary assets is fundamentally incompatible with capitalism (which is why this reviewer and others were proponents of it at the time). The rule of capitalism is, 'thou shalt sell'. The rule of financial repression is, 'thou shalt buy'. But if output and labour markets are increasingly dominated by suppliers, most of the mechanisms of a decentralized market economy cease to function and mechanisms of allocation that are more centralized and politicized become unavoidable.

Duménil and Lévy describe the Federal Reserve's action in 1979 as an 'American decision'. But both terms require qualification. Confronted by a dramatic flight from the dollar provoked by inflation and negative real interest rates, Volcker sought the assistance of the Bundesbank to stabilize the exchange rate, as there was a headlong rush into any and every alternative store of value—gold, real estate, oil reserves, Swiss Francs, Deutschmarks. The Bundesbank refused and invited Volcker to get the US money supply under control. So the 'decision' to squeeze credit was tightly constrained. Compare, to take the most obvious counter-example, the monetary contraction in Germany from the late eighties onwards—a 'European decision'. The Bundesbank squeezed longer and harder against an inflation rate below 4 per cent than Volcker had against inflation of 14 per cent and rising. So the move was much less constrained than its US counterpart, but of equal or greater consequence for European labour markets.

In general, *Crise et sortie de crise* ascribes too much unity and coherence to the calculations and strategies of ruling groups, and underestimates the importance of purely market developments in undermining the postwar model. Consistent with their treatment of finance, Duménil and Lévy tend to block together what they take to be the effects of its victory under the rubric of neoliberalism. In their usage, the term comprehends: the ideological and political assaults that shattered the postwar settlement and its institutions; the economic processes by which new regimes of accumulation were installed on a world scale; and the workings of the new globalized system of trade and investment that has issued from them. Duménil and Lévy acknowledge imprecisions in the term, but write that 'at the level of analysis at which we place ourselves, the degree of subjectivity or objectivity is a secondary issue. It is only the outcome which matters and this is unambiguous'. But while it is true that direct ideological challenge to the Keynesian consensus of the postwar era—the moment of Thatcher and

Reagan—was essential to the emergence of today's globalized capitalism, the pragmatists who manage the system today, from Greenspan downwards, are quite capable of acting in quasi-Keynesian fashion to shore it up. In this respect, the history Duménil and Lévy offer of the period is too streamlined. But this bold reconstruction of the time is a challenge to those disposed to a more objectivist reading of it to produce a better account of systemic response to the breakdown of the postwar settlement.

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Chapter 5

Sand in the wheels or spanner in the works? The Tobin tax and global finance

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COMMENTARY

This section is designed for the discussion and debate of current economic problems. Contributions which raise new issues or comment on issues already raised are welcome.

Sand in the wheels or spanner in the works? The Tobin tax and global finance

John Grahl and Photis Lysandrou*

This paper presents a radical critique of the Tobin tax—a tax on currency transactions—by undercutting certain assumptions about the size and character of the world's foreign exchange markets which furnish the tax with its basic rationale. While it is acknowledged that only a fraction of the massive volumes of FX transactions relate directly to trade in goods and services or to cross border investments, it is denied that all the residual transactions are motivated purely by exchange rate considerations (speculative or hedging activities). Rather, the argument is that a significant proportion of FX trades have money market characteristics and that these trades, together with domestic money market transactions, play an important role in the day to day operation of the global financial system. This perspective is used to show that the imposition of a Tobin tax would cause extensive material damage to the system, with consequences that may run counter to the expectations of supporters of the tax.

Key words: foreign exchange, Tobin tax, global finance
JEL classifications: F02, F31

1. Introduction

Taxes tend to be unpopular with the public at large, but James Tobin's proposal for a tax on foreign exchange transactions[1] is proving to be an exception to the rule, as support for it continues to grow among many constituencies.[2] The reasons for the popularity of the Tobin tax, more than thirty years after it was first proposed, are not difficult to fathom. The post-Bretton Woods era has been marked by an exceptional degree of currency

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[1] Tobin (1974,1978,1995,1996).

[2] Expressions of support have not only come from parliaments (motions in favour of the tax have been passed, for example, in the Canadian parliament in March 1999, and in the French parliament in December 2001) and political parties (particularly left-wing and Green parties) but also from various development and aid agencies.

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volatility which on occasion has had a catastrophic effect on real economic activity. The fact that this volatility has been accompanied by a huge daily turnover in the foreign exchange (FX) markets and the fact that the bulk of currency trades are extremely short term with no direct connection to trade in either goods and services or in securities have served to strengthen the general conviction that the root cause of currency volatility is currency speculation.[1] This position explains why a simple *ad valorem* tax on currency transactions is widely held to be an appropriate and efficient corrective measure for, if set at a modest level, it would apparently have no deterrent effect on long-horizon transactions undertaken for purposes of trade or cross-border investment while penalising short-term round trips.[2] Since even a minute tax would, given the massive volumes of currency transactions, generate substantial revenues[3] which could be dedicated to a host of multilateral causes, one can understand why the Tobin tax has become firmly lodged in popular opinion as a 'good' tax.[4]

If to date there has been no sustained effort to implement the Tobin tax on an international basis, this is not merely because of the strenuous opposition from those institutions whose interests would suffer by it. A more plausible reason is that the proposal contains flaws that have been readily exploited by opponents. A number of critics, for example, have attacked the simplistic identification of FX trades and speculation, some arguing that a significant proportion of the latter is accounted for by currency arbitrage,[5] and others arguing that much of what appears to be excessive trading volumes are simply risk spreading and position balancing trades undertaken by dealers.[6] In both cases, the position is that the imposition of the tax could undermine the efficiency of the currency markets and possibly enhance, rather than diminish, exchange rate volatility.[7] A further problem is that, even if the Tobin tax were considered desirable, it is by no means clear that it would be effective. Tobin tax supporters appear to take it as read that most speculative currency transactions are not only driven by short-term profit opportunities but also executed through successive short-term round trips. However, recent experience indicates that major speculative attacks on particular national currencies have been driven by the

[1] This conviction is shared by expert and popular opinion alike. In fact, it is surprising how many economists reach this view on the most casual observations of FX trading volumes. Harcourt (1995), among many others, assumes that as FX transactions can only divide into three categories, i.e., to finance trade, foreign direct investment and speculation, and as the first two categories only account for a small fraction of the massive growth in daily turnover, speculation must be the cause of volatility. Similarly with Arestis and Sawyer (1997) who, before evaluating the 'thesis that a transactions tax can reduce the excessive volume of speculative transactions' simply take it as read that non-trade-related FX transactions must be 'excessive' and therefore 'speculative' by virtue of being 60 times 'greater than the volume required to finance trade'.

[2] Tobin has suggested tax rates of 1%, 0·5% and 0·2%; but the figure now typically discussed is 0·1%, although one commentator (Spahn, 2002) has recently suggested a rate as low as one half of one basis point or 0·005%.

[3] Felix and Sau (1996) give some estimates of the sums that might be raised.

[4] Michalos (1997). Tobin himself has always insisted that the revenue raising potential of a currency transactions tax is a 'by-product'. Its central objectives are to give back to governments some scope for macroeconomic policy autonomy and to reduce exchange rate volatility. It is clear, however, that not all Tobin tax supporters agree with Tobin's own particular ordering of priorities or, indeed, even with his stated range of objectives of the tax. Thus where some protagonists can also see the Tobin tax as a sin tax that penalises socially undesirable behaviour (Felix,1995) or as a surrogate tax on capital income(Spahn,1996; Wachtel, 2000), others see it as part of a wider programme for contesting the neo-liberal agenda (Jetin and De Brunhoff, 2000) and for democratising the globalisation process (Patomaki, 2001). The publications of ATTAC, a French pressure group campaigning for the Tobin tax, give some idea of the range and variety of reasons behind the support for it.

[5] Davidson (1997).

[6] Frankel (1996).

[7] Shome and Stotsky (1995), Folkerts-Landau and Ito (1995), Stotsky (1996) and Spahn (2002)

expectation of a substantive re-alignment in exchange rates and that the determining factor has been the scale of short-selling rather than its frequency. Clearly, in such cases, the existence of a small currency tax would have had little if any deterrent effect.[1] Finally, there is the issue of feasibility. While Tobin tax supporters recognise that there are impediments standing in the way of legislating for, and enforcing, such a tax, they believe these to be surmountable.[2] Critics disagree and argue that the level of agreement and coordination required to prevent evasion/avoidance of the tax by the use of different financial centres or different instruments are such as to make operation of the tax infeasible.[3]

While it may seem that every possible argument for or against a Tobin tax has been exhaustively discussed, we believe that there is something more to be said on the subject. Although the dispute over the tax has been intense and wide ranging, it has taken place on the basis of an assumption that is accorded axiomatic status, namely, that all non-goods/securities-related FX transactions are driven by exchange rate considerations (the distinction drawn by disputants is merely between those motivated by a desire to profit from exchange rate movements across time—or from exchange anomalies across space—or to hedge against the risk arising out of such movements). This assumption sustains a view of the world's currency markets in which exchange rate volatility and FX volumes can appear to be locked together in dynamic reciprocity: expectations of volatility generate mounting volumes of currency transactions which then react back on exchange rates, causing more volatility. This explains why the Tobin tax is taken so seriously even by sceptics, and why every financial crisis reawakens debate around it.

This paper challenges the rationale behind the Tobin tax proposal, not by returning to the much debated issues of desirability, effectiveness or feasibility, but by undercutting the basic premise that sustains the whole debate. We deny that all non-goods/securities-related FX trades are exchange rate motivated. Rather, a growing part of FX turnover is determined by liquidity and interest rate considerations, in other words, by those same concerns and priorities that lie at the heart of domestic money-market transactions.[4] Emphasising the increasing importance of FX swaps, we suggest that FX turnover plays an essential role in the day to day operation of the global financial system. From this perspective, it follows that a tax on currency transactions, assuming it to be feasible, would have a profoundly damaging impact on the world system—it would be less like sand in the wheels than a spanner in the works.

The more 'gung-ho' proponents of the tax might well consider this to be an acceptable outcome provided that it reined in financial activities so that they were once again subordinate to the demands of industry, but we argue that this would not happen. On the contrary, we stress the uneven manner in which the Tobin tax would impact on the

[1] The similarities and differences between Grieve-Smith (1997) and Davidson (1997) are instructive here. Both authors believe that speculation in the world's financial markets is a major problem that needs tackling through a more ambitious reform plan than is represented by the Tobin tax proposal: 'boulders' rather than 'sand'. But where Grieve-Smith believes that there is still need for a Tobin tax 'as a means of reducing run-of-the-mill speculative transactions', Davidson does not because he sees most run of the mill trades as arbitrage activity.

[2] Haq *et al.* (1996), Griffith-Jones (1996) and Schmidt (2000).

[3] Garber and Taylor (1995) see the implementation of the tax as infeasible on technical grounds, while Kenen (1996) cites political reasons for his scepticism. Eichengreen seems to have shifted his position from one of believing the tax to be both politically and technically feasible (see, for example, Eichengeen and Wyplosz,1996) to one of seeing it as essentially infeasible on technical grounds (Eichengreen, 1999).

[4] It can be noted that if FX swaps tend to be traded in the major markets like London, this is precisely because their depth and liquidity are such as to enable these transactions to be executed without exerting any discernible influence on exchange rates. London currently accounts for approximately 32% of all world forex trades, but approximately 50% of FX swaps.

different national financial markets. Our view is that the US markets, given that they are already the world's biggest in terms of breadth, depth and liquidity, would be likely to expand even further. By inadvertently contributing to the expansion of the US markets, a Tobin tax would only enhance their supremacy. In this event, the impact of the tax is likely to be directly opposite to that which is intended.

The paper divides as follows. In Section 2, we look closely at changes in the composition of daily FX transactions over the last decade and show that FX swaps represent an important adjunct of money market transactions. In Section 3, we explain the general contribution of the money market to the operation of the global financial system before moving on to discuss the contribution of FX swaps in particular. In Section 4, we draw on capital market data to give weight to our claim that the imposition of a Tobin tax would strengthen, rather than undermine, dollar hegemony. Section 5 concludes.

2. FX trading as 'speculation'

The aims of this section are, first, to call into question the view that FX trading is driven primarily by exchange rate speculation, second, to suggest that other accounts of FX transactions which focus on exchange rate movements are also flawed and, finally, to argue that an increasing share of FX transactions arise from money market operations and have nothing to do with exchange rate fluctuations.

Since much of the present confusion over the size and character of the FX markets stems from a failure to pay close attention to the different types of FX transactions, we begin with a brief discussion of these. There are basically three types of FX transactions, spots, outright forwards and foreign exchange swaps. S*pot* transactions involve an exchange of currencies at the current rate for settlement within two days. *Outright forward* transactions involve the purchase and sale of currencies at a specified future date at a rate agreed now. They are priced, as is well established, in terms of the spot rate, adjusted for the interest rate differential between the two currencies involved. Forward markets are in general less liquid than spot markets, and exhibit higher bid–ask spreads than the latter.

A *foreign exchange swap* combines a spot transaction with a forward transaction in a single contract; that is, a sum of currency is bought spot from, and is simultaneously sold forward to, the same counter-party.[1] Textbook treatments of the FX swap have often considered it as a variant of the outright forward, a tendency reflected by the fact that up until 1992 central bank surveys conflated the two. It is in reality a very different transaction to the outright forward, as is indicated by the following characterisations from the last four Bank of England surveys of the London foreign exchange market:

1992: 'Most recorded forward transactions are swaps, which in themselves involve neither party assuming foreign exchange risk and are closely akin to money-market transactions.'
1995: 'The more widespread use of swaps suggests that investors are becoming increasingly sophisticated in their management of liquidity and currency risk. It also provides further evidence of the increasing integration of global currency and money markets, and, by extension, asset markets.'
1998: 'Foreign exchange swaps . . . are closely linked to money-market deals (most are short-dated) and are often used to hedge currency risk and manage liquidity.'[2]

[1] Note that swap transactions take place on the spot market and that, therefore, the market for swaps is more liquid than that for outright forwards.

[2] This expression 'to hedge currency risk' is, as will be seen, misleading and, in a strict interpretation, illogical.

Table 1. *Covering an outright forward position (adapted from Burnham 1991)*

Transaction	Future settlement date: 0–2 days	Future settlement date: 30 days
1. Outright forward—corporate customer		Sell euros Buy dollars
2. Spot interbank	Buy euros Sell dollars	
3. Swap	Sell euros Buy dollars	Buy euros Sell dollars

2001: 'FX swaps are often used as tools to manage interest rate risk; they are effectively linked to interest rates of two different currencies, with their value determined by movements in those interest rates.'[1]

Two key points emerge from these excerpts. The first is that, although classified as FX instruments, FX swaps are more like money market instruments: since neither party to an FX swap assumes any currency risk, it follows that interest rate and liquidity considerations, not possible exchange rate movements, are always the *immediate* motives behind the swap.[2] The second point is that FX swaps, viewed from a functional perspective, fall into two distinct categories: those *related* to hedging and speculation strategies (the Bank of England should certainly have mentioned the speculative use of swaps) and those used *purely* to manage liquidity and interest rate risk. The first category of swaps, exchange rate-related swaps, can be distinguished by the fact that they are matched with spots and with outright forwards (as is the case in hedging strategies) or simply with spots (as in the case of speculation). Table 1 illustrates the standard case for hedging.

When requested by a corporate customer to supply a currency forward, say euros in 30 days' time, a bank will usually react by undertaking two additional transactions: to this outright forward deal with its customer (transaction one) will be added a spot inter-bank trade (transaction two) and a foreign exchange swap (transaction three).[3] The purpose of the spot transaction is to eliminate the bank's exchange rate risk resulting from the forward; the purpose of the swap is to provide the dealing bank with a currency (often its domestic currency) which can be placed more advantageously than the currency in which it has acquired a forward liability. Since the forward leg of the FX swap is priced in accordance with interest rates on the offshore inter-bank market, where spreads are lowest, this means that the bank expects to achieve a return on its holding of the swapped currency

[1] Bank of England (1992, 1995, 1998, 2001A). Within money markets, one can distinguish a basic recycling function from the hedging and speculation on interest rates which arise from this function. FX swap transactions relate to both. They are priced on the basis of interest rate differentials and thus can be used to take a position on one of the interest rates to the extent that its movement is mirrored by changes in the differential. Emphasis here, however, is on the broad difference between exchange rate motives and money market motives for an FX transaction.

[2] Choudry (2001, p. 517) makes the very significant observation that, in most major banks, the FX swap trader sits on the money market desk and *not* the FX desk.

[3] Table 1 also illustrates and confirms an argument made by Davidson (1997, p. 678). In the same article (footnote 12, pp. 678–9) this author sugested that the 'growth in swap and forward transactions *vis-à-vis* spot transactions is consistent with the view that more hedging per transactions [is] occurring compared to the past'. Davidson refers to Jan Kregel in this context.

Table 2. *Funding a long speculative position*

Transaction	Future settlement date	
	0–2 days	2–4 days
1. Spot purchase	Sell dollars Buy euros	
2. Swap	Sell euros Buy dollars	Buy euros Sell dollars
3. Spot sale		Sell euros Buy dollars

superior to that prevailing for offshore deposits. Thus, within the hedging strategy, the motive of the swap itself concerns liquidity and interest rates, not possible FX movements. The swap is a money-market operation, not in itself a hedge.[1]

Similarly, a swap, or indeed a series of swaps, can be used to hold open either a long or a short speculative position, although it introduces money market considerations into such strategies. For example, a US agent with a long position in euros (transaction 1 in Table 2) might swap them for dollars (transaction 2) if a more advantageous return could be obtained from a dollar placement (or from clearing a dollar loan) than was available on euro deposits in the inter-bank market. When the swap is completed by exchanging dollars for euros, it could be repeated, to roll the open position over, or profits/losses could be taken immediately via a spot sale of euros (transaction 3). A short position, financed by borrowing euros and selling them spot for dollars, might also be swapped. This could reduce the cost of the position by clearing the euro debt. When the swap is completed, dollars might be swapped again for euros to hold the position open as before, or profits or losses could be taken by a spot purchase of euros. Here once again, the speculative position as such is not established by the swap but by a previous spot sale or purchase. The swap is motivated by money market considerations: it provides either a more advantageous interest rate, or a better adapted pool of liquidity, than simply holding the speculative position.

The second category of swaps, pure money market swaps, is completely unrelated to exchange rate positions, whether hedging or speculative. The motive now is solely liquidity and interest rate management. These swaps can be identified by the fact that they arise on a *stand-alone* basis and not in connection with either spot or outright forward transactions (see Table 3, where there is only *one* FX transaction, between two *credit* operations).

The Bank of England does not make this particular point explicit in its general characterisation of swaps. For that matter, nor does anyone else, as far as we are aware. Yet it is absolutely essential to the interpretation of activity in the FX markets. The logic is straightforward. If the volume of swap transactions were seen to lag behind or broadly correlate with the volumes of spots and outright forwards, one could safely interpret

[1] This does not mean that spot transactions themselves cannot have a certain money-market aspect. Until very recently, the term 'spot' has been something of a misnomer in that delivery and settlement were not simultaneous and therefore an extension of credit (for up to two days) could be involved. The new CLS settlement system moves these transactions much closer to a simultaneous exchange of currencies. If our view is correct, this will lead to a further decline in the observed ratio of spot to swap trades, because the credit functions of the former will be absorbed by the latter (CLS, 2001).

Table 3. *A pure money market FX swap*

Transaction	Future settlement date	
	0–2 days	2–4 days
Credit operation I	Borrow dollars	
FX swap	Sell dollars Buy euros	Buy dollars Sell euros
Credit operation II		Repay dollars

FX activity from an exchange rate perspective. If, on the other hand, swap transaction volumes are seen to dominate those for spots and outright forwards, an alternative perspective on FX activity which foregrounds money market concerns becomes more convincing. What does the evidence tell us?

Comprehensive statistical surveys of the world's major foreign exchange markets, undertaken by central banks and coordinated by the Bank for International Settlements (BIS), have taken place on a triennial basis since 1986. In Table 4, we present BIS data for average daily FX turnover since 1992, the year that FX swaps began to be classified and measured separately from outright forward transactions.

2.1 Speculation

Table 4 shows that average daily FX turnover hovered around $1·2 trillion over the past decade, a sum that is more than fifty times the daily trade in goods and services and approximately ten times the daily trade in securities. This has led many commentators, subscribing to the view that the only legitimate FX trades are those accompanying either trade in goods or services or foreign investments, to characterise these FX volumes as 'excessive' and to see them as proof that the currency markets are dominated by speculation. The immediate objection to this view is intuitive. In principle, speculation is a zero-sum game: one agent's gains from currency appreciation must exactly match another agent's losses as soon as positions are closed. As Table 4 shows, and as the proponents of the Tobin tax themselves emphasise, positions in FX markets are extremely short run, closed out within days or even hours. How can this huge market persist over decades if it does not generate net gains for its participants?

But the main objection is empirical. Table 4 shows that approximately one half of total trading volume is now accounted for by FX swaps.[1] As we have seen, these cannot in themselves be speculative in nature because neither counter-party assumes foreign exchange risk. One can only speculate on foreign exchange (or any other asset) by taking an open position in it; neither counter-party to an FX swap takes such a position. If one still wished to maintain the 'speculation' account of FX volumes, in spite of the rapid decline in spot trades and the rising proportion of FX swaps, one could do so by arguing that speculative positions were being held open for longer periods of time and that short-dated swaps were being used to roll over these positions in the manner above in Table 2. But the evidence is against this. First, BIS data show that maturity breakdowns in the FX market are stable. Second, as regards the foreign exchange exposure of international

[1] There are still commentators who fail to make the indispensable distinctions between spot, forward and swap trades (see, for example, Hau *et al.*, 2002, and the critical remarks of Portes which follow their article).

Table 4. *Reported foreign exchange market turnover by instrument, counterparty and maturity*

Instrument/counterparty	1992	1995	1998	2001
	Daily averages in April, in US$bn			
Spot	**394**	**494**	**568**	**387**
With reporting dealers	282	325	348	218
With other financial institutions	47	94	121	111
With non-financial customers	62	75	99	58
Outright forwards	**58**	**97**	**128**	**131**
With reporting dealers	21	33	49	52
With other financial institutions	10	28	34	41
With non-financial customers	28	36	44	37
Up to 7 days	–	50	66	51
Over 7 days and up to 1 year	–	44	59	76
Over 1 year	–	2	5	4
Foreign exchange swaps	**324**	**546**	**734**	**656**
With reporting dealers	238	370	512	419
With other financial institutions	39	108	124	177
With non-financial customers	47	68	98	60
Up to 7 days	–	382	529	450
Over 7 days and up to 1 year	–	155	192	197
Over 1 year	–	7	10	8
Total	**776**	**1,137**	**1,430**	**1,173**
With reporting dealers	541	728	909	689
With other financial institutions	96	230	279	329
With non-financial institutions	137	179	241	156
Local	316	526	658	499
Cross-border	391	613	772	674

Source: BIS (2001).

banks, there is no new evidence to disturb Goodhart's (1988) conclusion that they avoid carrying open FX positions. Bank of England data, for example, indicate that the currency breakdown of liabilities and assets of London-based international banks is extremely stable.[1]

Technically speaking, exchange rate speculation can be conducted in the traditional market for outright forwards, but in practice this is not likely to take place to any significant degree because of the costs involved. Rather, professional traders are likely to take positions in the spot market, where the ability to cover an open position quickly is far greater and where the bid–ask spreads are substantially narrower than in forward markets. Confirmation that most outright forwards are in fact undertaken for currency risk hedging purposes would also seem to be given by the relatively high proportion of trades in this category accounted for by non-bank financial intermediaries and by non-financial institutions.

[1] See Bank of England, *International Banking Statistics*, Table D, 'Banks Operating in the UK, External Liabilities and Claims by Currency and Sector'. At the end of the third quarter of 2001, dollar liabilities were $1,034 billion against assets of $917 billion. Euro liabilities were $611 billion against assets of $717 billion. The net open position between these two currencies was thus less than $100 billion. Frequently, the imbalance is even smaller: at the end of the first quarter of 1999, net open positions in dollars were less than $7 billion, in euros less than $2 billion.

To repeat, the speculation thesis cannot apply directly to swap transactions, which are rising and now constitute well over half of the FX market, and is most unlikely to apply to outright forwards. The upshot is that, if speculative activities can dominate a market for any one type of instrument, it must be that for spot trades. The key problem for the speculation thesis in this respect is that spot trades, as is manifest in Table 4, represent a rapidly declining part of total FX volumes.[1] Thus, to the extent that the speculation thesis was ever plausible, it is becoming rapidly less so.[2]

2.2 Hedging

Other explanations, although more valid than the speculation notion, also err in emphasising exchange rate fluctuations as the basis of FX activity. Consider hedging. There is no doubt that this explanation, unlike the speculation thesis, is consistent with the continuity of the market and that it must be, to some extent, valid. Again, this account cannot apply directly to swap transactions. Swaps cannot be used to hedge exchange rate risk any more than to speculate on exchange rate movements, and for the same reason: they are closed positions. To hedge an open position in a currency, one would necessarily have to take out a second open position with the opposite exposure—it is impossible to use an FX swap for this purpose. Swaps, as explained, form part of a hedging strategy when used in conjunction with spots and outright forwards; but given the wide disparity between the amounts of outright forward transactions and swaps in Table 4, it would seem that only a small fraction of swaps are embedded in forward hedging operations.

Hedging by FX dealers themselves, which is very short run, normally makes use of opposite *spot* exposures to eliminate risk. It is an alternative to the use of outright forwards, which is the preferred strategy of non-financial agents, working over longer horizons. Several commentators argue that 'fundamental' FX trades, arising from trade in current output or securities, are multiplied several times by this kind of inter-dealer hedging. This game of 'hot potato' can easily be mistaken for speculation but, in fact, represents its exact opposite. To quote Burnham (1991): 'Some commentators observe that the bulk of foreign exchange activity (over 85%) is between banks and conclude that vast amounts of speculation are taking place. But rather than being speculative, part of this activity is actually the means by which speculative positions are avoided.'[3] One account (Portes and Rey,1998) even suggests that the multiplier involved may be as high as 10—an international security trade of $1m, for example, might give rise to $9m-worth of inter-dealer activity. Our view is that it is implausible to make such a large volume of secondary, interbank, transactions rest on such a small base of 'fundamentals', dealer–customer trades. High ratios between primary and induced trades are certainly typical of organised asset markets in general, but such a ratio as one to ten would be a very extreme value. Some commentators attribute this very high ratio to the supposed 'inefficiencies' of the FX market, where there is a network of dealers and brokers rather than a centralised market, but this decentralisation can be exaggerated: there are not very many players and their communications are extremely rapid.

[1] The full extent of this decline can be better appreciated by going back to the very first central bank surveys of the FX markets. To take the London market as an example, spots accounted for 73% of the total volumes traded here in 1986 but by 2001 the ratio had fallen to 30%.

[2] We certainly do not deny that trading in the currencies of some developing countries is often driven by pure exchange rate speculation. But such currencies are a vanishingly small fraction of the world FX market.

[3] This view is reiterated by Flood (1994): 'the large volume of inter-bank trading is not primarily speculative in nature, but rather represents the tedious task of passing undesired positions along until they happen upon a marketmaker whose inventory discrepancy they neutralise'.

2.3 Arbitrage

A few writers suggest that a large volume of FX transactions might be a question of arbitrage. Two objections can be advanced. First, the speed with which prices are communicated on FX markets makes it implausible to suggest that the bulk of transactions are driven by inter-dealer price differences, as would have to be the case for the arbitrage thesis to be valid.[1] Second, this explanation would seem to apply only to spot trades—since the cost of a swap transaction depends only on the interest rate differential which is applied to the forward price relative to a single spot price (the well-established theory of covered *interest-rate* arbitrage), a swap cannot be used to exploit differences *between* different spot prices. Technological factors may reinforce this view of arbitrage. Increasingly, deals between brokers are mediated by electronic brokerage systems rather than separate market operators, and this suggests that price discovery is becoming easier and more rapid.[2]

Similar considerations apply to 'micro-structure' theories of FX volumes.[3] Originally developed to fill in the gaps in 'macro' explanations of short-run exchange rate volatility, this approach to exchange rates explains the high volumes of intra-day spot trades in terms of inventory management and risk sharing: given the decentralised, non-transparent nature of FX markets where bilateral dealer–customer orders are not observable by others, dealers, seeking to avoid exposure to open positions incurred in trades on behalf of customers, pass on their inventory imbalances to other dealers who in turn pass these on. As this takes place, dealers alter their prices, and so more price exploration becomes necessary. This seems to us to be essentially a combination of the hot potato hedging and arbitrage theories and to be open, therefore, to the same objections.

To summarise, if the speculation interpretation of FX volumes held by proponents of the Tobin tax had some credibility in the days when transactions were dominated by spot trades, it is completely implausible today, when swaps represent the dominant instrument. In fact, the domination of the FX markets by swap transactions means that no account of FX volumes that is centred on exchange rate movements can be satisfactory. Recall that the precondition for this is that swap transactions at most broadly correlate with spot and outright forward transactions. Yet the global data presented in Table 4 make clear that there are now more swaps than can be accounted for by hedging and speculative activities. What is particularly striking in Table 4 is that, in the period between 1998 and 2001, spot volumes fell in absolute, not just relative, terms. In addition to the influence of electronic brokering and the decline in the number of banks as a result of bank mergers a further important reason for the drop in FX spot volumes was the replacement of 11 European currencies by the euro. The corresponding impact on FX swap volumes, which appeared to stagnate between 1998 and 2001, can be partly explained by the fact that, with the introduction of the euro, it was no longer necessary to hedge legacy currency movements using the dollar as a vehicle currency.[4] Nevertheless, the decline in FX swap turnover was not nearly as pronounced as the decline in spot trades, a fact which

[1] As we say, the 'decentralisation' of the FX market—as opposed to a situation where one market-maker might centralise all trades in a single security—has been much over-emphasised. The network of dealers active in each time-zone is small (the key agents being the 70 world banks linked to the US-offshore payments system, CHIPS) and their communications are extremely efficient.

[2] In its latest survey of the London FX market (November 2001) the Bank of England reported that more than two thirds of inter-dealer activity is now conducted using electronic brokers, compared with around 30% in 1998.

[3] See Frankel (1995) and Lyons (1997; 1998).

[4] A further explanatory factor for FX volumes is the impact of the dollar as a 'vehicle' currency. Although broad and deep, the foreign exchange market for currencies cannot provide depth and liquidity in every currency pair. Consequently, dealers taking on cross-currency transactions on behalf of customers usually do

confirms that 'stand-alone' swaps constitute an increasing proportion of the total, necessitating, therefore, a money-market rather than an exchange rate explanation of FX activity.

Although to date there is no clear theoretical account of FX swaps from a money market perspective, an interesting parallel is provided by the analysis (Fabozzi and Modigliani, 1992) of an analogous long-term instrument—the currency swap. The latter essentially concerns bond markets and involves the exchange of the principal sums raised by issues in different currencies together with both the stream of coupon payments and final redemption payments. The motive is clear: to exploit an advantageous opportunity to borrow in one currency in order to finance expenditures in another. This interest-rate arbitrage generates gains shared between the advantaged borrower and another agent requiring the first currency but able to borrow only on 'standard' terms in either market. In our view, the FX swap, although a much shorter-term instrument, can be explained by essentially the same logic—it arises as advantageous opportunities to borrow (or surplus liquidities) in one currency are matched against lending opportunities (or acute liquidity needs) in another.

There is, however, one important difference between the markets for long-run currency swaps and FX swaps. The former have become much less common with the convergence of bond markets in terms of both pricing and procedure; the increasingly globalised role of the same credit-rating agencies has tended to eliminate advantageous spreads in an issuer's borrowing power across currency zones. In contrast, given the continuous emergence of new liquidity needs within short-run credit systems and their vast scale, these recycling opportunities remain a continuing feature of money markets, even though they have been rapidly reduced by standardisation and international credit ratings in the markets for bonds. This argument is expanded further in the next section, which explores recent developments in money markets.

3. FX transactions and the money market

This section looks at FX transactions in the context of increasing money market integration across currency zones. First, the recent rapid growth of money market activity is explained in terms of widespread changes in the financial system: in particular, disintermediation (see Figures 1 and 2). Second, parallels are drawn between money market and FX activity in respect of scale, rhythm and the major players involved. Finally, these parallels are interpreted in a way which suggests that cross-border monetary flows have become a key factor of flexibility in domestic money markets.

Figure 1 shows that the growth in world financial stock over the past two decades has outstripped that of world GDP, so that from being roughly equal in size in 1980, the financial stock stood at twice the level of annual real output in 1992 and at three times that level by 2000. Figure 2 shows that the major impetus for financial growth has come from the securities markets, particularly the market for government bonds. While nominal stocks of tradable securities grew at an average rate of 10% over the past two decades, or at approximately 5% in real terms, the money supply, largely comprising bank deposit money, grew at a nominal rate of 7%, or approximately 2% in real terms, a rate similar to that of OECD GDP growth and growth in fixed capital formation.

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so by undertaking two deals, home currency/dollar, dollar/foreign currency. Once again, however, this factor is of limited significance. This is because a large number of economic and financial interactions must involve the US economy in any case and because, even when two other countries are involved, the use of a vehicle currency will normally only double the number of transactions required to effect a given trade.

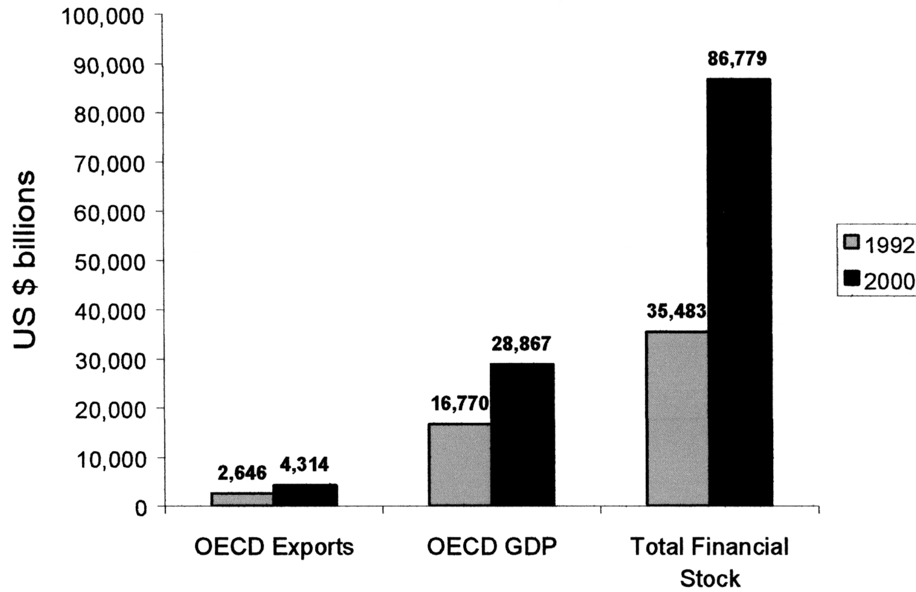

Fig. 1. *Stock of financial assets 1992–2000. Source: Bryan and Farrell (1996), FIBV, BIS.*

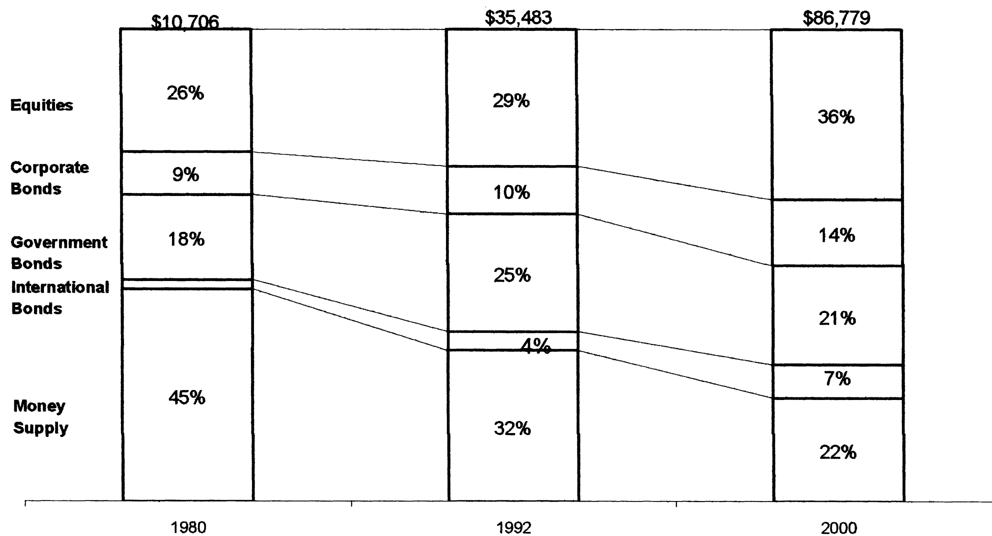

Fig. 2. *Distribution of financial stock outstanding, 1980–2000. Source: Bryan and Farrell (1996), BIS, FIBV.*

The sharp fall in the share of the world financial stock accounted for by bank deposit money is, in the first instance, a reflection of the continuing process of bank disintermediation, as large corporations increasingly fund their borrowing needs through the bond markets, and of changes in the structure of public finance, as governments increasingly fill the gap between income and expenditure with bond issues. At a more fundamental level, the constraints on the growth of bank deposit money represent an essential pre-condition for the continued increase in the stock of debt securities outstanding. In order to ensure that domestic and international bond markets continued to absorb government bonds, governments have made inflation targeting their overriding economic

priority and this, as a result of the restrictive policies pursued, has kept the growth of money stocks well below that of other financial assets. We can also note that, in addition to government-imposed constraints on the rate of bank deposit money creation, banks face similar pressures to keep down this rate both in the bond markets (where banks' credit ratings depend on tight balance sheet management) and in the equity markets (where return on equity requirements demand that banks make efficient use of capital and thus must adhere to strict lending criteria).

It follows that disintermediation of financial systems, as a well-established trend in advanced economies, together with the move to more restrictive monetary policies associated with the general reassignment of macro instruments taking place in the 1980s, have led to an acute contradiction: on the one hand, money is less and less held as an asset; on the other, the huge increase in securities transactions makes for an increased demand for money as an exchange medium. This *paradox of disintermediation* is resolved by a very rapid growth of the money markets, because it is here that monetary resources are recycled from surplus to deficit units on an immense scale, at great speed and at low cost. A recent Bank of England report on the sterling wholesale money market gives a striking picture of the size and speed of flows in this market (see Tables 5 and 6).

Table 5 shows that, over the previous decade, stocks of sterling denominated securities grew at a faster pace than British GDP, so that, where they stood at one and a half times the level of annual output in 1990, they stood at roughly three times the level of output in 2000. The left-hand column of Table 5 shows that the expansion in the total stocks of money market instruments outstanding has similarly outstripped GDP growth. Compared with an average growth rate in nominal GDP of approximately 8% during the 1990s, the 17% growth rate in money market instruments may appear 'excessive'. It can

Table 5. *Size of sterling markets. Amounts outstanding: £bn*

Year	Money market	Gilts	Non-gilt sterling bonds	Equities	Swaps	Total	Multiple of annual GDP
1990	183	125	60	486	167	1,021	1·8
1995	195	233	117	849	541	1,935	2·7
1998	434	301	203	1,334	1,979	4,251	5·0
1999	475	294	255	1,893	2,194	5,111	6·0
2000	504	294	314	1,715	2,533	5,360	5·9

Source: Bank of England (2001B).

Table 6. *Sterling money markets. Amounts outstanding: £bn*

Year	Interbank	CD	Gilt repo	Other instruments	Total
1990	89	53	n.a.	42	183
1995	93	66	n.a.	37	195
1999	155	135	99	85	475
2000	159	125	127	93	504

Source: Bank of England (2001B).

be noted, however, that, although the overall growth in the stocks of money market instruments over the previous decade has exceeded annual GDP growth, it broadly corresponds to that for stocks of government and corporate securities (these grew at a nominal rate of 19%). We take this correspondence to be evidence that money market transactions are an essential support for active trading in the securities markets under circumstances where these markets require ever expanding financial transaction balances but at the same time constrain the supply of the deposits to which these balances correspond. In other words, it is not financial speculation that is the driving force behind money market transactions so much as cash conservation and liquidity management.

Although we do not have full, up-to-date, information on the scale of some of the other major money markets, a reasonable proxy for the growth of these flows is provided by statistics for inter-bank payments systems; these must be dominated by short-run credit operations because there is simply no other way of explaining the scale of flows involved. US payments data throw some light on money market activity for, as one would expect, the scale of payments flows here is immense, large enough, according to the Federal Reserve Bank of New York to circulate annual US GDP in less than three days.[1] The two main systems, Fedwire ($1·35 trillion per day) and CHIPS ($1·19 trillion), are specialised in domestic and international transactions respectively, and recent reforms have been introduced to strengthen the linkages between the two systems.[2] Although the data do not allow us to break down money market activity by maturity or instrument, the fact that they pertain to an intense degree of cash recycling activity is indicated by Choudry's (2001) report that transactions on just one sector of the US money market—repos—are above a trillion dollars a day.[3]

In this respect, data for the Eurozone's TARGET system are particularly interesting because they allow us to distinguish intra-country from trans-frontier payments in the zone. The latter begin, at the launch of the euro in January 1999, at some 300 billion euros per day. By October 2001, they were in excess of 500 billion a day, around 8% of the zone's annual GDP. Since one can hardly invoke FX speculation to account for this growth, given that the flows take place within the same currency zone, it must follow that they concern essentially short-run credit activities. This interpretation is confirmed by the fact that the abolition of internal FX rates has not reduced but accelerated these activities.

Apart from the magnitude of flows, an equally striking feature of money markets is the concentration of lending activity towards the short end of the maturity spectrum—levels of activity increase as maturities shorten, with the shortest loans, especially overnight on the inter-bank market, accounting for the highest turnovers. Market-clearing and equilibrium theories of financial markets tend to obscure this feature of short-run credit. However, its rationale becomes clear if one thinks of markets failing to clear, leaving dealers in securities with surpluses and deficits which are often impossible to predict. The very continuity of the market economy then depends on a vast recycling process, driven rather by quantitative mismatches than by price arbitrage.[4]

[1] Federal Reserve Bank of New York (n.d.).

[2] The contrast between the nature of the systems is also relevant. Fedwire is a Gross Real-Time system: this gives greater security against payments failure. CHIPS uses multilateral net clearing, which enhances liquidity and lowers transactions costs. It seems therefore that counter-party risk is lower in the international sector, presumably because the banks involved are smaller in number and larger in size.

[3] Data collected by Cook and Laroche (1993) suggest that just three sectors of the US money market—T-Bills, Repos and Federal Funds—had a total daily turnover of $1·3 trillion in 1992. Payment systems data suggests that daily activity must have grown by some 40% since that date.

[4] Cartelier (1996).

Each longer-term transaction seems to lead to escalating volumes of activity at shorter maturities. For example, a bond issuer who has just successfully raised capital for a ten year project has immediately to relend most of the funds thus raised at shorter maturities. The borrowers who accept these placements then have an analogous problem at shorter maturities—no agent in the contemporary economy will hold much idle cash. The flows cascade down the maturity spectrum, ending with an enormous concentration of overnight trades (overnight inter-bank transactions in the sterling market, for example, averaged £12 billion in 2000, a figure that dwarfs an average daily flow of output of £2–2·5 billion). But in this overnight market, of course, the central bank stands ready to make up any long or short position which emerges.[1]

A further striking feature of money market activity is the extent to which this is dominated by the banks (see Table 6 for the case of sterling), with the largest banks being the main players. (Smaller or local banks are essentially in the position of customers to the larger ones which have offshore subsidiaries, above all in London, able to borrow, lend and trade the major currencies at the keenest margins.) Faced with increasing short-term borrowing demands, especially those related to primary and secondary security markets, but at the same time constrained by government monetary policy and by regulatory rules and return on equity ratios from creating deposits above certain limits, banks resolve the dilemma by continually passing around any spare liquidity among themselves.[2] Thus while the top-heavy volume of inter-bank transactions may make it seem that much of these are unconnected to underlying fundamentals, the opposite is true: rather than divert resources away from underlying trades in real goods and services or in financial securities, inter-bank credit operations in fact constitute an essential mechanism to facilitate these trades.[3]

It is clear by this point that there are several strong parallels between the money markets and the FX market. In both cases, trading volumes appear excessive when set against GDP data; in both cases, trading activity is heavily skewed towards the very short end of the maturity spectrum; and in both cases inter-bank transactions easily outweigh dealer–customer relations. *Correspondence in scale; correspondence in rhythm; correspondence of actors*—these all provide strong, if indirect, motives to relate FX turnover to the money markets. If the direction of structural change within contemporary financial systems—where ever-growing values of securities have to be circulated by relatively scarce and always costly monetary resources—is such as to place an increasing burden on domestic money markets, it is also the case that part of the burden is carried by the FX market. Nowhere is this burden sharing more explicit than in the eurozone money markets. A recent ECB study of these markets demonstrates *directly* the role played by external liquidity in the functioning of the internal credit mechanism (see Figure 3).

Figure 3a shows that, just as in the sterling money markets, so also in the euro zone markets, flows cascade down the maturity spectrum, with a heavy concentration of trades in the overnight market. Figure 3b shows that although unsecured trades dominate

[1] This maturity structure confirms the intuition of 'hot potato' theories of FX markets—but it is not foreign exchange which drives trading so much as excess liquidity as such.

[2] We note that, while the largest banks are able to participate in both the unsecured and secured loans markets, many of the smaller institutions tend to concentrate their activity in the overnight market where settlement costs are low and credit risk considerations are negligible.

[3] It is from this same standpoint that we take issue with Arestis and Sawyer's (1997) argument that the high daily volume of FX transactions is not only 'excessive' but also that this 'volume clearly absorbs resources to effect the transactions'. As will be shown below, FX transactions do not so much absorb resources as constitute an important source of liquidity for domestic credit markets.

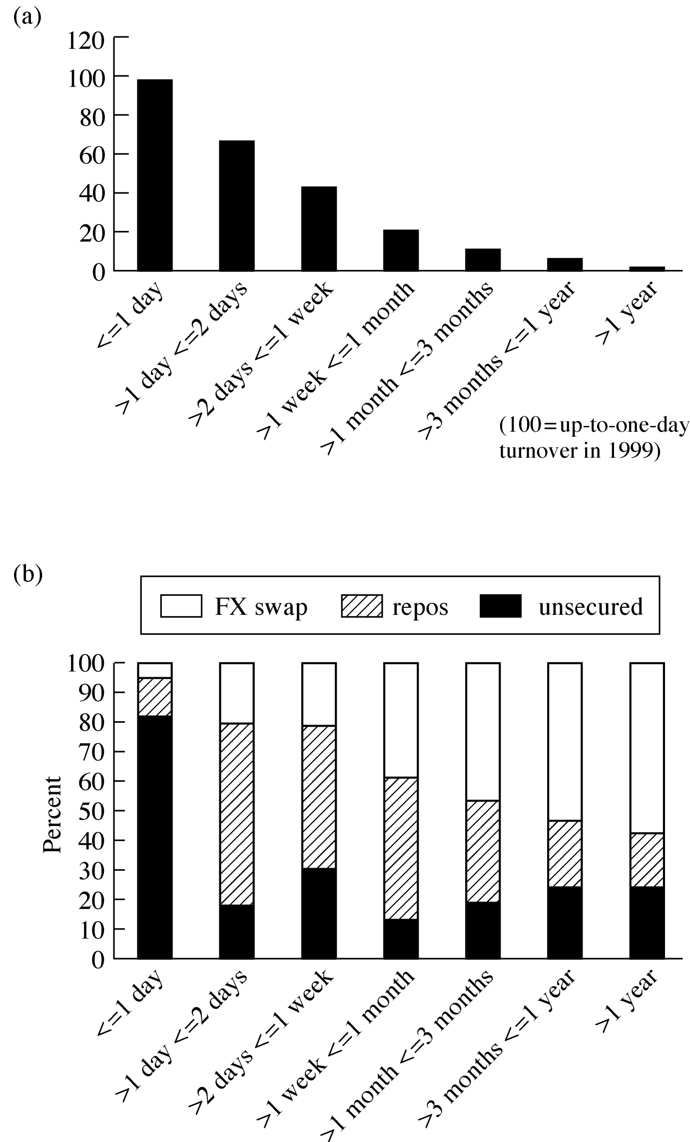

Fig. 3. *(a) Euro money market by maturity. (b) Euro money market, breakdown by collateral. Source: European Central Bank (2001).*

the overnight market where credit risk is negligible, the preference at longer maturities is for collateralised transactions which, because they minimise credit risk, lower the cost of obtaining liquidity. However, of particular interest here is the fact that while the predominant instrument in the secured inter-bank market is the repo—that is, the collateral takes the form of euro-denominated government securities—some 15% of the total market is against foreign currency (almost certainly dollar) collateral. In other words, some 33% of the secured market makes use of the FX swap to transfer liquidity *within* the eurozone banking system. This is straightforward and, in our view, decisive evidence that the FX market serves to link money markets across currency zones.[1]

[1] Although the study does not break down the market into national and cross-frontier operations, it is surely to be expected that dollars play a larger role in the second because within individual member states there must be better knowledge of counterparties and of collateral assets than exists in the eurozone at large.

All that is needed to bring about such a linkage is the readiness of a commercial bank to create a deposit in domestic currency against funds originally borrowed in a foreign one. This will often be done by the offshore branches of domestic banks which can borrow FX at the keenest rates and which are subject to the least onerous regulatory and reserve requirements. In accounting terms, we may well be looking at two distinct monetary movements: a deposit in the lender's currency moving from onshore to offshore; a deposit in the borrower's currency moving from offshore into the domestic banking system. But if the basis of the whole operation is a dollar loan from a US to a eurozone agent, which can then be used exactly like a repo to obtain liquidity in euros, then in economic terms this is essentially a monetary movement across currency zones. Of course, one can if one likes view this as a kind of financial *cabotage*—as a loan, let us say, from a eurozone bank to a eurozone customer which is merely *facilitated* by the possession of dollars. But this is surely an extremely artificial way to look at the question: if a foreign currency deposit can be easily and routinely used to collateralise the creation of a domestic deposit then, when the foreign currency is borrowed, there is an effective recycling from a surplus unit in one zone to a deficit unit in another. Within domestic banking systems monetary surpluses are recycled on a routine basis to agents with deficits—no exchange of real output or long-run securities is needed to 'justify' such transactions. Exactly the same is true today for short-run lending across currency zones.

Available data on international bank relations also support this interpretation of the role and contribution of FX transactions. The BIS puts the stock of international bank lending at some $8·5 trillion, of which over $6 trillion is inter-bank.[1] The relationship between such lending and FX transactions is complex—not all such loans need involve FX transactions although some will involve several. However, we have here a form of activity which, unlike trade in current output or international securities, can be put into a meaningful relation to the size of the FX market. If, to give some purely illustrative figures, international loans are turned over once a week and involve on average one FX transaction each, then we have *over-explained* the scale of the FX market. The size of the FX market only becomes a puzzle when 'fundamentals' are, quite unjustifiably, restricted to trade in current output and long-run securities. As soon as money markets are admitted as an explanatory factor, the problem of scale disappears.

If the preoccupation with exchange rate movements and hedging or speculative strategies is one reason why the liquidity management function of FX swaps and short-term international bank lending tends to be overlooked, another reason may have to do with the influence of monetarist thinking. Although there are few commentators today who maintain the quantitative aspects of monetarist doctrines, the unexamined legacy of these doctrines continues to distort thinking about international questions. According to the 'monetary approach' to the balance of payments, the supply of any given currency is fixed (under the control of the relevant central bank) as indeed is the value of transactions which that stock of currency can support. If the world were like this then the cross-currency transfer of monetary resources would be impossible: one could effectively transfer real resources across currency zones, by selling either goods or securities to non-residents, but euros could not replace dollars, say, in supporting domestic US transactions.

To the extent that such a view ever had any validity, it is surely obsolete today given the extremely high degree of interpenetration of monetary systems among the advanced

[1] BIS (2002) Table 1. This is *not* the same as FX exposure which is several orders of magnitude smaller—hardly any of this lending involves open positions.

industrial countries. The supply of, say, dollar deposits has to be regarded in this context, as in others, as extremely elastic and responsive to the needs of borrowers, with the central bank having some influence over the price of accommodation but, when the lending concerned is secured, essentially none over its volume. In this situation external monetary assets are perfectly good security, *in a collateralised loan exactly analogous to a repo*.

However, behind the persistent neglect of trans-frontier monetary movements in the examination of FX markets, there perhaps lies a deeper error. A clear and distinct separation of monetary spaces is almost a necessary condition for the definition of national economies; it is only on the assumption that such spaces are well defined that one can hold to an *international*, rather than a *global* interpretation of contemporary financial developments, and, ultimately, it is only on the basis of such an interpretation that one can overlook the money market nature of FX swaps and the contribution they make to the operation of monetary systems.

To sum up, the characterisation of the FX market which we are putting forward is that it serves as a central factor of flexibility in the operation of internal money markets. This role is necessary because both the process of disintermediation and the assignment of monetary policy to the target of price stability lead to immense tensions: the first increases the demand for financial transactions balances at the same time as it reduces the relative supply of the deposits to which those balances correspond; restrictive monetary policy raises the rate of interest at which these liquidity needs can be met. International bank lending, together with the FX swaps which now dominate the FX market, helps to reduce the frictions and imbalances arising within currency zone financial systems. What is starting to emerge, in other words, is a globalised money market accompanied by a globalised payments system. It follows that accounts of FX transactions in terms of exchange rate speculation, or indeed in terms of exchange rate hedging, are increasingly obsolete and therefore form a poor basis for thinking about policy. We turn to policy issues in the next section.

4. The effects of the Tobin tax

This section argues that the main impact of a Tobin tax would be on the liquidity of money markets rather than on the stability of exchange rates. It is also stressed that the impact on money markets would be *asymmetric*, with the US economy likely to be the least affected. We assume throughout that the manifold technical difficulties to the implementation of the tax could be overcome.

There are three main motives for the Tobin tax; that it would reduce volatility, that it would enhance national monetary autonomy and that it would raise valuable revenues. The first of these is not proven: there is no clear causal link between transaction volumes and exchange rate volatility. Although a tax might reduce destabilising speculation, it could also, by reducing liquidity in the FX market, amplify the price disturbances arising from a smaller volume of trading. Certainly the decline in spot trading—the trading necessarily linked to speculation—between 1998 and 2001 has not led to any perceptible reduction in exchange rate variability. A study of transactions taxes (stamp duty) in the London Stock Exchange finds no detectable impact on volatility.[1]

[1] See Saporta and Kan (1997). In general, the sources of volatility in FX markets are not well understood (the same, of course, is true for many asset markets). Standard ‘over-shooting’ models under-explain FX volatility by several orders of magnitude and some leading theorists have even resorted to chaos theory to account for it (De Grauwe and van Santen, 1991). We have little sympathy for approaches which attempt to maintain strong assumptions as to market efficiency and investor rationality. Nor do we exclude the role of

Tobin's original motive for his proposal—the defence of national monetary policy autonomy—dates from a different world, and it is doubtful whether, in most countries, much autonomy remains to be defended. The reassignment of monetary policy to the goal of price stability, and the almost universal move to 'independent' central banks which followed, in fact testify to a considerable loss of autonomy.[1] Nevertheless, the original logic of the proposal still appears to hold in that a Tobin tax would make it more costly to sell a currency short, and this might create a little more scope for variations in domestic interest rates.[2] Three factors qualify this view. First, as is today widely acknowledged, the tax would do little to discourage attacks on a currency where a significant devaluation or depreciation was seen as very likely, because the costs of the tax would then be dwarfed by the potential gains from a short position.[3] Second, the day-to day operation of monetary policy might be made more difficult or more uncertain if the tax led, as is suggested below, to narrower or less liquid money markets, since it is through these markets that monetary policy is implemented. Finally, it is necessary to consider the role of alternative instruments.

Proponents of the Tobin tax have given a lot of thought to the possibility of avoidance/evasion through the use of alternative *financial centres* and/or alternative *instruments* to currency itself. But there has been little examination of the possible use of bonds[4] and other fixed interest securities, which could be traded to give open positions in a currency without the need to hold bank deposits. Thus, under circumstances where the tax was effective in limiting exchange rate speculation, there might be a certain destabilisation of bond yields. There are few central banks, if any, which would regard such a development as increasing their room for manoeuvre.[5] Indeed, current monetary policies are better seen as directed at the term structure than at the level of interest rates: a successful policy move is one which impacts on short rates while leaving long rates steady; if, for example, a tightening of policy is followed by a rise in long-date bond yields, this would usually be seen as a sign of lack of credibility of central bank policy.

We have no arguments against raising large amounts of tax on an international base and directing the receipts to the needs of, in particular, the less developed countries. On the contrary. Our doubts concern only the specific nature of the tax which is proposed.[6] As regards taxing currency transactions, there are major uncertainties surrounding the key parameters which would determine the tax yield. The rate of imposition is put at anything

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speculation. It may be that different factors need to be invoked to account for different historical episodes: thus the huge swings in the dollar exchange rate in the 1980s may be related to uncertainties about interest rates and macroeconomic policies; the more recent gyrations of the dollar-euro rate seem to be more connected to fluctuations in equity markets. Our aim in the present article is to analyse transactions volumes rather than price fluctuations and to stress that there is no connection between exchange rate volatility and the growing volume of FX swaps.

[1] As Aglietta and Cartelier (1998) argue, it is above all non-resident users of a country's currency who need a political guarantee of its stability.

[2] The relation between autonomy and volatility is unclear; we believe that existing levels of volatility actually work to sustain a certain measure of interest rate autonomy.

[3] Davidson (1997) gave the first algebraic demonstration of this result.

[4] The stability of differentials among bond yields for the main traded currencies suggests that they are not, at present, used to take speculative positions on exchange rate movements.

[5] Compare Haldane and Read (1999): 'The effects of greater monetary policy *credibility* (for example, belief in the inflation target) are likely to show up in smaller movements in longer-maturity interest rates. Credibility dampens yield-curve volatility at the long end' (p. 173).

[6] Many of the obvious alternatives, such as an international wealth tax, raise serious political difficulties. But in our view, this may be an advantage. It is better to confront these difficulties directly than to hide from them in the technical thicket of the FX market.

between 1% and 0·005% of the value of each transaction. The elasticity of FX activity with respect to the rise in dealing costs as a result of the tax is much debated but, if our characterisation of the FX market is correct, this elasticity would be very high because a great deal of the purely money-market-oriented trading would be suppressed. It should be emphasised in this respect that, however low the Tobin tax is set, from the point of view of the money markets its effect would always be *large.* The resources used on these markets are typically turned over with a frequency of once a week or higher; thus a tax of, say, five basis points levied on each transaction would accumulate over a year to something of the order of 2·5%, a level which would clearly be prohibitive—it would become uneconomic to meet short-run liquidity needs from external sources.[1]

When we turn to the impact of the tax on the financial markets taken as a whole, it is clear that, as well as a direct effect on the liquidity and the costs of money market operations themselves, there would also be an indirect effect on the liquidity and costs of the markets they serve—above all the security markets which give rise to most money market activity. The desirability of such an effect in the abstract is an open question, but it is not usually seen as part of the Tobin tax agenda to bring about such an effect on either the money markets, which are extremely stable, or the securities markets where problems of stability are surely better addressed directly.

However, our main concern here is not with the general nature of these liquidity effects but their *asymmetry* across countries. The key scale factor here is the size of economies not in terms of GDP, but in terms of their financial systems (see Table 7).

At a glance it can be seen that the financial dominance of the US is an order of magnitude greater than its relative strength in production and trade. Historically, the US capital markets have been bigger and more efficiently organised than their counterparts in other countries because of the greater reliance on them by the corporate sector and for social

Table 7. *Capitalisation of major securities markets, end-2000 (nominal value outstanding, US$bn)*

Country of issuance	Bond market Public sector	Bond market Private sector	Equity market	Total market capitalisation
USA	8,539	7,795	15,215	31,549
Japan	4,566	1,814	3,194	9,574
UK	440	1,020	2,612	4,072
Germany	750	1,852	1,270	3,872
France	663	719	1,447	2,829
Italy	1,045	440	768	2,253
Canada	524	273	780	1,577
The Netherlands	163	471	640	1,274
Others	2,660	2,595	5,134	10,389
Total	19,350	16,979	31,060	67,389

Source: FIBV, BIS.

[1] It is perhaps for this reason that Tobin himself, in his final statement on the question, argued that transactions as such should not be taxed, only 'open positions' at intervals of a week. This would not interfere at all with swap-based money-market trades but, on the other hand, it would not leave much of the tax base targeted by the proponents of the tax since, as has been stressed above, the banks active in the market do not maintain significant open positions. ('An idea that gained currency but lost clarity', *Financial Times*, 11 September 2001).

provision (pensions, insurance etc.). At present, there is no doubt that these markets have benefited from the opportunities thrown up by the world-wide trend towards financial liberalisation and deregulation. Outside participation is now an important contributory factor to scale: attracted to the US markets by virtue of their depth and range, and by the low dealing costs, the heavy involvement of foreign institutions in these markets serves in its turn to promote their scale and liquidity further.

These scale advantages permit the US to adopt an attitude of 'benign neglect' towards external developments, a luxury which is denied to virtually every other country in the global economy. While any general disturbance to securities markets, from whatever source, is easier to absorb in the vast dollar-based system, such a disturbance can lead, as has been seen too often, to catastrophic crises in smaller or less developed financial systems. This point is certainly not lost on the Europeans, who have now made the integration of EU capital markets and the achievement of scale effects in the financial sector the overriding priority of monetary union.

Consider the effects of a Tobin tax in this setting. The imposition of a currency tax would restrict the FX swap turnover and the short-term international bank lending that together constitute an important source of external liquidity to domestic monetary systems. More to the point, however, is that this squeeze on external liquidity will typically have an economic impact in inverse proportion to the size of the financial system concerned. Smaller systems, making more extensive use of the FX market for internal liquidity needs, will be the most affected: it will become significantly more costly to issue securities, to trade them, and to raise short-run credit, including bank loans, in these economies because there are few alternative sources of liquidity. At the other extreme, there will be a minimal impact on the US because its domestic money markets are so sophisticated and so immense that less use is made of external liquidity in the day-to-day working of the internal credit market. Even where external credit *is* used, it will be much cheaper and easier to mobilise alternative sources. The upshot is that, not only will the US economy emerge relatively unscathed from a Tobin tax but it would probably even be strengthened, because one unavoidable consequence of the tax will be to divert borrowers and lenders around the globe to US capital markets where the costs of issuing and retrading securities, already low, will fall relative to costs in other markets.

The eurozone financial system would be hard pushed to maintain its position. Although relatively large in size compared with most other systems, its scale continues to fall short of that of the US. This, combined with the fact that it remains relatively fragmented in nature, means that dollars continue to make a major contribution to the liquidity of its money markets, especially where transactions cross national frontiers within the zone. By inhibiting this contribution, the Tobin tax will significantly disrupt money market functions and thereby retard the process of internal financial integration. This retardation will inevitably impact on the scale of both short-run and long-run capital markets and thus reduce Europe's ability to compete with US finance.

These results throw a different light on the issue of policy autonomy. While it is true that, in today's globalised world, loss of autonomy is general, there is nevertheless a qualitative difference between the position of the US and that of other economies. There are today no serious external constraints on the exercise of US monetary policy. Central banks in the other main currency areas have to pay more attention to external developments but still enjoy a certain measure of discretion. At the other end of the spectrum, in the weakest economies, the monetary authorities must establish their priorities and policies with reference to the dollar. Basically, the size of local financial markets relative to

those of the US is today the key determinant of how much autonomy remains: the smaller these markets, the greater the gravitational pull of US markets and the smaller the scope for independent policy decisions; conversely, the larger the local capital markets, the more easy it is to resist or offset the impact of US actions, and the greater, therefore, the scope for discretion—a point which helps explain the sense of urgency behind current efforts to complete capital market integration in the eurozone.[1] Since a Tobin tax would inevitably strengthen the dollar-based financial system relative to its competitors, it follows that any increase in policy autonomy from the use of the tax would be certainly accompanied by a strong adverse effect on the distribution of this autonomy. The smallest systems would be worst affected, but other large systems, including the eurozone, would also be badly hit.

This outcome is surely the exact reverse of that intended by the proponents of the Tobin tax. Their general intention in seeking to establish some kind of multilateral control over FX flows is to restore the balance of priorities in favour of industry and trade, and to give back to national governments some of the power lost to the financial markets. However, they could not have chosen a more inappropriate instrument for these purposes. For in giving a boost to the US financial system relative to the others, the Tobin tax will only serve to reinforce, not weaken, the domination of finance over industry. And by accentuating US hegemony over world finance, the tax will work to undermine, not promote, the policy autonomy of other governments.

5. Conclusion

Although we are opposed to the Tobin tax, our opposition is not based on considerations of practicality. Despite the manifold technical or political problems standing in its way, we are assuming, for present purposes, that these can be overcome. Nor is our opposition to the tax motivated by a lack of sympathy with many of the broader aspirations and objectives of those various movements which promote it. Far from it. We recognise that the contemporary globalisation process contains dangers to employment, to economic stability and to social justice, and that this process, therefore, will need to be brought under some form of social control and given a new direction.

But the Tobin tax does not represent an instrument of control so much as an act of vandalism. It is informed by notions about global finance, and about the FX markets in particular, which are exaggerated or simply inaccurate. Its implementation would bring about a deep disorganisation of existing financial structures that would not only fail to achieve, but indeed would work against, the basic objectives of those who support it. Rather than target financial speculation, the tax's chief impact would be to suppress precisely those FX volumes that currently contribute to the liquidity of many domestic financial systems. Given that these systems already differ greatly in terms of scale and depth, a currency tax that interferes with an important external source of their liquidity would not increase policy autonomy so much as exacerbate its unequal distribution.

In the last analysis, the most problematic feature of the Tobin tax is its anachronism. The idea was born at a time when governments still retained considerable power over national economies, when the world economy was still essentially an extension of national economies, and cross-border flows still concerned primarily current output and foreign direct investment. That time has gone. Rapid economic, technological and institutional change

[1]See the Lamfalussy Report, European Commission (2000).

has resulted in a globalised market which constrains the actions of governments as much as those of other agencies and which is dominated by financial processes. To control and redirect this new reality, one has to start by seeing it for what it is, not for what one might wish it to be.

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Chapter 6

The Eurozone and financial integration: the employment relations issues

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The Eurozone and financial integration: the employment relations issues

John Grahl and Paul Teague

Together the macroeconomic and financial attributes of monetary union are changing the rules governing the European economy. This paper assesses the consequences of these changes for employment relations in member states. The analysis focuses on three matters in particular. First, how labour market actors are responding to the fact that macroeconomic policies are not only out of their own control but may therefore fail to correspond to the needs of particular countries. Second, how employment relations are adapting to the new microeconomic challenges released by the move towards deeper financial integration inside the EU, which has its main impact on the structures of corporate finance and thus on corporate strategy. Finally the implications of both patterns of change for the EU employment policy are assessed to gauge the impact of monetary union on the European social model.

Introduction

The creation of an economic and monetary union is the most far-reaching act of integration since the European Union was established in 1958. This is essentially for two reasons. First, monetary union has radically transformed the macroeconomic regime—with participant countries losing all autonomy in monetary policy (interest rates and foreign exchange rates) as well as being subjected to tighter constraints (the Stability Pact) on their budgetary policies. Secondly, however, the achievement of monetary union has led to a powerful drive for financial integration which today concerns not only banks but, in particular, the securities markets—markets for shares and bonds, which are becoming much more important in company finance in most EU countries. This second group of changes is particularly topical because the main policy initiative

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involved, the EU's Financial Services Action Plan, was only launched in 1999 and gathered pace only in the last two years.

Together the macroeconomic and financial attributes of monetary union are changing the rules governing the economy and business in Europe. Regime transformation is taking place across the participating countries. The extent and direction of this change is still unfolding and a matter of hot debate (Dyson, 2002). This paper addresses one particular aspect to these discussions—the employment relations implications from deeper monetary and financial integration inside the EU. This is an important topic that warrants close investigation as it may allow a more informed assessment of the extent to which European monetary union is compatible with Social Europe. An ill-defined term, Social Europe is normally associated with the operation of two big social institutions—comprehensive welfare states and highly organised systems of employment relations (usually referred to as corporatist). These two institutions have played a central role in European economic life for the past half-century and more. To sketch the situation in schematic terms: the economic status of those in employment was determined by collective bargaining, more or less reinforced by legislation, while the rights and obligations of those not in jobs, such as the retired and the unemployed, depended on the welfare state. Thus Social Europe represents a form of economic citizenship as it establishes important rules for the incorporation of people into the world of work (Grahl and Teague, 1994).

Examining some ways in which monetary union is interacting with employment relations will shed light on whether or not economic citizenship will change in light of the EU's decision to adopt a single currency. The main focus is on employment relations because, although social protection regimes will certainly be influenced by monetary union, the most rapid and direct effects will be on employment relations as national economies meet changed macroeconomic constraints and enterprises adapt to the increased role of organised capital markets.

The paper is organised as follows: firstly, the macroeconomic challenge is examined—how labour market actors are responding to the fact that macroeconomic policies are not only out of their own control, but are established on a supranational basis and may therefore fail to correspond to the needs of particular countries; secondly, we look at the financial challenge, which has its main impact on the structures of corporate finance and thus on corporate strategy—how are employment relations adapting to these microeconomic changes? It will be suggested that although adaptation at the macro level has been relatively successful, the deep challenges arising from the transformation of financial relations are only just beginning to be addressed. Finally we make some remarks about the implications of both patterns of change for the European Social model.

The new macroeconomic regime and national social pacts

The impact of the new macroeconomic regime in the Eurozone countries is essentially mediated through output markets—markets for goods and services. There are continuing debates about just how monetary policy works (the discussion of 'transmission mechanisms') but it is generally agreed that employment is primarily affected via the impact of policy on the demand for the output of the employing enterprise. Tight constraints in output markets are hardly a novelty in Europe—the general stance of macroeconomic policy has been restrictive over the last two decades. What is new is that policy is now largely set on a supranational basis, so that it might not respond to significant changes in national rates of inflation or unemployment.

In this context, national social pacts are of particular interest because they can adapt employment terms to specifically national conditions. Table 1 outlines the wage determination systems in the EU and it shows that almost everywhere multi-tier collective bargaining institutions are in place. Thus the anticipated shift away from centralised bargaining institutions heralded a decade ago has not materialised in any decisive manner: the generalised trend is for pay awards to be at the very least

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Table 1: Social pacts and wage bargaining levels

	Intersectoral Level	Sectoral Level	Company Level
Austria		XXX	
Belgium	XX	X	X
Denmark	X	XX	X
Finland	X	XX	X
France		X	XXX
Germany	X	XXX	X
Greece	X	XX	X
Ireland	XXX	X	X
Italy	X	XXX	X
Luxembourg		XX	XX
Netherlands	X	XXX	X
Portugal	X	XXX	X
Spain	X	XXX	X
Sweden		XXX	X
UK		X	XXX

Key: X = evident XX = important XXX = dominant.
Source: Compiled from European Industrial Relations Data.

influenced by some type of extra-firm agreement or rule. At the same time, important institutional variations exist between these national bargaining arrangements. In some member states, the negotiated deals have economy-wide coverage while in others they are limited to particular sectors. Some of the agreements are obligatory as they have legal status while others constitute only guidelines. The scope permitted for trade unions and employers to conclude additional company-level agreements is another important source of divergence. Thus the picture that emerges is that, while there is some institutional diversity to pay setting, there has been no decisive shift towards labour market flexibility on the British or the United States model. It is also useful to point out that trade union density—another proxy for institutional continuity—did not change greatly in most member states during the 1990s. Does this mean that corporatist employment relations have proven more resilient in the new macro economic regime or that something else, something more complex, is emerging in European employment relations?

The argument of this paper is that a complex pattern of change is unfolding in European employment relations. In essence, the institutional characteristics associated with corporatism in the past more or less remain, but the purpose and functioning of these arrangements have changed. We have continuity of institutions but innovation in substance. This path of transformation can be detected in the actual content of extra-firm collective bargaining. Pay systems in Europe currently display three common features. First, it is accepted virtually everywhere that the rules associated with membership of the European monetary union club constitute a non-negotiable macro-economic framework for pay determination (Fajertag and Pochet, 2000). Claims for wage increases that threaten to infringe these rules are strongly resisted. Thus each national wage bargaining system gives top priority to moderate pay bargaining behaviour consistent with being a full and loyal participant of the single currency club. Second, the theme of competitiveness, particularly in terms of controlling unit labour costs, is dominant in most of the agreements. Setting pay levels that allow domestic industry to compete inside the European internal market as well as global markets is the new *reféréntial* for collective bargaining negotiations across the EU (Freyssinet and Seifert, 2001).

Third, there appears to be an acceptance that the scope for distributional deals is small. Although some of the national wage deals contain the conventional *quid pro quo*

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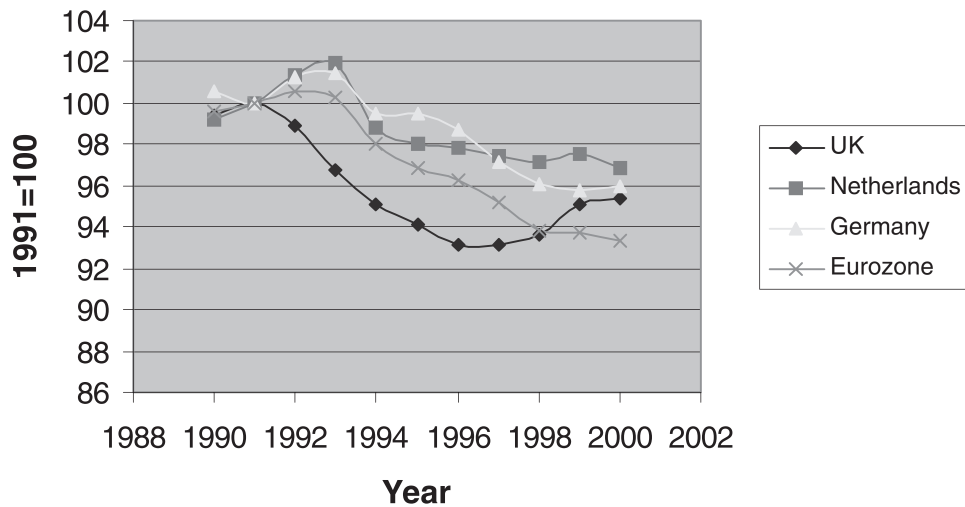

Figure 1: Trends in Unit Labour Costs

Source: Eurostat

of the 'social wage'—the situation where increased public expenditure on social protection or social services is exchanged for pay moderation—these are fairly insubstantial trade-offs. If anything, the streamlining of welfare state provision is seen as an important strand in national social pacts in continental Europe (Ebbinghaus and Hassel, 2000). In smaller states such as Ireland, the reduction of tax levels, rather than increases in public expenditure, has been a feature of national agreements. Overall, equity considerations appear to be a secondary concern in the recent national pay agreements. Wage moderation has been the main focus of attention.

One interpretation of these developments is that the traditional 'peace formula' between employers and employees in Europe has been torn up and that the 'new' agreements represent the institutionalisation of an employer-defined, market-driven employment relations agenda (Streeck, 1999). While this would be an over-statement there is little doubt that traditional corporatist employment relations, with their emphasis on the distribution and redistribution of income have been weakened as member states have sought to comply with the Growth and Stability Pact and the strong anti-inflationary stance of the ECB—two core features of the Eurozone area. Three trends are particularly worthy of note. First of all, trends in nominal wages are consistent with price stability. A big disinflation process has continued in Europe since the late 1980s with, as a long-term consequence, a huge reduction in inflationary pressures. In the Eurozone area nominal wage increases per employee now move more or less in parallel with price increases. A by-product of this disinflation process is that the (absolute) dispersion of nominal wage increases has declined so that there is now broad convergence on this front.

A second general development, as shown in Figure 1, is that real wage increases have been lower than productivity increases, leading to a fall in unit labour costs—an important indicator of competitiveness. Real wage moderation, which often amounts to real wage devaluation, has prevailed in almost all countries in the Eurozone area. The most striking examples of this development are Ireland and Finland. Of course, another way of presenting this development is to point out that labour's share in national income has fallen. The third development is that the share of profits in GDP across the Eurozone area, as shown in Figure 2, has increased during the lifetime of most of the latest agreements. Levels of profitability make an important contribution to the overall investment of an economic area and hence to its productivity and growth potential. Thus one would be hard pressed to sustain the claim that the latest social pacts have not been good for European business. This is probably the key factor in

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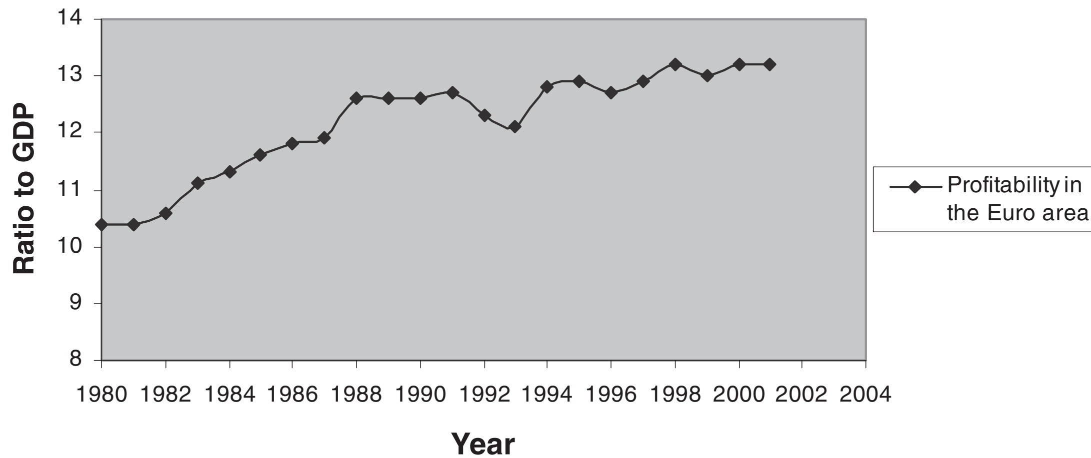

Figure 2: After Tax Profitability in the Euro Area

Source: Eurostat (after tax profitability is calculated as GDP at market prices minus labour income (excl. self employed), times one minus effective corporate tax rate, all in per cent of capital)

explaining why in virtually all cases employers have complied willingly with social pacts (Dolvik, 1999).

All in all, although the institutional form of agreements is continuous with the 'corporatism' of the past, their content gives heavy emphasis to the adaptation of general wage levels to given macroeconomic conditions. But if nation-wide agreements continue to display important advantages in terms of co-ordination, they do not have the same content as in the past. On the one hand, there is no longer any real possibility for governments to offer an expansionary macroeconomic policy as the counterpart of the wage discipline accepted by employees in a social pact. Rather the macroeconomic pay-off to employees takes the form of a boost to external competitiveness, hence to net exports and hence to output and employment. Such effects are likely to be strongest in the smaller member states, which trade a very large proportion of their GDP, and this in itself is one reason why the many of the most developed examples of such pacts are to be found in the smaller member states. Thus the social pacts that have emerged inside the EU during the past decade must be seen as an effort to encourage labour market behaviour that is consistent with monetary union.

This has taken an explicit form in some member states. For instance, in Belgium, a weighted calculation of wage increases in neighbouring countries, particularly Germany, France and the Netherlands is used to determine the scope for domestic pay awards. This procedure was first introduced in 1989. In Finland, a number of 'buffer funds' have been added to the centralised collective bargaining system. The operation of these funds is relatively straightforward: during good economic times government, employers and trade unions contribute to the funds so that when a business downturn arrives employers will not have to pay extra unemployment insurance contributions which may further reduce the demand for labour. In essence the scheme is about maintaining equilibrium unemployment in the event of an 'external' shock inside Eurozone. The main point is that monetary union has led to some Europeanisation of national collective bargaining behaviour and a greater preoccupation with competitiveness by wage negotiators.

Cross-jurisdictional pay bargaining

The single currency has also led to increased efforts to establish greater synchronisation of pay bargaining across jurisdictions (Sisson and Marginson, 2002). Trade unions

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from Belgium, Netherlands, Germany and Luxembourg in the metalworking industries get together to conclude cross-border agreements on collective bargaining co-operation. The agreements, known as the Doorn process, seek to prevent national bargaining systems being used to bid down collectively agreed pay. More specifically, the wage setting collaboration encourages the participating unions to pursue wage claims that amount to exhausting the 'neutral distribution margin', which is calculated as the sum of domestic increases in inflation and productivity. No attempt has been made to use the process to launch American-style pattern bargaining strategies, which would involve different national trade unions working in similar industries pushing for the equalisation of wages across the EU irrespective of differences in productivity levels. The network is also used by the unions to exchange information on domestic collective agreements covering training, job redesign and employment security. There is some disagreement on how fully the national trade unions have complied with the various agreements in national bargaining rounds, but a consensus exists that the Doorn process is a significant new departure in Europe-wide collective bargaining (Schulten and Bispinck, 2001). Discussions are at an advanced stage to allow French, Austrian, and Swiss unions entry into the group.

Other initiatives of a more limited regional scale have been concluded. Big German unions orchestrate most of these essentially sub-national cross-border networks, with IG Metall being the main sponsor of such arrangements (Gollbach and Schulten, 2000). These mostly involve unions from neighbouring countries attending collective negotiations of German employers and unions to monitor and learn about the agreements that are being forged and to deepen information exchange. Undoubtedly, there is a strong measure of self-interest behind these initiatives. Many German unions are extremely anxious that, in the context of monetary union and EU enlargement, unions from bordering countries such as Poland and the Czech Republic will enter into 'national' coalitions with employers to take advantage of their relatively low social standards to attract investment from Germany. Presumably the calculation on the part of German unions is that building cross-border trade union networks may create institutional hurdles in the way of such a strategy. Additional cross-national trade unions have emerged in recent times. In August 1998 the Southern Baltic Sea Inter-Regional Trade Union Council[1] was set up involving German, Danish and Swedish unions and has set itself the challenge of performing like the Doorn group. Established connections between the Scandinavian trade unions, particularly under the auspices of the Nordic Council, are being strengthened so that there is greater synchronisation among national collective demands.

A number of pan European coordination agreements have been signed between trade unions operating in the same sector. In the chemical industry, unions from Germany, France and the UK (IG-CPK, IG-BCE, Chimie-Energie-CFDT and GMB) signed a co-operation agreement in 2000 which involved mutual recognition of trade union membership, the organisation of a joint training programme and a commitment to increase the velocity of information exchange (Le Queux and Fajertag, 2001). In the construction industry, unions from seven countries—Germany, Italy, Poland, Austria, Switzerland, Netherlands and Belgium—signed in 2000 a ten-point declaration, which committed those involved to taking some form of solidarity action if any of the participating unions were engaged in strike action. Other initiatives designed to intensify cooperation were included in the declaration.

Efforts at creating EU-wide wage norms by the European Trade Union Confederation and sector-level European trade union industry federations operating in Brussels to guide the behaviour of trade union negotiators in national collective bargaining rounds have been less than successful (Dufresne and Mermet, 2002). In 1999 the ETUC attempted to establish a norm for national pay awards but had to backtrack on the proposal as it encountered too much internal opposition. European trade union federations have adopted framework agreements to influence the direction of national

[1] See http://www.eiro.eurofound.eu.int/print/1998/08/inbrief/DE98008177N.html.

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collective bargaining in their respective industries but these have mostly remained paper tigers (Keller and Bansbach, 2001). Thus there is no formal connection between EU-level and national-level trade union organisations on the matter of pay determination. A big difficulty is that national trade unions are still reluctant to transfer upwards to their European counterparts the necessary authority to allow them to steer pay determination inside the EU. Furthermore, problems of scale and heterogeneity may seriously limit the possibilities of centralised Euro-wide wage norms. In the EU of 15 member states, there are over 120 million people living in disparate circumstances, divided by language and culture as well as by ideological, national and religious traditions. In this situation, it would be very difficult for the EU to establish pay norms that would be credible at ground level. These problems are only likely to intensify with the imminent process of enlargement.

Technical problems also stand in the way of establishing a European wage norm. In some countries, the convention is to include some measurement of productivity when calculating a wage award; in others the convention is to rely more or less on inflation rates. Even countries that use productivity benchmarks calculate them in different ways (some use productivity per hour, others productivity per person still others productivity by sector). A further obstacle is that some wage agreements take social security contributions and a range of other factors into account. In this situation it would be very difficult to for the EU to establish pay norms that are credible at ground level. Furthermore, at present, employers would be likely to resist any strong aggregation of employee interests. Thus little prospect exists of unions regaining at EU level the influence some of them once enjoyed at national level over the macroeconomic context of the wage bargain: no macroeconomic counterpart to wage moderation, in the form of either redistribution or of a commitment to fuller employment is on offer. This state of affairs strengthens the new macroeconomic regime in the EU—the European Central Bank and the Stability Pact—because it means that they are not threatened by serious wage pressure.

Thus monetary union has not encouraged a decisive move towards a Euro-corporatist system. The biggest change that has occurred has been a certain degree of Europeanisation of national bargaining. National collective bargaining activity is now more sensitive to European developments than ever before. So far it has encouraged collective bargaining activity that is consistent with a single currency in Europe. A certain amount of cross-jurisdictional 'focal point' bargaining coordination has occurred, involving non-hierarchical, decentralised collaborations between national trade unions, to synchronise national wage setting across Europe. As a result of this activity a multitude of new pan European trade union networks are emerging across the member states. The main motivation behind much of this activity is to ensure that wage competition does not occur between national employment relations regimes. Little or no effort has been made to launch American style pattern bargaining which would involve pay awards cascading from one country to another.

From a trade union point of view, the most optimistic comment that can be made is that initial assumptions, particularly within the economics profession, that the single currency would fragment 'corporatist' employment relations and pave the way for the 'Americanisation' of European labour markets have not proved to be justified. As a result, the special 'public status' of organised labour in European politics is still evident. In this context, the possibility of a new politicisation of European industrial relations in the future cannot be ruled out. Moreover, the cross-national networks that are emerging might continue to strengthen and these could give rise to some from of multi-level European industrial relations regime. However, in light of the current pattern of institutional development, this regime is unlikely to be a 'vertical' and tightly integrated arrangement, which were characteristics of the classic corporatist model. Although these possibilities cannot be ruled out, current political and economic circumstances demand a more modest assessment: the relationship between wage bargaining and monetary union is a less important item on the economic and political agenda than it was a number of years ago and that it is unlikely that big initiatives will be launched on this topic in the immediate future. Top of the monetary union

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agenda now is building an institutional architecture to realise and hold together fully integrated capital markets in the Eurozone area. Important implications arise from this development for the institutional rules used to incorporate employees into the world of work. Yet insufficient attention is being paid to this development by the employment relations academy.

European financial integration, corporate governance and employment relations

The single currency is accelerating integration of capital markets in the EU. The financial transformations taking place will have an important impact on employment relations. Once again it will be argued that the pattern of change is difficult to interpret but may well be of great significance. The point of departure of most analysis is the well-established distinction between stakeholder and shareholder models of capitalism. The essential difference is that a stakeholder enterprise is a coalition of interests (including, notably, employee interests) whereas a shareholder enterprise is essentially the property of its owners, with the interests of employees, customers, suppliers, the local community and so on being clearly subordinated to profitability objectives. In financial terms stakeholder capitalism is often related to a bank-based financial system and to the presence of major 'insider' investors closely and permanently linked to the enterprise; shareholder capitalism on the other hand tends to arise from market-based financial arrangements, where there are large numbers of 'outside' investors, most of whom need have no close association with, or even knowledge of, the day-to-day life of the enterprise. The key point is that, when an enterprise finances its long-term investment with bank credit, the claim held by the bank is not easily marketable: thus the bank is locked into a long-term relationship with the firm and must attempt to deal with problems by intervention into the firm's strategy. An enduring partnership between firm and bank becomes necessary which often widens to embrace other parties with influence over performance in the long run, such as the employees.

When, on the other hand, investments are financed by the issue of marketable securities—shares or corporate bonds—then the holders of these securities can respond to emerging problems by selling them on organised asset markets: this puts immediate pressure on the firm by raising the cost of capital and, possibly, by exposing its management to the threat of a hostile takeover. Thus the management are impelled to adopt strategies which guarantee that shareholder interests are prioritised at every moment of time, through continuously high dividend pay-outs and a rising share price. In the face of this pressure, the interests of other groups, such as employees, suppliers or local communities may be subordinated to the maximisation of profits. Japan and Germany come closest to the bank-based system while the UK and USA are examples of market-based systems.

Both types of financial system have a strong influence on management-employee interactions inside enterprises (Gospel and Pendleton, 2001). Bank based systems are generally regarded as more conducive to cooperative employment relations. A frequent characteristic of these systems is that banks hold equity and have seats on the boards of individual companies. But these shareholdings may not be easily marketable and hostile takeovers are rare. This does not mean that banks are actively involved in the short-term operational direction of an organisation on a continuous basis. For the most part, if a company is doing well banks adopt a hands-off approach. Direct intervention normally only happens when the firm is in financial or commercial trouble or in need of restructuring. Thus managers typically enjoy a certain latitude to pursue autonomous action: they are better positioned to develop corporate strategies that not only meet the needs of shareholders but also other stakeholders. As a result, a corporate environment emerges that facilitates, if not encourages, cooperative relationships between managers and employees (Roe, 2003).

Market-based financial systems may be less likely to foster 'mutual commitment' manager-employee interactions, largely because organisations are monitored and con-

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trolled on the financial markets with a continuous threat of takeover. In such stock market economies, all publicly quoted firms are continuously up for auction. The interests of shareholders are paramount in this system. Other stakeholder interests, those of employees, supplier companies or consumers, are subordinate to those of shareholders. Managers may be less able to make strategic decisions that seek to incorporate the interests of employees. Making credible commitments to employees, which are a cornerstone of sustainable cooperative employment relations, may thus become more difficult (Lazonick and O'Sullivan, 2000).

Eurozone and financial transformation

Eurozone is encouraging a series of transformations within European financial systems that have far reaching implications for investment and credit mechanisms at member state level (European Commission, 2002). The EU has adopted a programme of measures that seeks to accelerate this transformation. The core of this programme is the Financial Services Action Plan (FSAP), which is meant to sweep away the technical, regulatory and legal obstacles to a full integration of EU finance, especially security markets (markets for company shares, and for government and corporate bonds). The FSAP is supported by a similar programme in the specific field of risk capital and by a renewed attempt to adopt a common code for company takeovers in the EU, which is seen as necessary for an integrated market in company shares because potential control over companies is an important aspect of the value of corporate securities.

These policies have been launched in the context of on-going changes in European finance, which can be traced to the internationalisation and deregulation of financial structures all over the world (Grahl, 2001). One aspect of these changes is *disintermediation*, which reduces the role of bank credit in the finance of corporations while increasing the importance of traded shares and corporate bonds. Another aspect of the same general shift has been the growth of institutional investors (pension funds, unit trusts, insurance companies and so on) which channel household savings onto the securities markets. The institutional investors reinforce disintermediation by offering substitute savings outlets to the banks which have traditionally absorbed the vast bulk of individual savings in continental countries.

The FSAP is seen by the Commission, the Council and other EU leaderships as necessary to strengthen the EU economy relative to that of the US, where disintermediated, security-based finance is highly developed. The legislative programme associated with the FSAP is extremely complex and elaborate, but it has been given very high priority by the Commission and member state governments and it is now clear that most of it will be completed by the target date of 2004. Although all member states are participating in the FSAP, it is clearly linked to the single currency used by 12 of them because the fact that securities are denominated in a common currency greatly facilitates the integration of security markets.

The implications of these financial developments for employment relations are potentially far-reaching because they tend to transform the relations between large companies and their investors. The new patterns of finance make much more use of 'outside investors', that is of resources drawn, via the security markets, from very large numbers of investors with no particular relationship to the company concerned, whose shares or debt obligations they treat simply as one component in an ever-changing portfolio of assets. Although it may be very advantageous for companies to tap these sources of funds, increased dependence on 'outside' finance also brings new constraints on company behaviour because companies now have to respond to the requirements of the financial markets on which shares and corporate bonds are traded. Profits, dividends and other financial data are continuously scrutinised by portfolio managers (the reporting of this kind of data in a standardised form is itself one of the requirements of the new financial model). Holders of shares and bonds, if they do not have any long-standing relationship to the company concerned, can at any time liquidate their holdings on the financial markets if they perceive its performance as infe-

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rior to that of other companies; the exercise of this sanction tends to deflate share prices, raising the cost of capital to the company and even exposing its management to a hostile takeover.

This pattern of financial change is clearly towards the kind of financial structure and mechanisms which prevail in the US; and indeed the EU has justified the FSAP in terms of a move towards US practices, which are perceived as more efficient and as promoting higher rates of investment. Thus, as opposed to the European Central Bank itself, which impacts on employment relations essentially through the level of demand for goods and services, the FSAP and the financial changes with which it is associated impact on corporate strategy and corporate governance. As companies adapt to the new financial constraints and possibilities, they alter corporate behaviour in ways which may destabilise employment relations. Three examples can be given of this connection. The first relates to corporate structures. Although 'outside' shareholders have no particular interest in any given company as an industrial entity, they tend to prefer specialised enterprises, focused on one or a few core activities; pressure is often put on companies to dispose of subsidiaries in unrelated fields and to outsource inessential activities if these might complicate managerial tasks without furthering overall performance. These pressures correspond to shareholder interests, since shareholders can control the risks of their investments by diversifying their portfolios—by holding shares in a large range of companies in various industries and countries. Conglomerate companies, with a diversified range of activities, do nothing to reduce shareholder risk but they may well make the scrutiny of performance and profitability much more difficult. Employees, on the other hand, confront higher levels of job insecurity if the company they work for reduces the scope of its activities (Streeck, 2001).

The second connection concerns incentive structures. A key tension in the 'outside' investor model is between company management, who might be tempted to pursue their own interests, and shareholders with no presence in the firm or enduring relationship to it. In US and British practice, the response to this tension has been to offer managers very high rewards, geared to financial performance—as measured, for example, by dividend pay-outs and increases in share prices. On the other hand, shareholders may seek to reduce rewards for groups of employees who do not possess strategic influence over corporate performance (Blair, 1999). The third link refers to employee representation. US corporations today have elaborate systems for communicating with employees, but these are very much focused on a full use of skills and productive knowledge. They are not in general intended to involve employees in strategic decision-making. Over continental Europe, of course, there are systems of employee representation which go much further than this—in particular the co-determination structures in Germany. Now, to the extent that the interests of 'outside' investors become more important, it can be expected that pressures will develop to move European firms towards the US model, in which the consultation of employees is very much focused on their contribution to output and profitability while the strategies of the enterprise are the prerogative of (shareholder-oriented) managers.

In addition to these shifts in the behaviour of individual firms, financial change involves a deep change in the nature of industrial restructuring. First of all, it intensifies the merger and acquisition process. Whereas 'inside' investor systems give priority to the strengthening of the competitive position of the enterprise when companies are merged or taken over, returns to shareholders—in terms of the market value of their holdings—is the deciding factor in an economy dominated by security markets. Secondly, it gives added momentum to hostile takeovers—aimed at the displacement of managements whose performance is judged to be unsatisfactory from the point of view of shareholders. These are much more frequent in the US and UK economies than they have traditionally been in continental Europe, where restructuring has often been seen as a form of industrial policy. The Takeover Directive is intended to reinforce shareholder interests within restructuring exercises (and this is the essential reason why it has repeatedly encountered resistance in the European Parliament). As with outsourcing, the ongoing change in financial mechanisms has implications for employment security (Barnard and Deakin, 2002).

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Thus financial integration in Europe has significant implications for employment relations across the member states. This is because integration does not simply aim at aggregating the existing financial systems in member states; rather it promotes a transformation of financial mechanisms in which the interests of 'outside' shareholders, represented by institutional investors and expressed through the management of their portfolios and the purchase and sale of holdings on stock markets, are much more important in the formulation of company strategies (Hopner, 2001).

For three reasons, however, the assessment of these new pressures on European employment systems is difficult to assess. Firstly, these are for the most part very recent changes—major shifts in the pattern of corporate finance only date from the late 1990s. Secondly, developments are very uneven across countries: for example, while there has been a major shift towards stock market finance by French corporations, the situation in Germany has been much more stable (Goyer, 2002). Finally, the huge decline in stock market prices since 2000 has tended to make savers extremely cautious in their approach to marketed securities and this has, at least, slowed down the process of change. Nevertheless, significant shifts in corporate practice can certainly be detected. Performance assessment systems are being reshaped towards the kind of accounting and reporting procedures required by the financial markets; disposals and outsourcing are narrowing the focus of large enterprises; although there has been no surge in hostile takeovers among European companies, the salience of shareholder priorities in agreed restructuring exercises is on the increase.

Thus financial integration arising in the wake of monetary union adds another dimension to the employment relations reform taking place almost everywhere in Europe. In the late nineties, somewhat dazzled by the apparent triumph of the stock market-based US economy, EU policy-makers sought to implant market-based financial systems as quickly as possible and with very little concern for their potentially adverse social consequences. At EU level, the Lamfalussy Report was commissioned to accelerate the implementation of the FSAP (Lamfalussy, 2000). In Germany, an important tax reform encouraged the break-up of long-standing relationships between banks and their industrial customers and a decisive shift towards a stock market-based financial system. In several countries, pension reforms promoted the accumulation of financial assets in pension funds, at least partly in order to stimulate market-based finance.

Today the prolonged stock market collapse of 2000–2002, the bursting of the dot.com bubble, the revelation of massive corporate malpractice in US companies such as Enron, and the slowdown in the US economy which is linked to these developments may be making for a more measured approach to financial change in Europe. Events such as the Enron collapse highlight the need for corporate governance systems that reduce the risks employees make in investing their human capital in individual companies and encourage organisations to actually implement (as opposed to simply espouse) human resource management policies that create a decent working environment (Kochan, 2002).

At the same time, some social policy initiatives continue to assert a rather different view of corporate governance and of employee relations than that which is associated with the US model. Some EU social legislation represents an attempt to reinforce and generalise the co-operative employment relations found in the traditional 'stakeholder' companies of continental Europe. Although these policies are much less coherent and less forceful than the drive for financial integration which remains the central reform project of the EU today, they are not simply token gestures. The most significant recent move has been the adoption of a European Information and Consultation Directive. For the best part of 30 years the European Commission has been trying unsuccessfully to persuade the member states to adopt a Directive on this topic. A host of technical difficulties arising from divergent corporate law regimes in Europe and the inability of powerful lobbies to adopt an agreed strategy on the matter have been the main sources of blockage. In particular, European employers as a whole have been adamantly opposed to any spread of German co-determination practices to other countries, while the Germans have refused to abandon them (Streeck, 1997). Finally,

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however, a new Information and Consultation Directive has been adopted that lays down certain minimum requirements for employee voice mechanisms in the member states (Sisson, 2002).

The new voting procedures introduced by the Amsterdam Treaty certainly facilitated a breakthrough on this matter, but market pressures have also played a role. The big push towards integrated capital markets has increased pressure for some type of EU action to create a European model of corporate governance. The new Directive, which was officially adopted in February 2002, is hardly radical. The legislation establishes the right of employees to regular, ongoing information and consultation on matters of concern to them. Such matters include recent or probable developments in the business situation of the organisation; the structure and probable development of employment (particularly threats to employment); and changes to work organisation or in contractual relations.

Most of the other member states have national laws that go further in placing obligations on employers to consult with employees than those set out in the Directive. Its biggest impact will be on the UK and Ireland, which have no integrated legislation on employee voice. Nevertheless, the passage of the Directive may be significant because it represents partial recognition by the EU that the institutional architecture for the emerging European financial area must include employee rights. Together with the European Works Council, the Information and Consultative Directive can be seen as beginning an attempt to build an employment relations dimension into a future European model of corporate governance. It is true that the Directive gives companies enormous scope to design their own customised information and consultation arrangements with employees and that therefore it bears more on the procedures of employee voice systems than on their content (Supiot, 2001). However, this inbuilt flexibility may itself work to ensure that the new regulatory framework is successfully adopted throughout the EU.

Conclusions

For a long time, many commentators have stressed the cleavage in European construction between the strong, clearly successful, drive for economic integration and the much more hesitant measures which are found in the sphere of social policy. The opposition between 'market-making' and 'market-correcting' policies, is almost as old as the European project itself (Scharpf, 1999). There are many reasons for this dichotomy—among them the historical reality that social policies are deeply embedded in the diverse experiences of specific national cultures and the pressing need felt today by national governments, confronted by globalisation and a loss of economic autonomy, to preserve as much freedom of manoeuvre as is possible in their welfare systems and public services.

In this context, employment policy has a deeply ambivalent status. On the one hand, the regulation of labour markets and of employment are inseparable from economic policy in general and therefore have to be included in the core drive towards an ever more integrated EU economy. On the other, working conditions and the wage determination process are the central realities around which social models are organised and there are inevitable spillovers from labour markets into the whole field of social policy.

How does monetary union affect the balance (or perhaps it would be more accurate to say, the imbalance) between economic and social Europe? In our view, any answer to this question must distinguish between the directly monetary and the indirect, financial, consequences of the single currency. The substitution of a single, Europe-wide, monetary policy (together with the new constraints on national budgetary policies expressed in the Stability Pact) for national macroeconomic policies imposes a challenging new constraint on the working of national labour markets which have now become the most important sphere in which national adaptation to macroeconomic developments must be pursued. In general, this challenge has led not to a weak-

ening of Europe's strongly institutionalised employment systems, but to a reorientation of labour market and employment institutions to address the need for competitiveness within the monetary union. The outcome has been to further reduce the risk of inflationary pressures within European labour markets and thus to stabilise the monetary union, but this has been achieved by limiting the aspirations of employees and their unions for a more employment-friendly economic environment or for more active social and redistributive policies to compensate for the moderation of wages. Here the very strength of national social models seems to work against the constitution of an effective system of employment relations at the EU level. Thus, as regards the employment relations dimension of the European social models, the main result of the new macroeconomic regimes has been to build upon existing national models, rather than to promote an alternative EU industrial relations framework.

One can detect the possibility of a different, and more ambitious, response to the same challenge in the efforts of, especially, German trade unions to co-ordinate bargaining across national frontiers and to formulate common positions on a range of employment issues. At present, this is a secondary development, very much subordinated to the reinforcement of national competitiveness, and only acts as a partial brake on the latter. However, the logic of market integration itself may tend to reverse this state of affairs and to promote the development of stronger and more co-ordinated systems of genuinely European employment relations. Any such development would, in its turn, release other dynamics—in particular by calling into question the key national mechanism of adjustment to macroeconomic pressures.

What of the second, indirect, consequence of monetary union, that is the accelerated integration and transformation of financial systems. Here the challenges to established employment practices are potentially even more radical because changing patterns of corporate finance, with an enhanced role for 'outside' investors, may tend to subvert long-standing compromises at the level of the enterprise itself. It is particularly difficult to interpret the responses to this second challenge because it is so recent but there are clearly risks to the stability of national employment systems. These risks arise from the fact that pressures on *corporate finance* are beginning to result in changes in *corporate strategies* and thus in employment relations at the level of the enterprise. These financial pressures are diffuse, but at the same time pervasive—it is difficult to predict how particular enterprises will react, but it is clear that virtually all enterprises will be affected.

In this case the implications for European Social Models are less clear. But in our view, financial integration might push European employment systems closer to the threshold at which EU-wide policies and structures are perceived as central to the effective governance of employment relations. In particular, financial integration may necessitate a certain harmonisation of corporate governance systems in Europe and this would mean addressing, at long last, the institutional place of labour within the enterprise as a European, rather than a national issue.

We emphasise that this threshold has not yet been reached. Neither the tentative experiments in trans-national trade-unionism which were discussed above nor the European employment strategy, with its use of soft law in the 'open' coordination of national employment interventions (Mosher and Trubek, 2003), have as yet destabilised the basically national character of employment relations. The same is true for the very limited and cautious introduction of EU-wide employment law. But each of these developments might acquire significantly greater substance if there arose a widely perceived need to reshape enterprise-level employment practice in response to changing corporate priorities. Thus, in our view, the indirect consequences of monetary union, via its impact on financial systems, may, over time, have a greater impact on European social models than the direct transformation of macroeconomic conditions which has, so far, absorbed most of the attention of industrial relations commentators.

And any such development towards a more highly Europeanised employment system would necessitate wider changes in the social models, just because social protection systems and social service provision, at present jealously guarded fields of

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member state autonomy, are so closely tied to employment systems and employment outcomes. As our final conclusion, we choose not to speculate further on the shape of future employment relations systems in the EU, but to make a methodological point. A clear aspect of recent developments is that continuity of established employment institutions can accompany deep changes in the actual content of employment relations. Thus it is becoming increasingly difficult to interpret change in purely institutional terms: given the radical changes in economic mechanisms it is increasingly important to focus on the detailed functioning of relatively stable institutional structures if one wants to assess the dynamics of European systems.

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Chapter 7

Problems of financial integration in the EU

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Problems of financial integration in the EU

John Grahl and Paul Teague

ABSTRACT A drive for financial integration, especially in the field of securities trading, is a very significant feature of EU policy today. This paper makes a critical assessment of the central component in the financial integration strategy, the Commission's Financial Services Action Plan. It is argued that an exceptional degree of political agreement around the strategy has allowed it to succeed in spite of the formidable technical difficulties to which it gave rise. It is suggested, however, that further reformulations of the strategy will be needed, to cope with the aftermath of the recent stock market crash and to link the strategy more closely to EU strategies in the social sphere.

KEY WORDS European integration; financial disintermediation; public policy.

INTRODUCTION

Financial systems play a central role in modern economies. They perform the crucial function of allocating scarce capital to competing investment alternatives. They monitor the performance of firms to ensure that the capital employed is being used efficiently. A malfunctioning financial system can have rapid and grave consequences for the wider economy. Financial relations can also have broader social effects – for example, they may affect the character of social compromises within an economic system by determining the amount that can be borrowed by economic agents and by influencing the behaviour of economic actors in such fields as wage bargaining.

The European monetary union has led to important changes in European financial systems. Although most discussion of monetary union focuses on the creation of a new supranational macroeconomic regime, and on the related loss of macroeconomic policy autonomy in participating countries, monetary union has also led to a powerful drive for financial integration which today concerns not only banks but also securities markets – the markets for shares and bonds, which are becoming more important to companies in most member states.

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Thus the creation of a well-designed and smoothly functioning financial system inside the Eurozone has become a key aspect of European construction. This paper attempts to make a preliminary economic and political assessment of the drive towards European Union (EU) financial integration. It is argued that because the financial integration agenda commands wide support among European political élites, the integration programme has been able to overcome many difficulties in that a host of technical problems which initially confronted the programme have been resolved and some important conflicts of interest have been dealt with. It is suggested, however, that two key problems continue to obstruct full financial integration in the EU.

The first of these arises from the stock market crash of 2001/2; this has not only slowed down financial integration on the ground; it has also called into question the present structure of financial services by raising problems of market stability, investor protection and corporate governance which will need to be addressed both in the US and in the EU. The second potential problem is a consequence of the spillovers from financial changes to other aspects of the socio-economic system. There has been insufficient consideration of how changes in financial mechanisms might impact on employment relations, for example, or on the balance between market and state provision in such fields as pensions and health care.

The paper is organized as follows. The next section makes an important contextual point about the growing trend towards financial disintermediation. The following section gives a brief characterization of EU financial policies and examines the rationale that is put forward for integration in the financial sphere. Then the EU's Financial Services Action Plan is discussed. The fifth section examines some of the technical difficulties that delayed the integration process. The following sections look at the reformulation of the integration programme following the Lamfalussy Report and at fallout from the stock market crash. The conclusion brings together the arguments of the paper and signals some issues that may require addressing as a result of deeper financial integration inside the EU.

THE CONTEXT FOR EU FINANCIAL INTEGRATION

An important contextual point about the character of the global financial system needs to be made before discussing the drive towards financial integration inside the EU. The main characteristic of the global finance system that has been emerging over recent decades is *disintermediation* (Schmidt *et al.* 1998). In an intermediated financial system strong banks stand between households, which are the ultimate suppliers of financial resources, and the corporate, public sector or private agents who make use of them. It is the bank which has a direct liability towards the savers who are its depositors; claims on the ultimate users of the funds are not held by these depositors but by the bank itself, whose reputation and solidity are the basis of confidence in the system. In financial systems where banks are the main channel for the mobilization of the savings of the public,

company shares tend not to be actively traded: control of companies tends to be highly concentrated in the hands of a few 'inside' investors with close and long-lasting connections to the company management. Close coalitions of interest between these two parties, often extended to employees, suppliers and others, provide the basis of the 'stakeholder' enterprise traditionally found, for example, in Germany.

In a disintermediated system, borrowers and users of equity capital issue securities (on *primary* security markets) which are held directly by the providers of funds, who therefore assume all the risks involved. Confidence in the financial structure then rests on the ability of the investors to sell their claims (in the *secondary* securities markets where the shares, bonds and other financial instruments are actively traded); the liquidity and security of the security markets become the key factors that underpin the financial system (Mayer and Vines 1993).

Of course, only very wealthy households make substantial direct placements in the security markets. Most savers purchase securities through institutional investors, such as investment trusts or pension funds, which are able to aggregate small individual sums in order to carry out large, diversified, purchases of securities. But institutional investment is not the same as classical bank intermediation: the individual saver is directly exposed to the risks of the security market and is also entitled to the gains which may result from rising security prices.

Financial globalization has not just established increasingly dense and rapid interactions among existing financial systems, it has also tended to change the nature of financial systems, away from classical banking activities and towards the finance of both governments and corporations by the direct sale of securities to the investing public (Berger *et al.* 1999). It is this shift in the operation of financial systems that is known as *disintermediation* (or, when the role of financial markets is stressed, *securitization*). A set of different influences lies behind this shift. Some of the original forces behind disintermediation can be seen as contingent. In particular, certain regulatory constraints imposed on the US banking system in the wake of the Great Depression, such as interest rate ceilings, encouraged borrowers from the 1950s onwards to issue securities directly to the public, rather than to make use of artificially restricted bank loans. More pervasively, the major changes in macroeconomic policy which occurred in the 1980s, with tight monetary policy and high interest rates being maintained over a long period of time to counter inflation, tended to make bank credit relatively expensive and thus to promote greater use of stock markets and bond markets to raise funds for both private-sector and public-sector borrowers (ECB 2001).

But the fundamental force behind disintermediation is probably the emergence of the global economy itself, with increasing interactions between economic agents on a planetary scale. Open securities markets derive much of their power from their sheer scale – from the fact that they can draw funds from investors anywhere in the world and place them with any of a host of potential users according to the risk/return characteristics of the company or country concerned. And this development is cumulative: the larger the securities

markets, the easier and cheaper it becomes to trade on these markets and the more likely they are to develop further. It should be stressed that, as with other aspects of contemporary finance, the trend to disintermediation is not homogeneous or uniform. The US financial system has tended to lead the way, simply because the scale, dynamism and financial sophistication of the US economy gave it a huge initial advantage as global financial systems emerged. To a large extent, financial globalization can be understood as the transformation and internationalization of the US financial system (Grahl 2001). In most of the countries of continental Europe, on the other hand, changes have been slower and classical bank intermediation still predominates.

THE DIRECTION OF EU FINANCIAL INTEGRATION

On first appearance the discussion in the last section might suggest that deepening of financial integration inside the EU gives rise to the following conundrum: should the member states attempt to reconstruct at EU level the bank-based financial model that can be found in many parts of Europe, or should they follow the pattern of change mapped out by the global financial markets? In reality, such a choice does not exist. This is because the various stakeholder models that have emerged in the member states are completely incompatible one with another. Each of them is embedded in a specific society, with specific mechanisms and priorities adapted to national, or even sometimes local, conditions. This social embeddedness (Granovetter 1985) is the main strength of these models, but it is also their fatal weakness in that it prevents them from expanding to embrace very wide numbers of outside investors or to undertake investments on an international scale (Grahl 2001).

The rule of Anglo-American finance, on the other hand, is: anyone can play. This gives the security-based financial system a global reach and a potential for cumulative growth which the other systems simply cannot match, in spite of the fact that they are often more efficient in the detailed, local, deployment of financial resources. By the 1990s, in consequence, stakeholder financial systems, centred on bank credit, were already on the retreat everywhere in Europe (while the Japanese system, unable to deal with the consequences of liberalization, was in complete disarray). A coherent European response could only take the form of an attempt to accelerate and unify the development of Europe-wide capital markets.

The opportunity to attempt this largely arises from the successful introduction of the euro in 1999 (Danthine *et al.* 2001). Savers, investors and borrowers over an immense and expanding economic zone are now using the same currency; the risks and costs of foreign exchange transactions have ceased to inhibit the sale and purchase of securities across national frontiers within the Eurozone. It therefore becomes possible to envisage a huge, integrated, security-based financial system, which was simply not possible when institutional investors had to take particular care not to expose their customers to big foreign exchange risks.

Financial integration based on the principle of disintermediation/securitization is seen as giving rise to a number of benefits. In the first instance, the same considerations apply to finance as to integration in other fields. An integrated financial system can be expected to lead to a more efficient allocation of capital as financial resources flow to those issuers of securities who offer the best rates of return, or, more strictly, the best combination of risk and return characteristics. One aspect of this process is that institutional investors in each member state should be better able to diversify their portfolios of assets and in this way reduce the risks which they undertake for a given return. This diversification effect is frequently stressed in official justifications of the financial integration strategy (European Commission 2002a).

Just as with integration in other spheres, certain complexities arise when we take into account the fact that existing financial systems are far from being fully competitive: the customers of existing financial companies are subject to the market power of these companies, especially if national markets are small and relatively isolated. The gains from integration will tend to be larger because of this in that integration will stimulate competition among the providers of financial services, whether these are institutional investors or the exchanges and dealing systems that facilitate large-scale trading. This means that integration can be expected to lead to narrower margins between the interest rates paid by borrowers and those received by savers. The cost of capital can be expected to fall in consequence. However, this consideration of market power does make the distribution of the benefits from integration a highly complex question. Strategic rivalries will exist among providers of financial services who will each seek to win advantageous positions on the integrated market. Just such a process can be observed among the various national stock markets in Europe, each of which is trying to win a larger share of the increasingly integrated market in equities (Gasper *et al.* 2003).

Finally, developmental issues can be raised when one takes into account that efficiency varies a great deal across different national financial systems. Integration can be expected to eliminate inefficient providers of financial services to the extent that they are unable to meet the challenge of more advanced competitors. This developmental question has two dimensions. Firstly, within the EU, integration could be expected to bring about a levelling up process which would displace the costly and unresponsive financial systems said to predominate in southern member states and some accession countries, and would introduce the more modern systems typical of northern European countries today. But secondly, as between the EU and the US, it was hoped that integration would endow the EU with the kind of low-cost and fast-moving financial system found in the States (Giannetti *et al.* 2002). Since it was thought that the level of financial development was an important factor in economic development in general, this pressure for modernization of European financial systems became a key element in the actual decision to launch financial integration, taken at the European Council in 1998 and subsequently promoted to become a key programme for deeper integration at Lisbon and Stockholm.

Financial integration was presented as a central feature of the economic modernization of Europe: in the words of the Stockholm summit communiqué financial integration would make the EU the 'cheapest and easiest place to do business in the world'.

THE FINANCIAL SERVICES ACTION PLAN

The EU thus adopted a programme of measures designed to promote financial transformation based on disintermediation/securitization – on the development of huge integrated capital markets. The core of this programme is the Financial Services Action Plan (FSAP), which is meant to sweep away the technical, regulatory and legal obstacles to a full integration of EU finance, especially security markets (markets for company shares, and for government and corporate bonds). The FSAP was supported by a similar programme in the specific field of risk capital and by a renewed attempt to adopt a common code for company takeovers in the EU, which was seen as necessary for an integrated market in company shares because potential control over companies is an important aspect of the value of corporate securities (Rajan and Zingales 2003).

The legal status of the FSAP gives it exceptional priority. It is seen as a series of measures to complete the internal market and as thus fully within EU competence and to be determined only by qualified majority voting (QMV). (It is the Directorate-General for the Internal Market which has responsibility for the plan.) As argued below, the implications of financial integration are vast and it would surely have been possible for member state governments to claim that in certain respects it overstepped the competence of the EU. This did not happen in general because there was virtual unanimity on the need for the comprehensive modernization it was hoped the plan could bring about (although, as will be seen, on the issue of takeovers there has been decisive member state resistance).

The FSAP was divided into three broad themes. The first of these was the integration of wholesale markets for securities: technical and regulatory differences made it difficult to issue new securities on primary markets across Europe and to trade existing securities in all EU secondary markets. A programme of legislation attempted to remove these barriers by, for example, standardizing the prospectus which has to accompany a new security issue or by harmonizing the information and reporting requirements which companies listed on stock markets have to fulfil.

The most contentious component of this legislation proved to be the Commission's proposal for a Takeover Directive. This relates to the market for company shares because the possibility of a takeover bid increases the value of shares; since in the past takeovers (especially hostile takeovers, that is those which are not welcome to the incumbent management of the target firm) were much easier to bring about in some countries than in others, the shares of companies based in different member countries could not be regarded as fully comparable financial assets. Commission proposals were to introduce a uniform takeover code which would open the way to hostile takeovers

throughout Europe, making them as easy in the continental countries as they already were in Britain. In fact, this component of the programme was originally rejected by the European Parliament (in a dramatic tied vote) because some Members of the European Parliament (MEPs) – the Germans in particular – were reluctant to expose enterprises to hostile takeovers to the extent that the Commission wanted. A compromise directive was eventually passed by the Parliament but the Commission regards this as unsatisfactory, and even as a 'retrograde step in economic reform', because it fails to establish the 'level playing field' which was desired. Incumbent managements will be much more able to defend themselves against hostile bids in some countries than in others (European Commission 2004: 3, cited in Frangakis 2005).

The second main theme of the FSAP was the integration of retail financial markets – where investment trusts and other institutional investors compete for household savings. As pointed out above, this is essentially part of the same agenda since these investors are the most important buyers of, and traders in, securities. Typical issues here were the definition of common rules for the increasing number of retail financial services which are provided via the internet and the harmonization of rules against fraud in retail finance.

Finally, the third main theme of the FSAP was financial regulation itself. This has two main dimensions. In retail markets it is necessary to provide a large measure of consumer protection. Households do not possess the same quantity or quality of information as the financial enterprises with whom they are dealing. Households may deal in these markets very infrequently: for example, individuals may purchase only one pension plan over their lifetimes. Yet they are parting with cash in return for financial products which are essentially promises of quite distant benefits. In such circumstances the activities of dishonest and unscrupulous enterprises can undermine public confidence in the whole savings/investment process. Consumer protection regimes already existed in all member states – the challenge to the FSAP was to harmonize them in such a way as to facilitate EU-wide competition among institutional investors.

In wholesale markets, this problem does not arise to the same extent because here the sellers of financial claims confront sophisticated and experienced investors, often financial enterprises, who can be expected to protect their own interests in a systematic way. On the other hand, the second regulatory theme, stability, becomes very important. The failure of any large financial actor, or a collapse in the price of any important financial asset, can disrupt the entire financial mechanism by compromising the position of other actors or by sowing distrust about whole groups of assets. Chain reactions can develop which threaten the financial system as a whole and which can have adverse effects on the rest of the economy (Boot and Thakor 1997; Boyer *et al.* 2004). Measures oriented towards stability are of two kinds: prudential regulation and supervision of financial companies and financial markets, aimed at preventing such disruptive events, and crisis management to prevent such failures, when they do occur, from leading to system-wide breakdown or

to counteract their effects. A key example of the FSAP agenda in this area is the development of common rules for capital adequacy of financial companies, rules which are designed to make them less vulnerable to disturbance. Regulatory integration is an exceedingly complex issue, but in this sphere the FSAP could take advantage of an on-going process of convergence driven by global forces: in the field of banking the Bank for International Settlements had for two decades been involved in the formulation of general supervisory principles; in the security markets there had been a broad convergence on the kind of procedures prevalent in the US because this was seen as necessary to attract the big American institutional investors (Lütz 2002).

DIFFICULTIES IN FINANCIAL INTEGRATION

Thus the FSAP, coupled with the plans for wider technological modernization to which it was linked, represented an extremely ambitious programme for economic change in the EU. Yet within a very short time the programme was in several kinds of difficulty. The failure of the Takeover Directive has been mentioned above, but this was very much an exception – the main problems did not result from a general political challenge to the programme, but rather from its inherent difficulty and complexity.

There were, firstly, many technical problems. With the Single European Act, the EU seemed to have found a very effective strategy for economic integration: approximation plus mutual recognition. The first of these procedures ensures a general correspondence among the member state rules governing some branch of economic activity; it prepares the way for the second procedure which abolishes the barriers arising from the existence of different rules at national level. The general assessment is that this strategy is much speedier and more efficient than the attempts at comprehensive regulatory harmonization which were often made previously. This approach had even been used successfully in the sphere of banking with the notion of a single banking passport, acquired when a bank is licensed in one member state and therefore, by mutual recognition of bank regulatory systems, permitted to operate in all the others.

However, the manifold difficulties which arose with the FSAP seem to pose a challenge to this established strategy in the case of security trading. A general reason for this is that very small differences in the nature of a financial instrument or financial transaction (differences in the small print, so to speak) can have a big effect on the risks involved or on how these risks are divided between different parties. An important example of these differences concerns default on financial payments and the related issues of bankruptcy and liquidation. The rules governing breakdowns in relations between borrowers and lenders are different in each member state. What remedies are available to a creditor who has not received interest or principal? What are the delays and the costs in using these remedies? What is the order of priority among creditors, that is, who, according to law, gets paid first when a company is insolvent? How easy is it to obtain control of the remaining assets of a defaulting debtor? Such

'details' have a significant effect on the risks, and therefore on the prices, of financial claims which are, at first sight, very comparable. At the same time such differences are deeply rooted in national legal systems.

In the early months of the FSAP a complaint frequently heard from representatives of the financial sector concerned the *quality* of the legislation involved. The directives were, usually, going through but effective integration did not result because of the multiplicity of significant details which the legislation failed to cover. The sheer dynamism of contemporary financial markets adds greatly to the complexity of the integration process; these markets are characterized by rapid innovation and by the continual introduction of new types of financial instrument, such as the vast range of financial derivatives, many of them exceedingly complex (Hartmann *et al.* 2003).

Much of the devilish detail turned out to concern what is often called the infrastructure of security trading, an aspect of financial systems which had hardly been mentioned in the original FSAP. Even when the conditions governing an actual security transaction – the agreement to buy and sell – have been approximated, there are a large number of further questions as to how the agreement will be implemented, that is, how the seller will obtain the money and how the buyer will obtain possession of, or effective control over, the securities.

The first of these issues involves the money market and the payments system. Security trading today involves holding large sums of money for short periods of time. Since it is costly to hold large transactions balances, there is a massive recycling system which transfers monetary resources from surplus to deficit agents active in security markets. The speed, cost and responsiveness of the money market in which this recycling takes place have an important effect on the functioning of the markets for shares and bonds because it helps to determine the cost of trading on these markets. A key issue here is collateral: financial market agents are usually in a position to put up collateral against their borrowing, because when they are short of cash they are correspondingly long on financial assets. In the United States the 'repo' market, in particular, executes collateralized loans very efficiently and on an immense scale (CEPS 2000). Cross-border borrowing and lending against collateral in Europe is slower, more costly and much less developed because there is less agreement on which types of asset are to be accepted as collateral and on what rights the counterparties to the transaction have when things go wrong (European Commission 2001).

The underdevelopment of payments systems in Europe (the systems which actually transfer money from one account to another) is another problem in financial integration. In this case it is the retail sector which is most affected. Large-scale transfers of money, for example through the European Central Bank's TARGET system, seem to be carried out in an efficient way. But the same did not apply to small-scale cross-border payments by households, which were horrendously expensive even when only the euro was involved and there was no foreign exchange transaction. Since such small-scale payments might often be needed when an individual in one member country buys a financial

product from an enterprise in another, this in itself was a barrier to financial integration. In the end, no agreement on the charges for such transactions could be reached with the big commercial banks and the problem had to be resolved by a crude but effective piece of legislation, which simply prohibited banks from charging more for cross-border euro payments than for domestic ones.

The issue of clearing and settlement – the delivery of purchased securities, either to the purchasers themselves or, more frequently, into the hands of a recognized custodian against payment from the purchasers – is another condition for the smooth operation of securities markets which is still far from being met. The basic problem here seems to be the existence of too many clearing enterprises, some of them working only on a national scale, and the consequent absence of the economies of scale which are usually obtained in the United States in the clearing and settlement of security trades (European Commission 2001). Consolidation is complicated by conflicts of interest since each enterprise in the clearing and settlement system wants to secure its own survival.

Although there are other technical difficulties in the financial integration process it is important to see that conflicts of interest also tended to retard the effective implementation of the FSAP (European Commission 2002b). It has even been asserted that the situation is analogous to that which once prevailed in civil aviation: each national authority seeks to maintain its own 'national carrier'. Since the FSAP necessarily involves co-ordinating the activities and procedures of national financial regulators, and since these regulators are understandably concerned to promote the size and the profitability of the sectors they supervise, there is perhaps a brake on integration arising not just from the complexity of the process but from the resistance of countries threatened by important losses from increased financial competition.

Finally, a series of difficulties is associated with the very persistence of distinct national regulatory systems in the financial sphere. In the process of monetary union the strategic decision was taken not to construct a unitary system of financial regulation and supervision but to rely on enhanced co-operation and co-ordination among continuing national authorities. One justification for this decision, which at the time concerned, above all, banking, is that national regulators are closer to, and better informed about, the activities of financial enterprises in their own countries; they might also be expected to react more quickly when things go wrong. Another justification was the acknowledged success of the approximation plus mutual recognition approach in other spheres. In any case, the same strategy was adopted for security-based finance: there would be enhanced co-operation among national regulatory authorities and an attempt to eliminate barriers arising from divergent rules and procedures. But these regulators would continue their functions and a single overarching financial regulator is not envisaged (European Commission 2002b).

One immediate consequence of this strategy is to make integration more complex, because national regulatory authorities have become, as will be seen, key actors in the whole process. In the long run other problems might be anticipated from the integration process itself, should it succeed. Successful

integration would multiply the number and value of cross-border transactions and interactions: this could increase the difficulties of co-ordination in all aspects of regulation – consumer protection in retail markets and both supervision and crisis management in wholesale markets. At present, however, this does not seem to be an imminent danger – the recent dramatic decline in share prices, for example, does not seem to have triggered serious difficulties of intra-European co-ordination. These early experiences of the FSAP suggest that several obstacles stand in the way of the EU in its attempt to build an institutional architecture to accelerate financial integration between the member states.

THE LAMFALUSSY REPORT, UNANTICIPATED EVENTS AND POLICY SHOCKS

The complexities and difficulties of implementing the FSAP led to an early reconsideration of the strategy for financial integration. In particular, the Committee of Wise Men, under the chairmanship of Alexandre Lamfalussy, was established in 2000 to consider the multiple delays and difficulties of the FSAP. Problems were arising at both European and member state levels of the legislative process, and were causing not only delays, but also the 'quality' problems alluded to above in that it was not always clear whether the Directives as formulated or their transposition by member states were in fact resulting in the open and consistently regulated financial markets which are the object of the exercise. The committee's report, in the same year (final version in 2001), reasserted the urgency of financial integration while suggesting a much more streamlined and expeditious legislative process.

Drastic changes were called for in the legislative and decision-making processes associated with EU financial integration. The report recommended that the established legislative process, involving detailed consideration by both the European Parliament and the Council of Ministers, be used, henceforth, only for very general enabling Directives. These would do no more than establish broad frameworks for the detailed legislation which would then follow. This detailed work was to be the responsibility of the Commission together with a new committee composed of high-level officials from the relevant ministries in each country. This latter body would become in a sense the effective legislature for financial matters and the decisions it reached with the Commission would be enacted by secondary legislation (on the pattern of, for example, statutory instruments in the UK which are laid before the Westminster Parliament but usually not debated by it). The transposition of European financial laws into national legal systems would be supervised by a further committee of regulators from each member state, which would ensure that the legislative process did actually result in an equivalent environment for securities transactions across member states. The regulators' committee would also provide advisory input into the programme of detailed legislation. Enforcement of the emerging

structure of EU rules would become, primarily, the responsibility of the Commission, acting in concert with the regulators.

This reformed legislative process was adopted, essentially in its entirety, by the Council and, after some negotiations, by the European Parliament. Both the European Securities Committee (the high-level officials) and the Committee of European Securities Regulators were put into place very quickly. The procedural changes have certainly resulted in a much more rapid and effective legislative process. The original programme of legislation was very largely completed by the target date of 2004 and a raft of supplementary legislative proposals has been added to the agenda, extending it, for example, into the problems of clearing and settlement discussed above, and into the newly prominent question of money-laundering. A series of taxation issues, such as the taxation of pensions provided across borders, has also been introduced into the FSAP.

The changes to the policy framework introduced by the Lamfalussy Report are likely to result in the adoption of most of the measures contained in the FSAP. But this does not mean that effective financial integration – the actual integration of markets for securities and related services – will be realized. One reason for this is the huge disruption of equity markets around the world which has, at least temporarily, dampened the incentives to carry out cross-border security transactions. As finance has become more expensive to raise on equity markets, some large enterprises have, at least temporarily, turned back to the big banks. Retail investors, having burned their fingers with security-based investments, are more inclined to keep their savings on deposit with the banks.

THE FALLOUT FROM THE STOCK MARKET CRASH

The stock market crash and its fallout have also exposed deep problems in the whole shareholder model. Consider a stylized account of a security-based financial system and compare this with its actual functioning today in a country like Britain or the US where an essentially market-dominated system is already in place. Households entrust their savings to institutional investors; the latter aggregate these savings into large sums which, using their expertise, they place on security markets, calling upon the dealing and investment analysis services which are provided on the latter; thus the funds find their way to corporations which use them to undertake profitable productive activities; it is the flow of profits thus generated which remunerates both the institutional investors and, through them, the ultimate savers.

Today, every link in this chain has been weakened by the distrust arising from multiple malfunctions: the institutional investors have failed to consult the interests of their customers, missold many financial products, poured billions of household savings on to obviously overvalued equity markets or into extremely speculative internet shares; dealers on stock markets, more concerned to swell the volume of transactions than to execute necessary transactions in an

efficient way, have given out misleading advice; many corporations, inadequately controlled by accountants and auditors, have misstated their present performance and future prospects; the investments undertaken by many large corporations have either involved ill-judged, speculative, acquisitions at inflated prices or have added to massive excess capacity in the media, technology and communications sectors (Blasi *et al.* 2003).

Thus the crash, together with its fallout on corporate and financial scandals, economic slowdown and big losses for small savers, has had a direct impact on the working of the financial mechanism itself. All the indicators of security market activity are at low levels; companies are not tempted to issue shares on to depressed stock markets; and many savers, discouraged by capital losses, are seeking more secure outlets.

The significance of this development should not be underestimated. The FSAP as a strategy was conceived and initiated at a moment when the US economy enjoyed enormous prestige, as the consequence of an economic boom which was clearly extended and reinforced by a continuous and rapid escalation of share prices (Brenner 2003). Since the EU, and in particular the major EU economies of France, Germany and Italy, were much less dynamic, it was difficult in this context to counter the argument for financial modernization along American lines and, in any case, this argument seemed to be endorsed by virtually all political leaderships in the EU. But in the aftermath of the crash, classical banking, especially when it is relational, that is, when there is a close, long-standing relationship between the bank and the customer to whom it lends, now seems more attractive. The renewed emphasis on continuing, stable and well-understood relationships is likely to represent an obstacle to the rapid expansion and extension of EU financial integration based on the organizing principles set out in the FSAP. Thus the stock market crash delivered a policy shock to the new arrangements set out in the Lamfalussy Report to reinvigorate efforts at obtaining deep financial integration inside the EU.

The equity market crash is unlikely to hold back, in the long run, the financial transformation from bank-based to security-based systems. The main trends involved are not a consequence of the share price bubble of recent years but of deep-seated changes in economic and financial systems which have continued over more than two decades. Already many stock markets have staged substantial recoveries from the crash and turnover on some exchanges, such as the New York Stock Exchange, has reached new highs. But the aftermath of the crash does make the financial integration project more complex because it is clear that important reforms to the savings/investment process will be needed on both sides of the Atlantic and that the Europeans, therefore, can no longer take American practice as a model in the same rather uncritical way as heretofore. On the other hand, there may be new opportunities for the Europeans – if, for example, they can find effective ways of increasing investor protection in European finance without compromising the efficiency of the financial markets, they might obtain an important competitive advantage against the US system.

CONCLUSION

Financial integration is a key component of the economic modernization strategy launched by the EU at Lisbon and reaffirmed at Stockholm. Although the declared objective of the strategy to create 'the most dynamic and competitive economy in the world' is perhaps overdone, there can be little doubt about the necessity of this financial aspect of the Lisbon strategy. To put it bluntly, if the EU does not develop huge, liquid security markets it will simply drive every investor and issuer on the planet into the North American ones. This would handicap the EU in two ways: it would disadvantage European corporations, which would be compelled to raise capital in the US markets, and it would weaken the monetary union because the effectiveness of European Central Bank policies depends on the scale and the efficiency of the credit markets in which it operates. In the face of this imperative, there can be little scope for sentimentality about the 'socially embedded' financial structures of the past – even if the FSAP were to fail, these structures would not survive – the question is only whether European or American structures would replace them.

The financial integration policies launched by the EU are a remarkable success. In spite of formidable technical difficulties and significant conflicts of interest among the financial sectors of member states, a very ambitious legislative programme has been completed which paves the way for a unified capital market in the EU. The condition for this success was a striking degree of commitment and unanimity among political leaderships at both member state and EU level, all of whom were persuaded of the need for a coherent European response to the emergence of global finance. Although the FSAP has proceeded under the aegis of the Directorate-General for the Internal Market and therefore by QMV, this could only happen because member states decided that it should; in the absence of political will there would have been ample scope for challenges to EU competence over many aspects of the FSAP just because it is such an ambitious and wide-ranging programme.

The financial integration programme exhibits a further strength, not always evident in the life of the Union – an ability to change, to recognize and correct mistakes. At the time of the Lamfalussy Report, major weaknesses in the FSAP were identified, both as regards legislative procedures and as regards the scope of the strategy. It proved possible to make timely and effective reforms to both, and in a manner which was acceptable to the European Parliament in terms of democratic scrutiny and control. Again, this unusally positive outcome depended on broad agreement among leaderships at both national and EU level. The first conclusion of this study, therefore, is that when such agreement can be secured the EU can act in a very powerful and effective way, in spite of its much discussed institutional flaws.

Two caveats will be entered against this generally positive conclusion. The first relates to the disruption of financial systems by the stock market crash of 2001 and 2002. There is no way in which such a contingency could have

been countered by the financial strategy in advance but, besides delaying actual integration within European markets, the crash, with its fallout of scandals and corporate failures, has somewhat altered the terms of the problem. To restore confidence in market finance, reforms will be needed – to corporate governance, to investor protection regimes, to accounting and auditing practices and so on, and such reforms will be needed on both sides of the Atlantic. This perhaps offers the EU the opportunity to strengthen the international competitiveness of its financial sector against that of the US, but the price of this opportunity will be to accept that the US cannot be taken as an economic and financial model in the same uncritical way as tended to be the case in the 1990s.

The second qualification concerns the social consequences of the strategy. In spite of its scope and ambition, the financial integration strategy does little to correct the inherent bias of European construction towards 'market-creating' as against 'market-correcting' forms of integration. This is not to assert that alternative lines of economic development are possible: on the contrary the on-going changes in financial structures are irreversible – the only question is how Europe responds to them. But the response so far, effective as it has been, minimizes the possible social impacts of security-based finance and offers no clear view of the European social models within the new structure of economic relations. One important social consequence of financial change concerns employment relations: when enterprises are required to respond to the needs of the stock market for 'shareholder value', what happens to the status of employees within the enterprise? (See, for the case of Germany, Streeck and Höpner 2003.) Another example concerns pressure to privatize certain aspects of social security; although this pressure does not result directly from financial change, the rapid growth of institutional investors offering market-based pensions is clearly an important conditioning factor. Although the revolt against the Takeover Directive in the EU Parliament did not involve the articulation of a coherent alternative, it did testify to deep anxieties about the general direction of social change within the emerging financial system.

The main lesson to be drawn from this case study in terms of policy-making is that the European integration process involves the movement from one disequilibrium position to another. As Schmitter (2000) has convincingly argued, the EU defies established political and economic categories such as federalism, intergovernmentalism and so on. It is a political arrangement that can destabilize (as opposed to break up) national systems of economic and social governance, yet it is often not invested with enough authority or legitimacy to create a fully-fledged European alternative. Thus in many instances European integration is about managing the disequilibrium effects that arise from trying to achieve unprecedented levels of political and economic co-operation between 'actually existing' nation-states without the EU having the capacity in most cases to assign policy competencies authoritatively to particular tiers of government.

Moreover, because the EU cannot usually build institutional frameworks that permit strong mutually reinforcing interactions between national and European

structures, much of its policy-making is gradual, experimental and open-ended in character. As a result, it is hard to predict in advance the direction, let alone the outcome, of European integration. Complexity is the byword for EU–member state interactions. In a sense, the EU is a serial problem-solving institution, a huge enterprise in unbalanced governance in which sometimes imaginative solutions and at other times tawdry improvisations are made to conjoin the 'European' and the 'national'. But much of the time the policy outcome is provisional and not final. Thus in one sense the progress that has been made towards deeper financial integration has been remarkable given the *mélange* of different national political positions and economic interests in the sector. But in successfully guiding the integration process through this complex policy terrain, the EU has arrived at another: how to reconcile the direction of EU financial integration with the established institutions of Social Europe.

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Chapter 8

Financial markets and globalisation

Financial markets and globalisation

John Grahl

John Grahl *looks at the internationalisation of financial relations in the period since the second world war.*

The notion of globalisation refers to social interactions of all kinds. It is often suggested that territorial states have less power now than in the past over interactions across frontiers - and that they are therefore constrained to adapt to external developments more rapidly and more completely. This article, which accepts that, in spite of many exaggerations, there is a lot of truth in this view, looks mainly at economic interactions, clearly a key part of globalisation. And in particular it looks at *financial* relations, which seem to be central to the changing relations among national economies.

The nature of finance

Finance means the mobilisation of monetary resources. Since economies today use money in virtually all transactions, nothing - from a visit to the cinema to the launch of a huge industrial enterprise, to the invasion of a foreign country - can take place unless it is financed. Financial relationships, however, are inherently problematic, in a similar way to employment relationships. There are tensions between different actors within the transaction, though all want the transaction to be successful. Thus employers and employees have important interests in common - they both want the good or service which is being produced to be

successful - but there are also inherent conflicts between them, as regards distribution and control (the questions of the way the proceeds of production are shared between the two parties, and who it is that controls the production process in which they are both involved). Similar contradictions characterise relations between the suppliers of finance ('investors') and its users ('issuers', in the sense of agents who issue claims such as shares, bonds or other claims against themselves in return for money). Both parties, in general, want the activity which is being financed to succeed. But there are inherent conflicts between them as to the remuneration of the finance (which the investor wants to be high but the issuer low) and as to control over, and information about, this activity.

Mainstream economics probably underestimates the importance of financial relations to the workings of the market economy. This is because mainstream accounts assume that markets tend to move quickly and efficiently to equilibrium - that sellers and buyers are generally able to fulfil their objectives at agreed prices. If the world were like this, then economies could theoretically function without finance. But if one abandons the idealised notion of smooth market equilibration, finance becomes a condition of existence of the market economy itself.

The agents in the actual existing market economy in fact tend to find that, at the prices which are established in the process of market exchange, it is impossible to cover necessary purchases from the proceeds of sales, because not all the sales they want to make can actually be carried out. Thus, only if those agents with monetary surpluses recycle them to agents with deficits can market exchange continue - this is the case today over even the shortest conceivable time period: without continuous and massive recycling of monetary resources through the financial system the market economy would break down in an hour. Thus the terms and conditions under which this recycling takes place are central to all the processes of market exchange and market adjustment. It is financial pressures on deficit agents which in fact bring about adjustment within market economies, rather than the magic of price signals which one reads about in economics textbooks.

Intermediaries and institutions

Because financial relations are inherently problematic, institutions develop to manage and limit the tensions involved. Specialist intermediaries of all

kinds - building societies, unit trusts, credit brokers and so on - have emerged to organise relations between the suppliers and the users of financial resources. *Banks* are particularly important financial intermediaries because the claims they issue against their own borrowing, the deposits of the public, have the status of money - these claims are accepted as settlement in transactions of all kinds. Since the stability and efficiency of financial relations are so critical to the functioning of market economies, complex systems of financial regulation have been introduced. One central motive of regulation is investor protection - this is not simply a matter of the beneficent support of those who commit their money to the financial system; it is a basic necessity for finance as such, since dishonesty or irresponsibility on the part of some issuers or intermediaries would otherwise easily undermine confidence in the whole system and result in financial and economic paralysis.

A second key motive behind regulation is to avoid financial crises. Financial malfunctions - typically the failure of an important borrower or other issuer to meet their obligations - can easily spread from one part of the financial system to the rest. This happens both because defaults can lead to chain reactions - if one debtor fails to repay, the creditor in turn may be unable to meet their own obligations - and because of the pervasiveness of mistrust - if one bank collapses or one important company goes bust the investing public may suspect that other banks and companies may do the same and refuse to part with their money.

Finally, central intervention into the financial system is also found when a crisis has broken out, in order to shorten and limit the economic disorganisation which results. Classically the *central bank* (a public institution charged with overseeing the workings of private, commercial, banks) has had important responsibilities in this respect, acting as a *lender of last resort* to the banking system.

International finance

Financial relations within early forms of capitalism are closely tied to the exchange of goods and services: late payment for goods received amounts to the finance of customers by suppliers; payment in advance on the other hand represents the finance of suppliers by customers. However, as capitalist systems

develop and become more complex, finance becomes more autonomous, in that monetary resources anywhere in the economy may be mobilised to finance activities at any other point, without there being any specific exchange relationship between the issuer and the investor involved. This requires the development of *financial systems* within which banks are able to mobilise and redirect monetary resources, while credit markets and other financial markets make it possible to compare the different requests for finance and to establish interest rates and rates of return for different financial investments.

Similar considerations apply to the development of the international economy. Borrowing and lending are at first closely tied to trade in goods but subsequently become relatively independent as mechanisms develop to recycle monetary surpluses between investors and issuers anywhere. Thus sophisticated and complex credit systems linked to long distance trade had already emerged by the late middle ages, and by the late nineteenth century the spread of industrialisation and the comprehensive use of money throughout the economy had led to what can be seen as a predecessor of today's global financial system. The core of financial, as of economic, relations was the Atlantic economy, linking Western Europe, above all Britain, to the rapidly developing economies of the United States and other lands of white settlement. Huge financial flows from the old continent accelerated the growth of the US; this was an era when there were few if any constraints on the freedom to invest across national frontiers. By some measures international financial relations were even more dense in the decades before the First World War than they are today.

The first half of the twentieth century, however, saw the weakening and fragmentation of international financial and economic relations. War, revolution and the emergence of new states in Europe disrupted trade and international investment. The growth of labour movements and the extension of the franchise led states to restrict international economic activity in order to stabilise internal financial conditions and sustain domestic employment. Increasingly, governments controlled and restricted access to foreign currencies. The financial collapse of 1929, spreading from the US around the world, and the Great Depression which ensued, virtually put an end to international economic relations on a multilateral basis. The leading economic powers established relatively closed off trading systems centred on their colonial possessions or on other subordinated countries. The Second World War and

the emergence of new communist regimes which rejected established forms of international exchange were the culmination of this period of international economic disintegration.

The US and the reconstruction of the world economy

At the end of the Second World War dominant interests in the US were committed to rebuilding a comprehensive, multilateral, system of international economic relations. In some respects the US took over the role which had, in the nineteenth century, been played by Britain as the key promoter of international trade. Clearly, a country with a large and highly competitive economy, together with enormous political and military power, is well placed both to press for a more open international economy and to take advantage of it. From the late 1940s world trade began to grow very much faster than world production, as economies, especially those of North America and Western Europe, re-engaged in multilateral economic relations.

At first, this development was confined to trade in goods and services, while international finance only exhibited a limited development: in fact for the first decades following the Second World War, most international financial flows took place betwen governments (the Marshall Aid programme is an example), while both private inflows and private outflows of capital were subject, in most countries, to comprehensive controls. The system of international monetary and financial relations (the Bretton Woods system) had actually been designed to minimise external financial pressures on most states and to permit their governments to intervene effectively in the allocation of internal financial resources. Comprehensive structures of financial control were used to limit the range of transactions open to domestic investors and issuers, partly in reaction to the collapse of unregulated banking and financial systems after 1929, partly as a consequence of Keynesian views of economic policy, and partly as an expression of the political importance of full employment. In the US, for example, there was a fixed maximum interest rate on bank deposits; in Britain consumer credit was subject to extensive controls which specified minimum downpayments and maximum payback periods on hire purchase agreements. Governments were able to impose political priorities on the working of financial systems by, for example, encouraging housing construction or exports; not surprisingly, they also made sure that finance for

the public sector itself was cheap and freely available.

In retrospect, it is easy to see here the emergence of a central contradiction, which is often discussed today in terms of the notion of globalisation. On the one hand we have a logic of increasing social and political control over economic and financial processes - but with systems of control emerging essentially *within* individual states. On the other hand there is a process of increasing intenational economic interdependence, driven by the growth of trade and, subsequently, the development of multinational enterprises and transnational production systems. In abstract terms it is also possible to specify the general way in which the contradiction might be resolved - that is, through the construction of transnational systems of social control. The actual economic history of the last four decades, however, corresponds to the opposite of such a process: systems of social control within countries have been weakened, disorganised and compromised by international pressures, while no structures or institutions have emerged at an international level capable of directing or effectively regulating transnational economic and financial relations. There are indeed significant international institutions, such as the Bank for International Settlements or the International Monetary Fund, which impose certain rules on financial practices, but these institutions, effectively controlled by the most powerful groups in the world economy, seek only to preserve a minimum of stability within which largely unregulated financial agents are given maximum scope to pursue private interests.

Could things have been different? Would it have been possible to have continued and extended national systems of economic control? Or would this have imposed unacceptable costs in terms of economic development? Should our emphasis today be on containing and restricting the growth of globalised financial systems in order to reduce constraints on national economic interventions? Or is it necessary to accept the rapid expansion of these systems while seeking, in the long run, to transform the ways in which they function? The present writer inclines to the latter position. But to inform such discussion, the actual emergence of the present global financial system can be looked at.

Offshore markets and the erosion of national regulation

During the postwar period, the rapid expansion of trade, especially among the richest countries, stimulated the process of private international investment

and the growth of multinational companies. This was led by US corporations which enjoyed a clear technological lead over their competitors but which sought to locate production outside the high-wage US economy. The range and intensity of the international business of these companies underpinned the emergence of offshore financial relations, that is of banking systems and financial markets which connected investors and issuers outside the scope of national regulatory systems. The first steps in this direction concerned finance in dollars; subsequently offshore banking and finance developed in all the most important currencies. The most important location for these activities was London; it was offshore business which permitted the resurgence of the City after the end of its historical role in imperial finance.

There were now, therefore, parallel financial systems - alongside the still tightly regulated systems within states there rapidly grew up a massive, unregulated international system. To begin with only the largest and most powerful agents in the international economy had access to the latter; ordinary companies and households were confined within the national systems. Such an arrangement could even seem advantageous to the US government: it seemed to give maximum freedom to the big corporations as they pursued their global strategies, while preserving the basic framework of control at national level. In the long run, however, the two systems were incompatible, and in fact the unregulated offshore systems prevailed as, during the 1980s, the deregulation of domestic systems removed the barriers between them.

By the 1970s, it had become difficult for the US government to reconcile its domestic and international objectives under the Bretton Woods system, that is to sustain growth and employment at home while also working to stabilise international payments and exchange rates. The second objective was thus sacrificed to the first in 1971, when the Nixon administration broke the link between the dollar and gold and sought to stimulate the domestic economy by lowering the international value of the dollar. The organised Bretton Woods system then collapsed and exchange rates between currencies, previously subject to effective control, were increasingly left to market forces.

This can be seen as a first decisive step towards a free market system in international finance: national governments now had no international framework to support their efforts at foreign exchange control, and were confronted with ever-growing pressures to move financial resources across

frontiers. In this context it often seemed best to liberalise capital movements while seeking to avoid exchange rate instability not by controls but by enhancing the reputation of each national currency for stable purchasing power and thus by waging war on inflation. In this sense, monetarist policies were a logical consequence of the collapse of Bretton Woods.

The Volcker shock and public debt

A second decisive step towards an integrated international financial system was taken in the 1980s. Concerned about the weakness of the dollar in the increasingly internationalised economy, the American monetary authorities decided to dramatically raise interest rates - a move known as the Volcker shock after the name of the then chair of the Federal Reserve - the US central bank.

Other countries were now confronted with an enormous challenge to their financial arrangements. The dollar gained in strength and investors around the world rushed to purchase the dollar securities issued by the US government. It proved extremely difficult, perhaps impossible, for other countries to sustain low interest rates - and the Keynesian regimes with which they were associated. Instead, other countries started to open their financial systems and sought to support their capacity to borrow in internationalised markets by keeping tight control over budget deficits and by suppressing inflation. This was by no means only a question of disadvantages: governments which succeeded in establishing their international credit-worthiness (above all the US but also Japan and West European countries) found that it was now possible to finance substantial payments deficits in a way that had not been possible under the Bretton Woods system. On the other hand, weaker states, including many Latin American countries, were only able to borrow in foreign currencies and at very high interest rates: they were caught in a debt trap which persists to this day.

The internationalisation of corporate finance

The wave of financial liberalisation released by the collapse of Bretton Woods and the Volcker shock essentially removed the barriers which had previously separated the internationalised offshore financial system from domestic systems. Financial resources now flowed easily between the two, and the interest rates and rates of return on external and domestic investments converged. The fact that government bond markets were now effectively internationalised made it

possible to use government securities as standards and benchmarks for the assessment of other financial investments, in particular, the securities issued by large corporations. The process of integration of stock markets (dealing in company shares) and corporate bond markets (in which companies borrow) was accelerated. The integration of corporate finance partly took place through corporations raising money on foreign stock markets but much more through the actions of powerful investors who increasingly made use of the opportunities to lend and invest in other countries. The consequence was that by the turn of the twentieth century, financial systems around the world, especially those dealing with governments and large corporations, had become highly integrated. As this happened the terms and conditions on which these agents could raise money tended to become standardised, and this in turn started to produce a certain convergence in their strategies and practices.

Although smaller and weaker agents - such as most households and most small and medium businesses - are not directly linked into this global financial system, they are also deeply affected by it, because the domestic financial institutions which they use to place their savings and to finance their expenditures are now operating in an internationalised financial environment and are subject to the competitive forces involved. Even large banks and other financial institutions have lost some of the autonomy they enjoyed in the days when they dominated relatively isolated national systems.

Transformations in financial relations

The process of financial globalisation which has been described is not just a question of deep interdependence of national financial systems; these systems have also changed their character as the process has continued. In stylised terms, the changing nature of financial systems involves the ever-increasing importance of *security markets*.

One aspect of the basic tension in all financial relations is the search for *liquidity*. In general, investors want to be able to withdraw their money, to liquidate their positions, whenever they choose. If this can be arranged they will be much more ready to provide funds. Issuers on the other hand usually wish to be financed for a long period and not to be required to pay off debts at short notice. In *direct* financial relations, where only the investor and the issuer are involved, it is not usually possible to reconcile these opposing requirements.

Financial institutions, however, make this possible. They do so in two very different ways. On the one hand, large banks are able to separate the financial relation into two distinct operations: the banks borrow from their depositors and lend to companies and households which need finance; the investor in this case does not have a claim on the final user of the funds, but on the bank itself; if the bank is involved in a very large number of financial relationships it will be able to repay depositors at short notice or even immediately without having to call in its own loans. In this case it is the strength and reputation of the bank which guarantees the liquidity of the investment. On the other hand, the need for liquidity can also be met through *security markets*. Here the investor retains a direct claim on the issuer but this claim can be sold to any other investor ready to purchase it (a security is a *marketable* financial claim). In this case the investors rely on the existence of a well organised *secondary* market bringing together large numbers of investors, to make it possible to turn their placements into cash when they choose. The term 'secondary' denotes the fact that the securities being traded are not being sold by the original issuers (who raise funds on the *primary* market) but are being passed from one investor to another. There is much more trading on secondary than on primary markets - securities, shares or bonds, once issued, are usually bought and sold many times. But the secondary market makes the primary market possible by underpinning the liquidity of the claims - the financial assets - involved.

Now, each of these financial structures has advantages and disadvantages. Powerful banks often work to stabilise financial relations; they may act as effective monitors of the users of financial resources because they build up knowledge of the credit-worthiness of their borrowers. On the other hand, security markets may have important advantages in terms of *scale* and *scope* - organised security markets bring together very large numbers of investors and issuers in an arena where their demands for and offers of financial resources can be compared and competitively assessed. (It is by no means necessary to accept idealised orthodox views on the efficiency and stability of markets to perceive these decisive scale effects.) And because it is essentially a process of extending the scale and scope of financial relationships, the process of financial globalisation has gone together with a major shift from the first to the second of these types of financial structure - away from classical bank finance towards a much greater reliance on stock markets and other organised security markets.

(It is important to notice that the move away from classical banking operations is not the same thing as a decline in the importance of the banks - banks today are very important players in the security-based financial system, in which they play a key organising role.) To see how this happened, it is necessary to look once more at the role of the US financial system.

The financial hegemony of the US

In very abstract terms, the emergence of a global financial system can be regarded as an inevitable aspect of the emergence of an interdependent world economic system. In more concrete terms, its actual emergence took the form of the deregulation and internationalisation of the US financial system. Things happened in this way because of the general economic strength of the US, and because the size of the US economy led to an emphasis on establishing very wide financial networks bringing together millions of issuers and investors across an entire continent.

Although the US, just like European countries, went through a phase in which domestic financial relations were closely controlled and restricted, the liberalisation and deregulation of the US system began earlier than elsewhere and proceeded at a faster pace. Comprehensive central control over finance was more difficult than elsewhere because of the size of the economy and the number of potential financial relationships which had to be monitored. It was also more costly than elsewhere in terms of the constraints imposed on both investors and issuers. On the other hand, deregulation offered very significant advantages in terms of the ability to draw funds from any point in a huge economy and likewise to place them with any one of a vast number of users. The early internationalisation of the largest US corporations and banks meant that financial transformation would be a world-wide, not just a domestic, process. The key role of the dollar encouraged agents around the world to invest in and issue securities on the sophisticated and highly organised North American security markets; this growth was cumulative in that increased scale itself made these markets more powerful and more attractive to financial actors.

Under American leadership, international institutions were reconfigured so as to sustain this expansion. Rules were formulated by the Bank for International Settlements to govern the operation of international banks. Stock markets around the world were led to reorganise themselves in order to attract

international investors - as with the 'big bang' on the London Stock Exchange. Such reorganisations were in any case a competitive necessity now that exchanges had to compete to attract international investors. In the countries with more developed capitalist economies these changes were more or less consensual; in much of the non-industrialised or newly industrialising parts of world financial liberalisation was forced through by the IMF according to the policies known as the 'Washington consensus'.

Consequences for European countries

The first direct consequences of financial globalisation are macroeconomic: currencies are continuously scrutinised by open foreign exchange markets, while the debt securities used to finance government spending are assessed on international bond markets. This certainly represents a new set of constraints on the formulation of macroeconomic policies, but it should also be remembered that in this system credit-worthy states are able to access international monetary resources on a very large scale - the continuous current account deficits posted by Britain over the last ten years show that in practice external constraints on British economic growth have been relaxed, not tightened, by the emergence of the global financial system. Provided the British growth process generates assets which international investors are happy to hold there is no longer any need to balance current trade transactions over short periods of time. What does seem to be ruled out, however, is a macroeconomic strategy which relies on creating specific financial conditions unrelated to those prevailing in the other major economies - for instance, by maintaining very low rates of interest or very low rates of return on other financial claims.

As financial globalisation has proceeded, its consequences have ceased to be essentially macroeconomic, however, and have begun to pervade economic systems as a whole. In the realm of corporate finance there is a general drive for 'shareholder value', that is to make high dividend pay-outs on shares and to secure increases in share prices. These priorities certainly have an ideological aspect, but they are fundamentally determined by the new salience of security markets in the allocation and provision of corporate finance. They are not a purely financial development but have an impact on corporate strategy as a whole.

In many European countries (not so much in Britain which has always tended

towards market-based finance, but, for example, in France and Germany) the financial systems which developed historically were very different from those of the US. Security markets were underdeveloped, while companies relied for long-term finance on closely related 'inside investors' with a continuing interest in their activities. These inside investors might be wealthy families, big banks closely tied to a specific company or indeed other related companies - suppliers or customers. The public as a whole did not hold direct claims on companies; rather they held bank deposits while the banks themselves advanced loans to companies. The banks, rather than agents on security markets, oversaw the use of the money advanced to industry, often developing close and continuing ties with their industrial customers.

This kind of structure was part of the basis of the so-called 'stakeholder' enterprise; big companies were to some extent coalitions of interests (managers, employees, creditors, customers and suppliers, perhaps local communities), in that each interest group had a certain influence on corporate strategy. The financial systems involved could be very sophisticated, able to absorb major disturbances and to reconcile investor and issuer interests over the long term. Clearly the stakeholder aspects of the systems implied a certain degree of social and political control over economic life.

Today these systems seem to be in more or less rapid dissolution, not because they were inefficient at the level of the enterprise but because they were not capable of the rapid and continuous expansion that was made possible by organised security markets, or the mobilisation of 'arms-length', outside, investors around the world. 'Anglo-American' type financial systems are winning out not because they arrive at better or more effective financial decisions in particular cases (there are good reasons to believe that they are often inferior to the traditional European systems in this respect) but because they can mobilise staggering amounts of monetary resources and deploy these resources on an immense scale. Thus European corporations are moving to shareholder based strategies, centred on stock markets, and in the process are posing acute problems of social control.

A second important feature of the on-going changes in European countries concerns household finance. Household savings are less and less held in the form of bank finance but rather entrusted to institutional investors - pension funds, investment trusts and insurance companies - which make placements

on their behalf on the securities markets. This is not the same as classical bank intermediation: the household is exposed to all the risks of the stock market or other investment which is made; the liquidity of the investment depends not on the strength of a bank but on the ability to sell the securities concerned.

In recent years, European governments and the European Union have abandoned any attempt to preserve their inherited financial structures and have sought instead to encourage the growth of security markets and market-based finance, essentially on the American model. This is probably a necessary response; if the Europeans do not develop their security markets they will simply drive every investor and every issuer in the world onto the North American ones. This would tighten constraints on European countries and disdvantage European companies. But this strategic position is full of social dangers. Two of the most obvious of these are, firstly, the threat of a deterioration in employment relations as employers adopt shareholder strategies and, secondly, the barely disguised intention of many European governments to curtail state provision of pensions and health care and encourage households to rely increasingly on the private sector and the institutional investors for the protections previously supplied on a socialised basis.

Winners and losers from financial globalisation

All markets, unless they are subject to strong forms of social control, are inequality machines. Markets work by establishing standards and determining prices; there are always those who cannot meet the standards or pay the prices. The answer to the question, ‘Who has gained from financial globalisation?’ is, in general, the strong - those with most resources and with the greatest capacity to adapt to changing market circumstances. Many third world countries have been the biggest losers - their elites have taken advantage of open capital markets to move their wealth abroad, and the new macroeconomic constraints have devastated their social systems and blocked development. Even the successfully industrialising countries of East Asia have suffered from massive economic crisis linked to the process of financial liberalisation. The United States, centre of the new financial universe, has on the other hand experienced rapid economic development, although the distribution of income and wealth in the US itself has become much more unequal.

Beyond these general judgements it is necessary to recognise that the gains

and losses from financial liberalisation are difficult to assess. One cannot simply identify one category of agents - for example, lenders - as clear winners. The era of financial globalisation began, as was pointed out above, with very high interest rates, and it is clear that some creditors have benefited greatly as a result; but some debtors have also benefited - the US economy as a whole is highly indebted but has been able to finance expansion with relatively cheap external capital. The big intermediaries - banks and institutional investors - have mostly done extremely well out of the process of financial change, and have benefited from a continuous flow of financial innovations, some of which represent real advances in financial practice, some of which are spurious. The middle classes in Europe and North America have benefited from relatively high interest rates on their bank deposits but were fleeced in the stock market bubble at the turn of the new century. Liberalisation in general produces many winners as well as losers - if it leads to more costly finance, creditors and investors benefit; if finance is cheaper, which is probably the long-run consequence, debtors and issuers gain. Like all market processes, the functioning of financial markets involves acute asymmetries and inequalities.

The logic of global finance

At the risk of both utopianism and fatalism, an attempt will now be made to separate the actual course and form of contemporary financial transformations (with all the adverse and indeed frequently disastrous social consequences which have been mentioned) from the historical meaning of the process. As was suggested at the start of this article, financial relations are a condition of existence of the market economy. Today this economy is evolving towards an integrated world system which will support a myriad of new social and economic relationships across - and increasingly to the disregard of - state frontiers. Huge transnational production systems, new communications networks of all kinds, and vast flows of goods, services and information, testify to what can be seen, in classical Marxist terms, as a new phase in the socialisation of production. These developments would be inconceivable without the emergence of an integrated transnational financial system able to identify monetary resources at any point in the global economy and transfer them on an immense scale, at high speed and at low cost towards the activities where they are needed.

The partitioned, virtually closed financial systems of the past could not

support such a process of global integration, nor would they express pressures for adaptation in a global context - comparisons of the costs and returns of financial transactions would express only local circumstances, not global possibilities.

Of course, the actual emergence of a global economy is characterised by huge distortions and imbalances. One of the most important of these is the fact that global systems and networks are overwhelmingly centred on the US, which has drawn financial resources to sustain its development from around the world - a huge flow of resources away from poorer counties and towards a rich one. But, when the logic of global integration is considered, the role of the US is relatively contingent, in the same way that British industrial leadership was in the long run contingent to the general process of industrialisation.

The problem of social control

Social control over contemporary financial development poses, in the first instance, the problem of extending to the international arena the mechanisms of control which previously developed within states: protection of investors, prudential supervision, crisis prevention and crisis management all must be considered today as international issues. Beyond these specifically financial questions, social control signifies the redistribution of assets and income and the redirection of resources to match the central contemporary priority of development.

Such questions should be seen as involving the redirection of the global financial system, however, not its dismantlement. Many policy positions adopted by critical economists tend towards such dismantlement; there are calls to reconstruct financial barriers among states, to shrink or even suppress the role of international security markets, or to preserve the insider-based investment systems of the past. One striking example is the demand for a Tobin tax (a tax on foreign exchange transactions) in order to limit the scale of transnational financial operations. This measure would lead to a profound disorganisation of many financial systems while reinforcing US financial dominance by rendering smaller and less developed systems illiquid. The vast majority of foreign exchange transactions today are not speculative, as is frequently asserted; rather they are a key mechanism for the recycling on which the financial system rests.

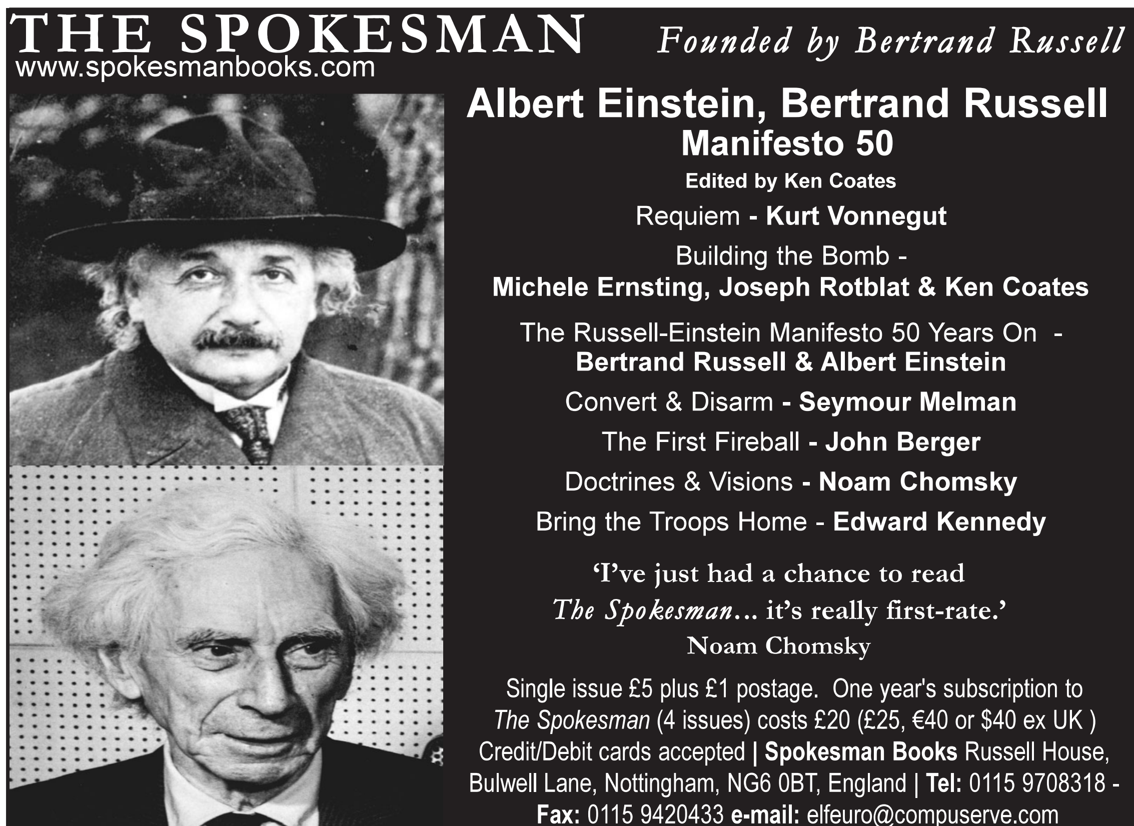
Of course, in the short run and in a defensive context, it may be quite justified to obstruct financial liberalisation in order to emphasise the adverse social consequences to which it often leads. But the key political challenge posed by financial developments today is to preserve and deepen international integration while reasserting, at European and at the world level, the need for social and political control over economic life.

Given that measures such as the Tobin tax, intended to suppress and restrict inernational finance, make little sense, what kind of reforms should be proposed? Three types of measure could work to develop social control over contemporary financial systems without obstructing international trade and investment. Firstly, much stronger systems of investor protection are needed in order to make banks, pension funds and other powerful institutions take full responsibility for the products and services they sell to households. Finance is not a realm in which it makes sense to apply the principle *caveat emptor* (let the buyer beware). For some products (mortgages, pensions) individual households may only transact once or twice over a lifetime – there is no way in which they can match the knowledge and sophistication of the institutions with which they are confronted. The rule should rather be *caveat vendor* (the seller is responsible). The institutions themselves claim that what they call 'over-regulation' would stifle 'innovation'. But since so many supposed innovations in retail finance are simply scams, some delay in the introduction of new products and services would be an acceptable price to pay for greater customer security. Nor would tighter regulation necessarily hamper the functioning of the financial system; it could lead to greater confidence in the system and mean that households were much readier to commit their savings to it.

A second line of reform concerns the working of international financial institutions such as the IMF. These have tended to act not as guardians of the system as a whole but as representatives of the strongest agents within it. For example, in the international debt crisis they have repeatedly sacrificed the interests of low-income debtor countries to those of powerful US and European banks and other creditors. Similarly, enormous pressure has been placed on low-income countries to open up their financial sectors to foreign penetration before they were ready to do so. This premature liberalisation has often led to huge economic and social dislocation. This is not an argument against liberalisation in the long run – there is an

abundance of cheap financial resources in the high-income countries which could contribute massively to development around the world. But institutions clearly biased in favour of Western interests need to give way to new structures with a broader representation of interests. The Europeans are well placed to press for such reforms.

The third, and most important, need is for an efficient redistribution of financial wealth, both within and especially among countries. In the short run this means richer countries meeting the development assistance targets to which they have already, in principle, agreed; in the long run some kind of international tax structure would be needed. But the target of such a tax should be the wealth which emerges within the financial system, not the functioning of that system, which is indispensable to the future development of the international economy.



Chapter 9

Scale and the Political Economy of Financial Change

4

Scale and the Political Economy of Financial Change

John Grahl

Introduction[1]

It is an honour to contribute to this volume, which originates from the launch of the *Festschrift* for Hajo Riese. The Keynesian monetary theory which Professor Riese has done so much to develop remains today a key source of insight into the macroeconomics of market economies. However, if Keynesian monetary theory is to continue to illumi-nate macroeconomic processes, it must be reformulated to take into account the vast change in monetary and financial systems which has taken place over the last two decades. Two key dimensions of this change are the *internationalization* (or even the globalization) of investment mechanisms and the process of *securitization* which has reduced the role of classical bank intermediation while expanding that of organized capital markets. In consequence, the relationship between savings and wealth on the one hand and, on the other, productive capital formation and economic growth is being transformed. Monetary theory today has to find a new definition of liquidity, and to reconstruct its view of the role of money, in order to understand new financial realities; bank deposits today, for example, do not play the same role as in the 1930s or even the 1970s.

The present contribution has no direct theoretical ambitions. It aims only to emphasize certain empirical regularities in the new financial and monetary environment. In particular, an attempt will be made to characterize one of the most prominent, but least understood, phenomena of the internationalized, securitized financial system: the massive scale of trading on financial markets today. This phenomenon attracts much less attention from financial specialists than variations in asset prices, although the size and the volume of trading on contemporary asset markets may well do more to explain the economic impact of internationalized finance than the dubious precision of its evaluations. In the Keynesian tradition, on the other hand, many commentators tend to see, in the huge scale of contemporary financial

transactions, the 'whirlpool of speculation' denounced in the *General Theory*, an unhealthy, development which subordinates the long- term needs of the productive system to the pursuit of short-term capital gains.

It will be suggested that such assessments are very misleading, that very high trading volumes are an intrinsic and necessary feature of the contemporary financial system and of the move away from bank intermediation on which that system depends. The argument will be carried out in three steps. First, a discussion of the specific case of foreign exchange markets will show that the very high levels of trading which are observed cannot be interpreted except in terms of the rapid integration of monetary systems across currency zones. Second, attention is paid to trading on equity and debt markets; it is suggested that this is to a large extent determined by the inescapable needs of the institutional investors which now predominate on these markets. Finally, the issue of scale is used to characterize the impact of the new financial mechanisms on the economies of Europe.

The foreign exchange markets[2]

Surveys of foreign exchange dealing are carried out by the BIS every three years. The astonishing trading volumes revealed by these surveys have given rise to intense discussion – in 2001, for example, currency trading was running at some $1.3 trillion per day. This total dwarfs both the needs of trade and those of international investment by several orders of magnitude. Commentators have often moved, too quickly, to the conclusion that these markets are simply casinos, that the primary motive behind most transactions must be to make speculative profits on changing foreign exchange rates.

There are general objections to such a judgment. Speculation is a zero-sum game, and it is known that positions in the FX market are closed out within a few days; how does the market continue if it does not generate positive returns for its participants? Some economists, realizing the problems involved in the speculation hypothesis, have opted for the opposite position – FX trades are, they suggest, dominated by hedging activities, carried out by dealers moving large amounts of currency among themselves. But such accounts are also implausible – this is a very efficient market with most trades being carried out by a handful of multinational banks. It is hard to believe that secondary trading, to meet the specific needs of FX dealers, could account for the lion's share of transactions as would be necessary for the hedging explanation to hold water.

The structure of the FX market points the way to a more convincing explanation. A high and rising share (now over 50 per cent) of transactions take the form of FX swaps – that is, of spot sales combined with equivalent forward purchases between the same counter-parties. Now, an FX swap represents, as far as the exchange rate is concerned, a *closed* position – neither party gains or loses from an exchange rate movement because both

end up in their original currency. Already, explanations of FX turnover in terms of either speculation or hedging seem rather inadequate.

One use of an FX swap can be to roll over an existing exposure – whether that exposure has hedging or speculative motives. But the evidence is that the principal players in these markets, the banks, do not maintain large open currency positions. Also, when swaps are used in this way they are combined with other transactions – with spot trades or outright forwards – which are needed to establish that exposure. Now these transactions – spot deals and forward FX contracts – are a rapidly declining part of the overall currency market. There is no evidence that such exposures as do arise in the market are being extended – they remain very short-run.

Thus, one is led to a quite different conclusion, that FX trading has less and less to do with exchange rates and is, in fact, driven by essentially money market motives. The FX swap, in this perspective, is an instrument exactly analogous to a repo – it is a collateralized loan which can be used to transfer liquidity efficiently and at low cost within contemporary financial systems. On this interpretation, the existence of different currencies ceases to constitute an obstacle to the recycling functions of the money market which, within currency zones, are well understood. For example, a Eurozone bank experiencing a shortage of liquidity, or with the opportunity to make an advantageous short-run loan, can borrow the resources required from a US bank in the opposite position, that is, one with excess liquidity or the ability to borrow dollars short-run at an advantageous rate. The borrower in such a case will have obtained the 'wrong' currency but this is not a problem because the dollars can be swapped, with the same counter-party or with another bank, for euros, either by mobilizing an existing euro deposit or through the creation of a new deposit. In both cases the dollars provide full capital to back the euro advance and thus preserve the capital of the bank which makes it.

Thus, what emerges is the possibility of supplementing internal sources of liquidity with external sources, raising the efficiency of the domestic money market and reducing the disturbances to which it is subject. The exchange rate plays no role in the transaction at all, except as a measuring rod to determine the size of the transaction: movements in the exchange rate are a matter of indifference to all concerned. The eurozone in particular makes substantial use of FX swaps to support its money market, just because cross-frontier money market transactions within the zone are not yet fully developed.

Thus, money markets can be integrated across currency zones. The existence of different general levels of interest rates is not a problem because the differential is built into the FX swap via the pricing of its second leg – the forward component which returns each participant into their original currencies. (It is the deposit rates in the offshore banking system

which determine these prices.) What drives these transactions, and indeed all money market flows, is the variation of interest rates around central rates and the need to recycle available liquidities from surplus to deficit agents.

FX trading, therefore, has to be seen as an extension and internationalization of money markets, where again there has taken place an enormous growth of transactions. This growth itself results essentially from the central tendency of modern financial systems away from classical bank intermediation and towards ever greater reliance on securities markets. One might speak of a *paradox of disintermediation*; bank deposits are less and less held as assets but the functioning of securities markets themselves gives rise to a need for enormous transactions balances to sustain the high turnover which renders these markets liquid.

The paradox is resolved in the money markets where surplus balances are recycled to deficit units on an immense scale, at high speed and at very low cost. FX trading represents, in essence, the globalization of this process – making surpluses anywhere in the world's banking systems available for recycling to any point where they can be advantageously deployed. This interpretation becomes obvious as soon as it is put forward. That many economists have failed to arrive at it is perhaps the consequence of their clinging to an obsolete doctrine – the 'monetary theory of the balance of payments'. According to this view the monetary stock which supports domestic transactions within any currency zone is given, under the control of the relevant central bank. Were this the case, the kind of money market integration which is described above would be impossible – countries could obtain real resources from abroad by the sale of either exports or assets but they could not use external monetary balances to support domestic transactions.

To the extent that such a view was ever valid it has surely ceased to be so. In contemporary banking practice, deposits backed by securities or foreign exchange can be created very easily because they do not impair the capital of the bank concerned. The central bank may influence the general interest rate at which these monetary issues take place but has little or no control over their volume. In such circumstances there is very little practical difference between a repo and an FX swap – they both put the debtor in effective possession of monetary resources. The fact that, in the latter case, these resources have been obtained from another currency zone makes no effective difference.

The volume of FX trades becomes a problem only if their money market character is not perceived, when it assumed, quite incorrectly, that foreign currencies are required only to support external trade or portfolio investments. Once this prejudice is banished, the nature of the FX market becomes obvious as does the concordance of its structure – dominated by large banks, focused on short-run placements and above all massive in scale – with that of the contemporary money market.

The scale of trading on security markets[3]

The argument so far has assimilated FX markets to short-run money markets. If one then asks why money markets themselves display such huge transactions volumes, the answer is clear: the monetary balances in question are needed to support security trading. There is simply no other explanation – certainly money market flows are much too great to be put into any meaningful relation with GDP or with current incomes and expenditures. Flows through US payments systems, for example, would be enough to circulate annual GDP in less than three days. Only the massive and continuous turnover of debt and equity instruments on the world's security markets can account for this activity.

Now the twin transformation of financial systems in terms of internationalization and securitization has been accompanied by a strong and continuing growth of trading on all the security markets concerned. On equity markets in particular, this growth has outstripped the strong growth of capitalization so that the average holding period for securities has fallen rapidly and average turnover rates (that is trading volumes divided by capitalizations) have risen continuously. Yet the interpretation of this growth in transactions is still rather obscure. In many of the most influential theoretical accounts of capital markets the volume of trading is essentially exogenous – liquidity and the readiness to trade have to be presupposed to explain the existence and the character of the market but trading volumes themselves are not accounted for.

This would seem to be the case for the efficient market theory (with as one key expression the capital asset pricing model) which remains central to much financial analysis. Large volumes of trading might even seem to be an embarrassment for this theory which seems to suggest that a 'buy and hold' strategy is optimal for investors on equity markets.

The efficient markets theory can be regarded as analogous to the Walrasian account of the market economy – it provides a powerful but extremely abstract view of asset evaluation. To move towards a more concrete view of asset market processes two distinct bodies of theory have been developed. The analysis of market microstructure addresses the absence in practice of costless information as to both asset values and trading intentions. In this view, trading, especially on the part of dealers, may be undertaken in order to facilitate price discovery, or to reveal the existence and the strategies of counter-parties. Thus, trading becomes, to a certain extent, endogenous to the working of the market. However, this perspective fails to illuminate the trend growth in security trading because actual developments in trading practices, with competition amongst exchanges and other trading systems supported by important advances in communication technologies, are making for more transparent markets and lower transactions costs.

Where microstructure approaches address the objective departures of markets from the full information paradigm, behavioural finance deals with

its subjective limitations and the failure of market participants to achieve full rationality. Psychological phenomena, such as overconfidence, a reluctance to admit one was wrong, the use of biased rules of thumb in calculations, focus on an inappropriate range of assets, help to explain certain anomalies in the prices of securities. An important insight is that the very existence of irrational investors alters the constraints and opportunities facing fully rational ones. For example, if an overpriced security is identified by the latter it may be risky to attempt arbitrage because of the possibility that the price discrepancy would persist, or even widen, before it narrowed.

However, only a limited contribution is made by behavioural finance to the explanation of trends in security trading. These theories certainly help to account for a certain level of 'noise trading' beyond that which might be undertaken by rational investors; on the other hand they may actually point to obstacles to the arbitrage trading which is usually taken for granted by analysts of the financial system. Nor does the 'behavioural' approach identify dynamic forces in the financial system which have accelerated turnover year on year over more than two decades. Behavioural finance may give some support to the critique of speculation put forward by many Keynesian commentators but does not fully justify that critique.

Empirical examination of security trading volumes reveals that trading is very highly structured, concentrated on a few exchanges, a few instruments and a few agents. In no case does the distribution of transactions support simple views of speculative excess. Thus, trading volume is much higher in the established bourses of the West than in emerging markets; trading in debt instruments is much higher than trading in equity, with public debt being turned over much more rapidly than corporate debt. In both equity and bond markets there is a marked concentration on specific issues, high-capitalization blue-chip stocks in the first case, 'on-the-run', that is, recently issued, paper in the second. Thus, the pattern of trading shows a comprehensive preference for the least volatile and most transparent securities in direct contradiction of any straightforward interpretation in terms of speculation. Of course, to point out these regularities is not to deny the existence of speculative transactions or even the predominance of speculative motives at certain times; but these waves of speculation are episodic, not a factor in the trend growth of security market turnover. In the US, for example, the dot.com bubble led to an enormous but temporary surge in NASDAQ trading; turnover on the NYSE was much less affected and, measured relative to capitalization, has already recovered from the equity crash to reach new maxima.

To explain these trends one has to invoke the strongest structural change which has taken place in capital markets over recent decades, that is, the rise of *institutional investors* (pension funds, insurance companies, mutual investment trusts and so on) and the relative eclipse of the individual investor.[4] It is probably fair to focus on US security markets in examining the phenomena

concerned because these certainly predominate in the global financial system both quantitatively, in terms of capitalization and, especially, in terms of trading volumes, and qualitatively, as the most advanced and technically sophisticated security-based asset markets. Within the US we find that the institutions account for virtually all trading in fixed income securities and for the lion's share of equity trading. On the NYSE, for example, block trades, exclusively used by the institutions, account for some 50 per cent of transactions by value, but the institutional share is much higher than this because institutions often use smaller transactions, fed into the market over a period of time, to try to avoid adverse price and liquidity effects from their portfolio changes.

Indeed, it is clear that, from the point of view of the larger institutions, security markets, far from being characterized by excess liquidity, present chronic difficulties in the implementation of desired trades. A host of techniques are used to overcome liquidity shortages – the use of 'upstairs' markets to find counter-parties for large transactions, the 'slicing and dicing' of big security packages into smaller ones, 'crossing' of securities on parallel markets to which only the larger investors have access, the use of derivatives to avoid the costs of trading in the underlying securities. It can be confidently asserted that we find, in the growing role of the institutional investors, the proximate source of transactions growth.

To take the argument further, and to specify the motives behind institutional trades, certain difficulties have to be addressed. Some commentators focus on what one might call the pathology of institutional investment – on certain practices which may lead to the 'churning' of portfolios even when this is in direct conflict with the interests of the retail customers who are the original suppliers of the funds invested. In some cases we have straightforward conflicts of interest between the household savers, as principals, and the institutions as their agents. Many of the malpractices revealed by the recent stock market crash fall into this category: a relevant example is the 'market-timing' which permitted informed dealers to trade at obsolete prices in the assets of the institutions and thus to misappropriate the wealth of the individual savers; unhealthy, 'soft-dollar' relationships between the institutions and stock market dealers provide a second example where transactions were swollen by essentially dishonest practices. Nevertheless, it seems that the growing experience and sophistication of retail investors, together with regulatory reform, can be expected to reduce the scale of such transactions.

Other malfunctions can be traced to the conditions of competition among the institutions. This has a marked Chamberlinian character and displays many of the problems associated with imperfect competition: excess capacity and a failure to realize potential scale economies; high marketing costs and spurious product differentiation (the actual needs of retail investors, above all risk avoidance and the accumulation of pension resources, are rather homogeneous; the proliferation of specialist institutional strategies

promising to beat average performance in the security markets has probably gone too far from the point of view of their interests). In this perspective it is certainly possible to trace certain transactions to imperfect competition; for example, the 'window-dressing' by which some institutions discarded unsuccessful investments and purchased rising stocks in order to give a false impression of acuity and foresight.

The view taken here, however, is that such malfunctions are related to the immaturity of the new financial system rather than intrinsic features of it. Such a view is encouraged by changes in the investment scene itself. Competition, including genuine price competition, is increasing; institutions have to pay more and more attention to the costs of their strategies (not simply to actual transactions costs but also to the price impacts of large trades); institutional investors are increasingly bound by relatively tight mandates which exclude adventurous or unbalanced portfolios; their performance is more frequently measured against more objective benchmarks such as equity or bond-market indices; incentive structures are being redesigned in order to make rewards more congruent with customer interests.

These important reforms, however, are likely to maintain, not to reverse, the strong trend towards high trading volumes. An important observation in US markets has been that 'rule-governed' trades account for a high and rising share of transactions; such a trade is one which reacts, in a predictable way, to the changing quality of specific securities. Now, such behaviour suggests a close link between the trading needs of the institutions and the attempt to stick closely to a clearly defined investment strategy; it suggests, in other words, that portfolio rebalancing, in order to preserve the risk-return properties of an institutional portfolio, is an increasingly important motive behind institutional trading.

For fixed-income portfolios, the archetypal rebalancing operation is *immunization*. It is often either impossible or extremely costly to match the time structure of a bond portfolio's cash flows with those of its liabilities to retail customers. This leads to interest rate and market risks which can be minimized by rebalancing the portfolio in response to every significant shift in market interest rates. The immunization procedure either increases or reduces the *duration* of the portfolio by the exchange of short-dated and long-dated claims. In equity markets, on the other hand, rebalancing involves reducing the tracking errors which unavoidably arise in the attempt to match an objective benchmark, such as an index, with an economically constructed sample of securities. Notice that in both cases rebalancing is a counter-speculative procedure. If the portfolio manager does *not* rebalance then that manager is speculating either on a favourable change in the structure of interest rates (in the first case) or on an exceptional performance by specific stocks (in the second). Notice also, that rebalancing relates to an entire portfolio but is implemented, as far as is possible, by trades in the least volatile and most liquid securities – for example, by buying or selling

on-the-run Treasuries in the fixed income case, or blue-chip stocks in the case of equities. Such securities are held by the institutions for just this purpose.

Both the logic and the empirics of this argument require further development, but enough has perhaps been said to suggest that high volumes of security trading are an intrinsic and necessary aspect of an investment process increasingly dominated by institutional investors rather than a result of malfunctions in that process. If this is the case, then there has been uncovered a logical basis for the growth of security trading which is both a consequence of the ongoing transformation of financial systems and a cause of its continuing dynamic as the deepening and widening of security markets makes more effective diversification possible and magnifies the risk-return advantages of the new systems *vis-à-vis* classical bank-based investment.

Competition amongst financial systems[5]

So far, the argument has been that the scale of trading in organized financial markets can be seen as an intrinsic and logical aspect of the ongoing financial transformations often described in terms of securitization and internationalization/globalization. Security-based financial systems seem to possess certain potential cost advantages as against classical bank intermediation. But to realize these advantages, and to compensate for certain intrinsic disadvantages, such as volatility, market-based finance requires a certain scale, both in terms of capitalization (the total value of the assets involved) and trading volumes (the liquidity of the investments which are made). Only when this scale has been reached, does the actual diversification of portfolios approach what is, in principle, possible. The transformation is cumulative in that the scale effects which strengthen the security-based system prepare the ground for its continued expansion. The institutional investors are key actors in this dynamic process because they can obtain levels of diversification which are impossible for all but the wealthiest individual investors.

On the basis of this position, certain considerations can be put forward concerning the rivalry between bank-based and security-based financial systems which may be relevant to the current difficulties of the former in such countries as Germany and Japan. The historically developed financial systems of these two countries are often characterized in terms of such features as the following:

- the importance, in corporate finance, of a small number of 'inside investors' closely related to the enterprise;
- the mobilization of funds from the general public by way of bank deposits rather than direct participations;
- significant cross-holdings among enterprises as a support for collaborations of various kinds;

- the absence of liquid capital markets and, consequently, the long-term nature of many investments.

Discussion of such structures often emphasizes that they may help to overcome problems of asymmetric information in relations between issuers and investors and that this may result in a very precise and efficient balancing of the interests of these two parties, just because competition has been attenuated and it is difficult for either to exit rapidly from their mutual commitments. In the terminology of Hirschman, these financial structures make more use of voice and less of exit in bringing about necessary adjustments. There are connections to wider debates on 'varieties of capitalism', 'Rhineland capitalism', and so on.[6] There are also acute concerns about the financial dimension of current difficulties in the German economy: the moves under way towards more 'Anglo-Saxon', security-based financial mechanisms have not all proved to be strikingly successful; on the other hand Germany's universal banks, central to its historical financial processes, are facing acute challenges in the new, internationalized, environment and are perhaps incapable of maintaining their traditional role in corporate finance. While the larger German multinationals seem to be adapting effectively to the new conditions, the same may not be true of the *Mittelstand*.[7] The coherence of the industry-wide systems which have promoted rapid and efficient restructuring in the past seems to be in question.

From the point of view developed here, it is necessary to stress one aspect of the inherited economic and financial systems in continental Europe, their *social embeddedness*. Economic relationships of all kinds, especially financial relations, are often supported by the fact that they coincide with social affinities which contribute to mutual trust and to a recognition of mutual interests. Almost any social affinity may serve this purpose: kinship, language, religion, nationality, regional allegiances and so on. The security-based financial system, on the other hand, has no such support – it is disembedded from specific social ties and, essentially, anonymous in that investors neither know nor care who is making use of their funds – all that matters are the risk-return characteristics of the placement.

Clearly, the presence of pre-existing social ties may be an important strength in the organization of a specific financial relationship. Problems of asymmetric information, of mutual trust, may be more easily overcome. From the point of view of financial systems as a whole, however, this strength becomes a weakness – it restricts the scope and the scale of financial relations to a specific social milieu and makes it impossible to extend investor-issuer relations across the globe. It is not an accident that financial globalization has taken the form of the deregulation and internationalization of the US financial system – the scale of the US economy encouraged much more dependence on security markets and worked against reliance on restricted social affinities as the basis of investment relationships. The rule of

security-based finance is, 'anyone can play'. In microeconomic terms this may impair the accuracy of specific decisions. But at the global level it becomes an overwhelming advantage – funds can be drawn from anywhere on the planet and placed, likewise, with any issuer. As global scale is developed cumulative processes are established, in the ways indicated above, which lead to ever greater cost/return advantages over the insider systems of the past.

From this perspective the historic financial mechanisms of the old continent are little more than a cluster of particularisms, systems which are incompatible one with another but which are alike in that it is impossible to extend any of them far beyond their given, local sphere of operations. Particularly for large corporations, seeking to finance productive strategies on a global scale, the inside investor has ceased to be a reliable support and become an unacceptable constraint.

It follows that the current EU strategy for market-based financial integration represents a logical response to the challenge posed by ongoing transformations.[8] If large integrated markets are not developed within the European Union the long-term consequence might well be simply to drive every investor and every issuer on the planet into the North American markets, an outcome that would both constrain EU policy-makers and disadvantage EU companies. On the other hand, experience has already demonstrated that this integration will not be easy to achieve, given the existence of very different institutions and practices in different member states and the multiple linkages between financial systems and other social and economic structures. The full implications of such policies as the European Financial Services Action Plan have perhaps not yet been appreciated either by the actors involved or by the wider public.

Conclusion

The argument developed here has gradually moved away from solid but limited assertions to very dubious conjectures. In exploring the causes and consequences of the vast trading volumes observed on contemporary financial markets, it was claimed at first, and with some confidence, that the scale of transactions on FX markets in particular is a money market phenomenon, to be seen as supplementing domestic sources of liquidity with external sources drawn from other currency zones. This is not a widely accepted interpretation but it can be supported by very strong theoretical and empirical considerations.

As for trading on money markets themselves, there is little doubt that much of it is driven by the needs of security markets. The evidence here is essentially negative – it is difficult to think of any other motive behind these vast recycling operations.

The next, and most important, step is therefore to address the huge turnovers on security markets themselves. Some evidence can be adduced to

suggest that this is neither a question of speculation nor a consequence of dysfunctional 'churning' by the institutional investors (although these are certainly both important realities) but rather an essential aspect of the development of these institutions and of the securitization process which they make possible.

The next, perhaps purely hypothetical, suggestion is that the development of trading scale on organized asset markets can be seen as a cumulative process which gradually widens and extends the competitive superiority of market-based finance as against the working of classical bank intermediation. This is little more than a supposition (although perhaps a plausible one) but it was nevertheless used as the basis for further conjectures, that the historically inherited financial systems of continental Europe face a decisive challenge and that a strategy of market-based financial integration may be a very logical response.

Many of these interpretations are fragile and weakly supported, requiring to be either corrected or replaced. Nevertheless, it can be claimed with some certainty that contemporary transformations in financial systems, whatever may be the best way to interpret them, have important implications for our understanding of money, monetary policy and macroeconomic systems.

Notes

1. This paper presents a summary of an ongoing research project into the volume of financial transactions carried out, with my colleague at London Metropolitan University, Photis Lysandrou. Some of the material on security market trading was presented at a seminar at the Free University Berlin in March 2004. I am grateful to Michael Hüther and Norbert Walter for critical comments at that meeting.
2. This section is based on J. Grahl and P. Lysandrou, 'Sand in the Wheels or Spanner in the Works? The Tobin Tax and Global Finance', *Cambridge Journal of Economics*, Vol. 27, No. 4, July 2003: 597–621.
3. This section draws on J. Grahl and P. Lysandrou, 'Capital Market Trading Volume: an Overview and Some Preliminary Conclusions', mimeo, London Metropolitan University, 2004.
4. For a detailed account see E. Philip Davis and Benn Steil, *Institutional Investors*, MIT Press, Cambridge, MA, 2001.
5. This section draws on J. Grahl, 'Globalised Finance and the Challenge to the Euro', *New Left Review*, March/April 2001.
6. See, for example, R. Dore, *Stock Market Capitalism, Welfare Capitalism: Japan and Germany versus the Anglo-Saxons*, OUP, Oxford, 2000.
7. For pressures on the German system, W. Streeck and M. Höpner (eds), *Alle Macht dem Markt? Fallstudien zur Abwicklung der Deutschland AG*, Campus, Cologne, 2003; for problems in German bank finance, T. Schmidt and H. Nehls, 'Credit Crunch in Germany?', *RWI Discussion Paper*, No. 6, Rhine-Westphalia Institute for Economic Research, September 2003.
8. See R. Rajan and L. Zingales, 'Banks and Markets: the changing character of European Finance', in V. Gaspar, P. Hartmann and O. Sleijpen (eds), *The Transformation of the European Financial System*, European Central Bank, Frankfurt am Main, 2003.

Comment

Michael Hüther

John Grahl is looking for an explanation for the increasing scale of trade in foreign exchange markets, money markets and security markets. He also draws some tentative conclusions concerning the European financial system. I will briefly comment on his main thesis that institutional investors are behind the rise in trading volumes on security markets and, in regards to Europe, point out some qualifications.

Institutional framework of capital markets

Liberalization and integration of financial markets have to be regarded as catalysts for increased trading volumes. Trading volume in the US has benefited from the size and integration of this 'single' market. European capital markets did not truly come into existence before the introduction of the euro. The advantages of agglomeration are evident in particular where the effect of scale economies is great, where market depth and liquidity play a key role, and where personal networks are decisive for business success.

The current state of integration of Euroland's capital market can be measured by comparing price differences within a country with price differences across intra-Euroland borders.

- Empirical examinations show a high degree of integration since the start of Stage Three of EMU in the unsecured interbank money market, the overnight interest rate swap market, derivatives markets (money market futures and government bond futures) and secured money markets (repos). The latter markets are of special interest to the ECB, as they are of particular importance for the implementation of monetary policy.
- Bond markets (general as well as government bonds) are still imperfectly integrated markets (these are the markets for high-yield debt securities and asset-backed securities (ABS) as well as for short-term securities). But the introduction of the euro led to a substantial increase in the integration of the ten-year government bond market.

- Equity market integration in the euro area had advanced significantly since the 1970s, but looking at the average variance ratio of less than 25 per cent gives the indication that the level of equity market integration reached so far is not particularly high. The equity market may be the least integrated market in the euro area.

In the US, potential for further increases in trading volumes lies with the implementation of technological innovations (e.g. electronic order books). In Euroland, increased integration of financial markets will create the necessary depth and breadth (Lamfalussy-process). The way to a uniform infrastructure and a harmonized legal framework in the EU is still long. In other words: there is remarkable room to mobilize these potentials.

A further argument in explaining the increase in trading volumes on finance markets may be the restructuring or better the industrialization of the finance sector. With the value-added chain being broken up, attention is and will be drawn to a vertical as well as to this horizontal work-sharing between individual fields of business. Standard processes (account management, clearing and settlement, payment transactions) will be more and more outsourced and grouped. This creates greater volumes in special markets and lower transaction costs, the basis for further increases in the original finance markets.

Further explanations: retail investors and demographic changes

If institutional investors are responsible for the increase in trading, the interesting question is: what caused the increase in institutional investors? It seems to be most important that the retail customer has become more sophisticated and therefore created a greater need for institutionalized investment. Another explication is the ageing and shrinking of many societies. The imminent demographic changes in Western Europe and North America will have not only a significant impact on social security systems in these countries but also on the importance of capital markets and thus on the volume of trade. The partial or total introduction of the full-funding principle in the social security system is also a huge opportunity for the financial market. The potential in Germany and Europe compared to the US is remarkable: the financial assets of households amount to 165 per cent of GNP in Germany, to 200 per cent at the European average, but to 320 per cent for US households.

Chapter 10

Financial Change and European Employment Relations

6

Financial Change and European Employment Relations

John Grahl

Introduction

This chapter explores the changing consequences of financialization in liberal market economies, the effects of its gradual penetration into cooperative market economies, and the possibilities for new forms of institutional hybridity. In doing so, it suggests, first, that the financial changes taking place in many countries have been widely misunderstood and, second, that the consequences of these changes for employment relations, although often adverse, are not necessarily so.

Aspects of Financial Change

What is sometimes referred to as the 'financialization' (for one analysis see Froud, Johal, and Williams 2002) of socioeconomic systems involves a number of phenomena. Three economic aspects of financial change are frequently referred to; it is important to distinguish between them. (There are also important cultural and linguistic aspects—such as the widespread perception that financial institutions and financial markets are central locations in society today.)

The Growth of Finance

First, there is simply the growth of finance and of the financial sector. There is more finance about in that economic agents today hold more financial claims on each other than in the past, relative to GDP as a measure of economic development. Expenditures, both for investment and consumption, are more likely to be supported by credit or other forms of finance than in the

past. The balance sheets of households and businesses carry a higher level of both financial assets and liabilities relative to real assets such as buildings or equipment.

This expansion of finance involves an expansion of the financial sector, of the corporations and other institutions which collect monetary resources from the public and channel them either to the agents who will use them or onto the financial markets. This is now a larger sector by all measures—the percentage of the workforce it employs, the share of national income for which it accounts, and the size of the financial flows and financial assets and liabilities involved. This expansion goes along with the expansion of closely related activities such as real estate: some commentators speak of a spreading FIRE (finance, insurance, real estate).

Disintermediation and Securitization

The second aspect of change is in the nature of finance. Financial markets, for company shares, bonds and other debt instruments, foreign exchange (FX), and derivatives, such as options and futures based on these assets, play an increasingly important role in the financial system; at the same time classical bank finance—the advance of credit from a bank, based on the deposits it receives from the public, is becoming relatively less important in quantitative terms. This shift, sometimes referred to as *disintermediation*, is linked to a liberalization of finance which allows investors in securities and issuers of securities to operate in many countries. The move away from classical bank intermediation should not be regarded as implying a decline in the importance of banks as institutions. In fact, the big banks are the key players in the whole transformation. Although deposit-taking and bank credit today make up a smaller proportion of the banks' activities, they are involved in every aspect of the security market-based finance which has emerged in recent decades. The banks issue securities on their own behalf and on behalf of corporate customers; they make markets in many securities; and provide many of the services linked to security trading, such as investment analysis, fund management, and the settlement of transactions.

This change in the nature of finance, however, also involves the rise of other financial corporations to rival the banks—these are the institutional investors: pension funds, insurance companies, and investment companies such as unit trusts in Britain or mutual investment companies in the United States. In classical bank intermediation the provider of funds, the depositor, has a claim on the bank, not on the borrower who actually uses the funds. He or she relies on the solidity of the bank to make the claim safe and liquid. In the security-trading financial system which has to some extent displaced classical bank intermediation, the provider of funds relies on the existence of a deep and wide market in securities to secure the same objectives.

In the 'secondary' markets, which account for the vast bulk of security trading, investors are able to liquidate their positions by selling to other investors. The 'primary' markets, where new securities are issued, are very much smaller—but it is usually price movements on secondary markets which set the terms on which corporations or governments can raise new money on the primary markets.

It has been known theoretically for a long time that portfolio diversification can reduce some of the risks of investment for a given expected rate of return. In practice, effective diversification is costly and only the richest investors could achieve it on an individual basis. The institutional investors (Davis and Steil 2001) offer the same advantage to the middle classes by aggregating thousands of small positions into an overall portfolio. But a savings plan with an institutional investor differs from a bank deposit in that it is the customer not the intermediary institution, who, in the first instance, bears the risk of the investment.

This process of *disintermediation* or *securitization* is not easy to explain. Why did one form of finance expand at the cost of the other? A full answer will not be attempted here, but it is interesting to see that this process might be *cumulative*: the ease with which securities can be traded, and hence the liquidity of an investment in securities, depends crucially on the scale of the security market. Thus, if security-based finance secures an advantage over bank intermediation, that advantage will tend to increase over time.

High Interest Rates

The third aspect of 'financialization' which will be discussed is financial tension—the pressure of financial constraints on economic agents. The same era—roughly the last quarter of the twentieth century—which saw the growth of finance and the changes in financial structure which have been referred to—was also marked by exceptionally high interest rates and thus by extraordinary pressure on debtors and on agents seeking finance. The most catastrophic result of these tensions has been the third world debt crisis, still unresolved some twenty years after it struck. But there have been other victims—for example, the EU member states failed to find a clear common response to rising interest rates in the world economy, and this put their socioeconomic systems under enormous pressure: both Keynesian economic intervention and high welfare standards became very difficult to finance. Likewise, the pressure for downsizing and closures in their manufacturing sectors were, although not caused, greatly exacerbated by the cost of credit.

Because the era of financial transformation coincided in this way with that of very high interest rates many commentators have closely associated, or even identified, the two developments (e.g. Duménil and Lévy 2004). This is one source of the misunderstandings that will now be explored.

Financial Demonology

A stylized account will be attempted here of the interpretation of the financialization process within critical political economy. Most of the difficulties are caused not by errors, but by emphasizing rather contingent or medium-term aspects of processes which have a wider significance. Financial sectors today are seen as overblown and parasitical; their growth is explained by political decisions taken in error or under the pressure of interested parties; the increasing role of security markets is seen as sacrificing enterprise to speculation and strategic concepts of investment to the short-term; where security trading is not put down to speculation it is attributed to the equally dysfunctional behavior of security dealers themselves, swelling transactions to gain commission.

Such positions obviously affect the positions adopted in wider debates on globalization, since the understanding one forms of the global economy is conditioned by the way one views financial change.

None of these positions is false—in fact all of them can be easily documented and illustrated by gruesome episodes of malpractice and inefficiency. The parasitism, the speculation, the abuse of political power—all are facts. Nevertheless, if one interprets the entire range of financial phenomena in these terms, significant developments in the nature and functioning of capitalist economies may be underestimated.

From Tight to Easy Money

Not all these issues will be addressed here, but as a start, it can be pointed out that the era of high interest rates seems to have come to an end, and thus that the changes in financial structures cannot be seen as essentially dependent on exceptional tributes extracted from borrowers. The eighties and to a lesser extent the nineties were characterized by exceptionally intense financial pressures, which in themselves tended to swell the profits of the banks. These developments suggested that financial transformations could be seen as a 'revolt of the lenders'. Indeed, the reactions of wealthholders to the inflation of the seventies was a key moment of the transformation, but, it is becoming clear, not an essential feature of it.

It is more difficult than is sometimes assumed to identify the interests which are advanced by the financialization process. We could distinguish debtors (and other issuers) from creditors (and other investors) and both from intermediaries. The general tendency to identify financial change with financial tensions would make the creditors the big winners; but this view is not easily reconciled with the position of the United States as the world's major debtor. A focus on the most powerful institutions and intermediaries is perhaps more realistic, but globalization has meant that even the largest of

these are subject to new competitive pressures—and it is easy to find casualties among them, such as Deutsche Bank, Crédit Lyonnais, or the Midland Bank, all of which came to grief in their international strategies. It is clear, again, that stock markets are subject to much more competitive pressure in the new financial regime.

In retrospect, there may have been two forces behind the era of very high interest rates. First, a flight of investors toward liquid assets, prompted by the decline in profitability in Western economies to the late seventies and the uncertainties which this induced. Second, and partly in consequence, the turn of macroeconomic policy toward monetary disinflation, which drove up nominal interest rates while bringing down inflation rates, and thus led to a sharp rise in real rates of interest.

This era may now be at an end,[4] so that the surplus of capital which has been latent in the world economy for several decades has now broken into the open. This clearly has implications for employment relations in that the massive rates of return which investors have sought in recent decades are becoming quite clearly impossible. (In fact, it is not only the fall in interest rates which is bringing down rates of return; it seems that the risk premium between bond and equity yields may also be coming under pressure.[5] This would be a consequence of the risk-reducing portfolio diversification made possible by globalization and brought about by the institutional investors.)

A Casino Economy?

A second widely held view of finance today is that it is dominated by 'speculation'. Of course, if speculation is defined in a very wide and loose sense this becomes true almost by definition; capitalism as such involves buying in order to sell but one does not usually interpret all capitalist enterprise as speculative. If one adopts a tighter definition of speculation as the adoption of an open position (long or short) in some asset in the expectation of a favorable movement (up or down) in that asset's price, then it is by no means clear that current financial activities are dominated by speculation. Speculation is always present in financial markets and may even be necessary to their effective functioning but it has not been shown to be the dominant feature of their recent expansion.[6]

Consider first the special case of FX, where the Tobinistas of the social movements deduce from the sheer scale of transactions that only speculation can be taking place. This is a simple error, although one which is at least partly to be explained by the absence of any coherent account of FX markets in the orthodox literature. A glance at the currencies which are traded should be enough to call the speculation hypothesis into question. A handful of currencies—the most stable—account for virtually all the trading in FX

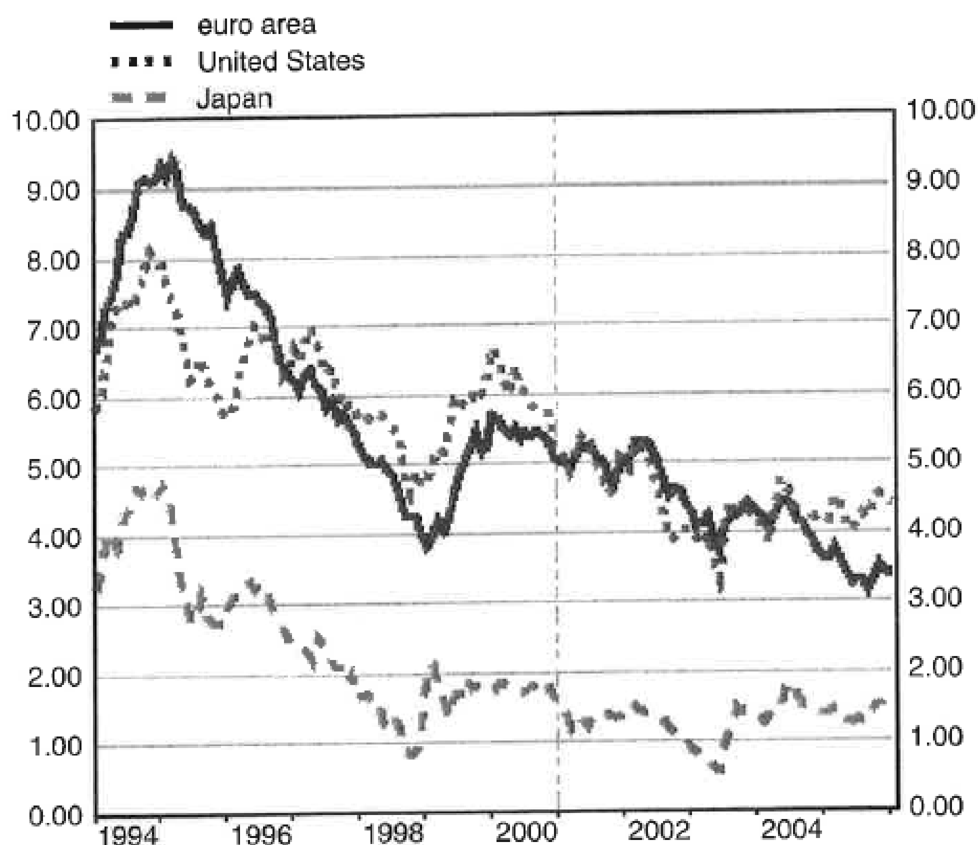


Figure 6.1. Yield on ten-year government bonds.

Source: ECB (European Central Bank) (2006). 'Hedge Funds and Policy Implications; ECB Monthly, January: 63–76

markets, with the exchanges among the three largest, dollar, yen, and euro, making up 48 percent of the total. The currencies of the developing world have, of course, been subjected to massively destabilizing speculation on many occasions. But it is a confusion of two completely different phenomena to believe that the $1.8 trillion FX trades taking place every day have anything to do with third world currencies.[7]

As well as the currencies traded, the character of the traders points in the same direction. A handful of giant banks do most of the dealing among themselves—and they are known not to take open positions in FX. But the most striking evidence comes from the *instruments* used. Transactions are dominated by the FX swap, which, because it combines a spot trade with a forward trade in the opposite direction, is a closed position as far as currency fluctuations are concerned. Today, these swaps account for half the transactions in the FX market.

In fact, most of these transactions are standard banking and money market operations, recycling liquidity from surplus to deficit agents in the normal way. The swap dealers do not even sit on the FX trading floors—because they

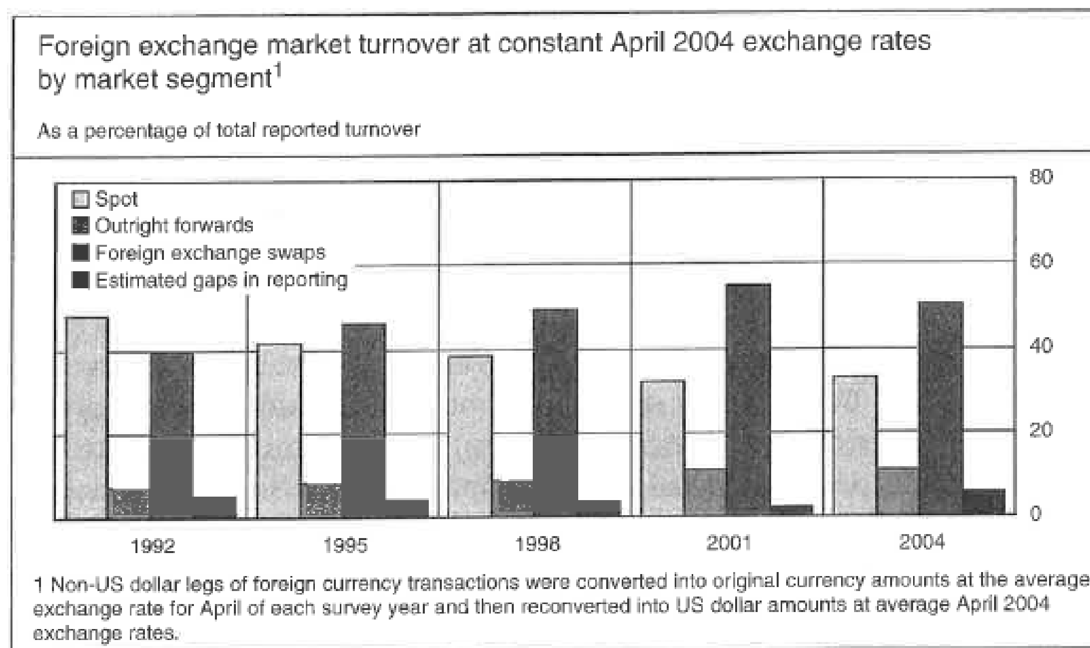


Figure 6.2.

Source: BIS (2005) Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity. www.bis.org.

are not taking open positions the price of currency is of no consequence to them. They sit where they belong—on the money market desk.

The size of the FX market testifies not to speculation but to integration—the very close money market integration of the major economies despite the persistence of separate currencies (for this argument in full, see Grahl and Lysandrou 2003).

Speculation in Securities

The same dubious notion of speculation as dominant prevails in many discussions of the securities markets. Clearly, such a view makes the broad move away from bank-intermediated toward security market-based finance an essentially negative phenomenon. It will be suggested here first, that this notion has little factual basis, second, that it obscures certain systematic features of financial development which are of considerable importance.

As with the FX markets, a simple examination of the structure of security market trading militates against an interpretation in terms of speculation. Markets—trading is concentrated on the oldest and most liquid markets with almost negligible fractions of turnover being found on the newer securities markets of emerging economies. Instruments—trading in bonds, especially those issued by the governments of rich and stable economies, dwarfs trading

in equities. Within equity trading, it is the shares of blue-chip companies, least susceptible to price volatility, which are most traded.[8]

Likewise, with agents. The institutional investors which today predominate over individuals prefer the largest and most liquid security issues.[9] For example, the NASDAQ, massively affected by the dot.com bubble, is dominated by individual traders; the NYSE, much more stable, and much more quick to recover from the collapse of 2000–1, is dominated by institutional investors.

Of course, many bubbles and speculative episodes have been observed on security markets. But these exceptions are not the rule and it is certainly the case that more traditional financial systems, centered on bank credit have been far more exposed to speculation and upheaval than have the emerging, more market-based, systems. If a perspective based on speculation exaggerates some phenomena, it may obscure others. One substantial strength of the security-based financial structure is its capacity for expansion—because these markets are open to investors and issuers from different countries they are well placed to establish financial linkages across national boundaries, whereas classical bank-based systems, relying to a much greater extent on 'inside' investors, may have more difficulty in functioning outside the social environment in which they developed (Grahl 2001). In other words, there are good reasons why global finance should tend to take the form of security trading rather than bank credit.

Critics of the global system often trace crises and instability to liberalization as such. But it is equally plausible to trace them to premature or rushed liberalization and to the confrontation between primitive domestic and highly developed external systems.[10] Once again, as with the notion that financialization is linked to financial tensions, specific or temporary phenomena are being seen as essential to the emerging global system.

Hypertrophy of Finance?

The notion that there is, in some sense, 'too much' finance has a simple basis in everyday experience, in the observation that financial enterprises, financial products and advertising, employment in the financial sector and so on have grown explosively in recent decades. From there, however, it is a large leap to the conclusion that the increased prominence of finance is, in some way, dysfunctional. If more specific charges are laid, then differentiated judgments are required. On the one hand, the landscape of retail finance, in countries such as Britain or the United States, where market-based finance predominates, suggests very strongly that there are very often too many products and too many enterprises. Although the needs of the population for savings products, credit facilities, and payments services are relatively homogeneous; on the supply side there is massive differentiation. This is

particularly the case in Britain where a series of authoritative reports, prepared by insiders, have issued comprehensive condemnation of retail finance for its high charges, opaque products, excessive marketing costs, and general failure to provide value for money.[11] Much of the sector is rather clearly characterized by Chamberlinian competition, centered on marketing rather than price and with the usual consequences—failure to obtain scale economies, excessive advertising and marketing expenditures, spurious product differentiation and so on. In the United States, very similar phenomena are seen but with rather more progress toward the control of these malfunctions by a standardization of products and procedures.

The other frequent claim that the sector is overdeveloped relates to trading on security markets. Here, as indicated above, it is much more difficult to reach a clear conclusion because the forces behind trading are not well understood. There are, however, good reasons to believe that the bulk of routine trading relates to portfolio management by the institutional investors, that it is not speculative in nature but rather heavily concentrated on the most stable and cognizable securities, and that it is not encouraged by 'excess liquidity' in and around the markets because, for the purposes of the big institutions, these markets are far from liquid.

More generally, the notion of hypertrophy has to be measured against the evidence that the expansion of financial activities is a reliable indicator of economic development in general, although the evidence concerning forms of finance and the structure of the financial sector is much more questionable.

Politics and Financial Liberalization

A very correct position, in the general debates on globalization, is that any simple opposition between the role of markets and states is likely to distort understanding of the processes involved. Many studies have analyzed the active policy measures leading to capital market liberalization as well as the reform strategies which inspired them (Helleiner 1994; Loriaux et al. 1997). Equally, the emergence of large integrated financial systems at an international level is dependent on a process of regime construction which has been going on for several decades and which has necessitated very high levels of intergovernmental cooperation and the construction of supranational authorities. The convergence of both institutions and practices in the field of financial supervision is an impressive example of this activism (Lütz 2002).

From this perspective, it is easy to interpret financialization as the latest wave of a neoliberal political strategy, designed to reshape the framework in which markets operate. The danger in such an assessment is that the economic forces behind these processes will be underestimated. Yet, many of the key developments were economic in their origin—for example, the

first emergence of offshore finance, centered in London, arose out of the activities of US multinationals; it was accepted by governments but in no way their design. Similarly, the rise of the institutional investors, which worked to restore the central role of security markets in the financial system was an essentially economic phenomenon.[12] More broadly, the rise of global finance is logically linked to the growth of international trade, international investment and migration, and international technology transfer. Once scale issues are dealt with realistically, by applying the criteria of a security-based financial system rather than those of a bank-based one, the dimensions of the global financial system correspond well to those of the global economy. Of course, in both instances, relations among wealthy economies are much more developed than those with the South, but this is a general characteristic of contemporary economic life, not a consequence of financial relations in particular.

The Crash

One obvious objection to the argument made above is that the dysfunctionality of security-based financial systems is clearly demonstrated by the recent bubble and then collapse in share prices. Often, however, these dramatic episodes draw too much attention away from the more regular working of financial markets in less interesting times.

What lessons are to be drawn from the recent stock market crash and associated scandals?[13] No doubt, a great deal of *Schadenfreude* is well justified but it is not clear that the move toward a security-based financial system will be or should be reversed. Reactions by the authorities, on both sides of the Atlantic, seem inadequate to the problems revealed, both in corporate behavior and in the financial system. There have been strident calls for more 'transparency' but these are not obviously pertinent. The very status of the modern corporation can surely be called into question by malfunctions on the scale revealed. Similarly, the very ability of market agents to make rational assessments of investment proposals can be doubted after the excesses of the Internet boom.

As regards the first of these, the 'Corporate Social Responsibility' so much in fashion today seems to be essentially a cosmetic device designed to stave off the necessary recasting and tightening of regulatory structures to protect customers, employees, small businesses, local communities, the environment and, by no means least, investors from these overmighty subjects.

As regards the formation of expectations within the financial system, what is confirmed is the existence of a public good—the stabilization and crystallization of individual perspectives which public investment permits. Yet, there are at least two reasons to doubt that the transition from an 'inside-investor'

and bank-based financial system to one centered on security-markets will be affected by the crash and its aftermath. First, although the gyrations of the stock market (encouraged by the Federal Reserve Bank) gave rise to the bubble, when it burst the economic damage was limited just by the highly developed system of security markets which moved risks away from the banking system. In less advanced financial systems it is the concentration of risks in the banking system which turns asset market collapses into major economic crises. Second, there is the simple fact that the whole EU economy was dragged into the bubble, and the supposedly more stable and conservative nature of the European business classes offered no immunity. In fact, huge outflows from the EU were attracted by the US bubble which they also helped to sustain. Much of this investment (quite legitimately characterized as speculation) took the form of FDI as EU corporations went on a spending spree in the United States. But the basic aim was the same as for stock market placements—that is to get exposure to United States and high-tech assets. (This outflow was the main reason for euro weakness in the early years of the new currency.)

It is also useful to distinguish the NASDAQ boom and bust, from the much milder developments on the NYSE. The former is much more influenced by individual investors, the latter by the big institutions. This is by no means

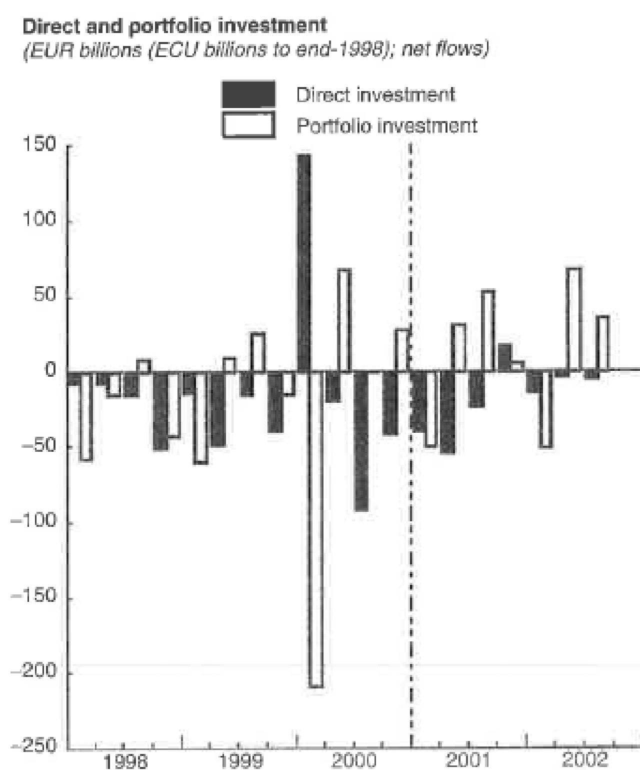


Figure 6.3. Eurozone financial outflows.

Source: ECB (European Central Bank) (2006). 'Hedge Funds and Policy Implications; ECB Monthly, January: 63–76

to exonerate the latter but merely to point out that the bubble in high-tech stocks was in the first instance the consequence of speculation by individual investors.

Consideration of the bubble, however, leads us to a key question. To what extent do the 'Anglo-Saxon' economies, that of the United States in particular, correspond to the necessary features of the security-based financial system? To what extent, in other words, does the financial transformation now taking place in European countries necessarily involve an Americanization of economic life? Clearly, this is a question of some significance from the point of view of employment relations.[14]

The question has tended to receive the same answer from political elites in Europe, whose frenzied imitation of all things American is well represented by the Lisbon agenda as from critical commentators who have often made the same identification of financial change with (undesirable) features of the US system.

The Shareholder Drive

An important issue where market-based finance has tended to be identified with the US practice concerns the role of shareholders. In the United States in the eighties, a drive for shareholder value was launched as means of resolving the conflicts of interest resulting from the separation of ownership and control in the corporate sector.[15] The new salience of the problem was to some extent contingent, in that very tight money and the pursuit of quantitative targets for monetary aggregates favored a further disintermediation of finance; however, the rise of the institutional investors, representing middle class wealth-holders, was working in the same direction. As the problem was formulated at that time, investor interests were mainly impaired by corporations undertaking excessive expansion, at rates of return less than the shareholders could expect to obtain elsewhere.[16]

The shareholder response involved several elements. One was a very positive assessment of the 'market for corporate control' and takeovers, especially hostile ones, which were seen as an important means of disciplining managements. A second feature was the use of new metrics to assess corporate performance. These attached a heavy weight to cash flows as a means of reducing managerial discretion in the presentation of results to shareholders. A third important element was the use of incentive systems intended to align managerial and investor interests—the massive use of stock options for this purpose began at this time. Various other devices attempted to strengthen the hand of dispersed shareholders against that of incumbent managements, including restructurings and disposals intended to refocus the enterprise on core activities and render it more transparent to

investors. It was also often seen as useful to increase a company's indebtedness since this would both leverage shareholder interests and limit managerial discretion.

Now this entire agenda has to be seen as a comprehensive failure in that, although it certainly encouraged brutal corporate restructuring exercises, it failed to prevent managerial predation on a colossal scale so that in the course of a decade, 1992–2002, US CEOs raised their personal stake in corporate America from 2 to 12 percent (Brenner 2003). Michael Jensen, perhaps the most influential advocate of the shareholder agenda, recognized the need for major changes in his position. One key consideration was that the 'discipline' imposed by the stock market fails completely if a company is overvalued—indeed, when this happens, managements are able to find cheap finance for any project at all, no matter how contrary it might be to investor interests. Jensen has also changed his views on managerial incentives; whereas he used to argue that higher rewards were needed he cannot repeat that position today (see Jensen and Murphy 2004).

How then can the continuing tensions between principals (shareholders) and agents (managements) be addressed? The future performance of the US economy may depend on effective social and economic reforms to stabilize savings and restore general confidence in financial mechanisms. The issue will not be pursued here—rather the question of European financial development will be raised.

European Finance

The centrality of the United States to the global financial system arises in the first instance from effects of *scale*. The existence of a continentwide economy with very high incomes led to the initial advantages of market-based finance, because in such a context the ability to raise capital from dispersed investors and allocate it to any part of the economy is of particular value. Subsequently, the process became cumulative as the size and liquidity of dollar markets attracted investors and issuers from around the world.

This genesis of the global financial system clearly gave the United States enormous influence over the standards which governed financial practice. For example, regulatory structures have often followed American patterns, although there is certainly nothing optimal about them. Similarly, US interests have been promoted in international systems, such as the Basle accords on banking stability (see again Lütz 2002).

However, it is important to distinguish those characteristics of the US financial system which are indispensable to its functioning and its contingent features. Among the former are scale, liquidity, and a supportive macroeconomic policy; the latter, on the other hand, include many of the practices, in

both finance and corporate governance, which have been called into question by the bursting of the high-tech bubble and the subsequent scandals.

Now, for very different reasons, both political leaderships and some of their strongest critics have neglected this vital distinction between intrinsic features of the global financial system and contingent practices and structures in the so-called 'Anglo-Saxon' economies. There has often been an empiricist tendency to conflate the two.

The European elites who formulated the Lisbon agenda seem to have been dazzled by the stock market boom which was then in full swing.[17] Their assessment of the productivity performance of the United States, which raises very thorny statistical issues, was close to a moral panic. The response was an attempt to ape the most superficial aspects of the dot.com bubble. In the realm of finance, the main components of Lisbon were the Financial Services Action Plan and the Venture Capital Action Plan (for an assessment, Frangakis 2005). The main objective of these initiatives—to build big, liquid capital markets in Europe on the basis of the euro—was very rational. The expectation, however, that such measures could transform the EU economies within a matter of years was utopian, while the endorsement of every aspect of the US financial model displayed much the same kind of 'irrational exuberance' that gripped stock market investors at that time.[18] As the weaknesses of US finance were dramatically revealed in the following years, the European Commission echoed the American authorities in demanding more transparency but rejected any deeper criticism of US practice.

Some influential critics of official Europe, on the other hand, also seemed to identify market-based finance as such with its US form. The notion of 'varieties of capitalism' emphasizes the mutually supporting nature of institutions and structures within a given model. These institutional complementarities together with path dependence are supposed to immunize given socioeconomic systems against piecemeal change or the introduction of foreign elements incompatible with their overall logic. Such a view may in practice coincide with that of the elites who drew up the Lisbon strategy: financial transformation amounts to the wholesale adoption of the US system in all its concrete details. As a corollary of the same view, preservation of the main characteristics of the 'coordinated market economy' might be seen to depend on the maintenance of its established, bank-based, inside-investor-dominated, financial mechanisms.

As against these excessively holistic approaches, more and more discussion seems to invoke the notion of *hybridity* in economic relations. Of course, the term itself only poses a question—what combinations of 'Anglo-Saxon' and European practice are viable or desirable? To indicate the scope of the question, reference will be made to two questions: corporate governance as it affects takeovers and executive rewards; and the changing strategies of German corporations.

Corporate Governance Issues

The Takeover Directive

Hostile takeovers, 'the market in corporate control', have often been presented as an essential feature of the market-based financial system. The capital markets will tend to mark down both the equity and the debt issued by an unsuccessful company but it was often suggested that the sanction of a higher cost of capital was not in itself sufficient to discipline underperforming or delinquent managements. Takeovers, encouraged by a low-share price, and resulting in the wholesale replacement of corporate leaderships, can be seen as a much more effective mechanism.

The European Commission clearly accepted this somewhat romantic view of shareholder capitalism. It took the view, first, that a uniform takeover code was necessary for the integration of EU security markets—if the conditions under which a company could be taken over were not the same in all member states, then the securities issued by these companies would not be fully comparable. Second, the Commission argued that the uniform code must be completely liberal—no barriers to hostile takeovers, determined by the acquisition of a controlling fraction of the target company's equity, were to be permitted. The Commission asserted that the decision to sell securities concerned only their owners—both an illogical and a cynical judgment in the context of a change in the control of an enterprise which obviously concerns many people. The draft directive on takeovers, however, was rejected by the European Parliament (EP) in a dramatic tied vote. The document subsequently accepted by the EP was a clear dilution of the original proposal and permitted, according to the country, a variety of defences to be used by incumbent managements. The appointed Commission did not hesitate to express its dissatisfaction with the elected Parliament: the compromise Directive was contrary to market principles and therefore unacceptable.

However, the hostile takeover may no longer be a key feature of the security-based financial system. On the one hand, the days when the key shareholder interest was to squeeze cash out of bloated corporations may have gone; the condition for the greenmail attacks of Carl Icahn or T. Boone Pickens was a level of interest rates so high that investors had no problem in placing their funds. Today, the hunger is not for cash but for assets, even if the yield is low. In the United States itself the excesses of the 1980s led to legislation in many states to obstruct hostile takeovers.

On the other hand, relations between corporations and the capital markets have evolved and are becoming more normalized: the liquidity of their equity (the more liquid the lower the required yield) is now a key consideration for the major corporations who are therefore constrained to pay continuous attention to the price of their shares. Under these new circumstances

noncontested takeovers, often influenced by shareholder power, are increasingly frequent and can act to displace failing corporate leaderships. In Germany, for example, the takeover of Mannesmann by Vodaphone in 2000 did not introduce a wave of hostile takeovers in the way some commentators anticipated, but the continuously high level of agreed mergers suggest that a functional equivalent has been found, less at variance with German industrial traditions.[19]

The social costs of the associated restructuring were a key factor in the EP's refusal to endorse the Commission's proposals on takeovers.[20] In France the existence of strong regulations governing mass dismissals has not prevented vigorous growth in the equity market. No doubt, the present legal situation on mergers and takeovers is not ideal: rules are different from country to country and, although incumbent managements are permitted to build obstacles to hostile takeovers, there is no clear indication of when or in whose interests they should exercise this power. But a codification of the existing rules, with a strengthening of the safeguards for employees in cases of restructuring, would be quite compatible with the growth of European security markets and there is no convincing rationale for the extreme position adopted by the Commission.

Managerial Rewards

Similar considerations seem to apply to the incentive structures for senior managers which have developed in the United States. The usual justification for managerial excess has been that it is necessary to align the interests of top management with those of the shareholders, although the predation of CEOs has been on such a scale that this rationale has lost any plausibility it may once have had. Quite apart from this direct cost to investors there are the broader socioeconomic problems which an explosion of high incomes generates throughout the income distribution. The case of Britain, where there are few signs of the dynamism and international competitive success which these rewards are supposed to induce, is particularly egregious.[21]

But once again there is no good reason to take this malfunction as an essential component of a market-based financial system. The same contingency governed the development of the key practices—that is, interest rates so high that the extraction of cash reserves from corporations raised no difficulties in terms of alternative placements. Huge payouts to the top managements concerned might make some sense in that context but through the nineties and into the new century seem increasingly anachronistic.

The lack of countervailing power to the big corporations has meant that the momentum of executive pay inflation is still unchecked but there are some signs that institutional investors, in a changing political climate, are increasingly hostile to this predation.

The forms of control exercised by institutional investors will never replicate those available to 'inside' investors in the socially embedded financial systems of Germany or Japan in the past but increasingly they do not need to do so. Both parties are increasingly focused on the securities markets. The investors, especially the institutions which now dominate among them, want strong enterprise performance primarily to underpin the quality and the tradability of the securities they hold. Managements want good investor relations to support their share price and to maximize the liquidity premium above the price justified by profits alone. This does not mean that top managements are now in harmonious relations with investors but it does indicate that, as the securities markets become more important to both parties, their conflicts are more constrained by market forces. Of course big gyrations in security prices and unstable expectations among investors will negate this proposition, but one should not take exceptional episodes as typical of the functioning of the markets.

What is being suggested is not that market forces will rein in the explosion of corporate incomes, merely that it is not clear that market forces would prevent social and political forces from doing so. Thus, in this case, as with the codes governing takeovers, the EU may have much more scope than it realizes to challenge the norms and practices of the 'Anglo-Saxon' financial system (for an extended argument around this point see Aglietta and Rébérioux 2005).

Corporate Strategies in Germany

The impact of financial change on the strategies of European business is a vast question, and debates are in an early stage. By far the most developed discussion concerns the impact on large German corporations and this is the only case which will be considered here. However, it is obviously a case of central importance, given the strength of these enterprises and their weight in the eurozone economy.

Until the last ten years, Germany was a paradigmatic example of 'inside-investor' and bank-based finance. German companies were closely held and not for sale. There were many cross-holdings among financial and industrial companies; these were stable and worked to cement collaboration among the enterprises concerned. The equity market was much smaller than its counterparts in the United States or Britain. Big enterprises were seen, in 'stakeholder' terms, as coalitions of interest in which codetermination laws supported a strong voice for labor.

How extensive are the changes induced in Germany's 'coordinated' market economy by the emergence of an international financial system centered on the security markets? One tends to get conflicting answers, depending on

whether what is examined is corporate strategy or employment relations. In the first case, the story is one of almost revolutionary reorientation; in the second, more of continuity and stability.

The adoption of shareholder economics by big firms in Germany has been rapid and comprehensive (Streeck and Höpner 2003). A closed system of corporate finance has been opened up to FDI and many companies have actively sought external investors. Legal changes have been introduced to permit the dissolution of cross-holdings among industrial and financial companies. The banks, although they still hold a lot of industrial equity, now tend to see these holdings as portfolios rather than as the support for specific relationships. Profitability metrics, oriented to the equity market, are increasingly deployed within the big firms, both to assess investment projects and to set targets for divisions. A host of other changes, for example, in accounting practices, have been stimulated by the same general shift.[22]

Within the financial sector itself the major banks are pursuing active globalization strategies, and an increasing share of their activities is connected to securities trading. As pointed out above, although the hostile takeover has not been institutionalized in Germany, merger and acquisition activity has grown very rapidly in close correspondence to stock market activity. Longstanding relations between big companies and their suppliers are, if not being dissolved, being placed under considerable pressure. From this point of view the stakeholder enterprises of the past seem to be dead.

A consideration of employment relations, on the other hand, calls this judgment into question. There are certainly unprecedented pressures on the German employment system. Not only have legislative changes reduced the level of social protection, but employers are also seeking to reverse some of the gains, especially on working time, made by the unions in the 1980s and 1990s. The Western employment relations system was never fully established in the Easter *Länder* and smaller companies especially in the East are pulling out of industrywide collective agreements. However, within the large enterprises, employee voice systems and structures of representation are stable (see, e.g. Vitols 2003). They may even be gaining a new importance because the shareholder economy emphasizes the enterprise as against the industry as a locus of decision-making. It certainly does not seem to be the case that *Mitbestimmung* and the high level of employee participation which it promotes are perceived as disqualifying the companies concerned in the securities markets. Indeed, the functional flexibility which depends on these systems is today, as in the past, a source of competitive strength.

Of course, large German enterprises are not the same thing as the German economy. Indeed, the dissociation between the two is certainly widening as the big companies pursue global strategies which many small and medium enterprises cannot imitate. A clear national economic interest then becomes harder to define, for instance because companies with an export orientation

have a very different view of developments than companies dependent on the stagnant home market. It may also be the case that it is the smaller enterprises which are adversely affected by the financial changes under way, as they find it harder or more costly to obtain bank credit. It is probably within the *Mittelstand* that one finds the greatest pressures on employment relations. The larger enterprises on the other hand continue to derive enormous competitive advantages from the excellence of their industrial systems although this no longer has the same meaning for the national economy.

The suggestion here is that it may be an error to regard market-based finance as simply working to dissolve all established and socially embedded economic relations. The capital market's demand for transparency implies that the outcome of negotiations within the enterprise should be disclosed to outside investors and the profitability calculations which are intrinsic to the security-based financial system certainly apply a general test to established relations. However, the continuity and density of localized economic relations, including especially employment relations, are a real factor in the productivity and profitability of enterprises and cannot therefore simply be cast aside by the new financial system.

Conclusion

The general interpretation of 'financialization' in general and 'shareholder value' in particular is probably that they represent the latest wave of a neoliberal strategy which has now dominated European economic policies for more than two decades. This interpretation emphasizes above all the political determinants of economic change. Neoliberalism promotes, in a very selective way, the intensification of market forces in order to achieve specific objectives, such as reversing many of the socioeconomic gains of organized labor. Although an understanding of economic processes is obviously necessary to this view, the key issues are political—how such a strategy is arrived at, how it wins acceptance, how it is implemented.

This interpretation is not wrong. In the present context, for example, the Lisbon agenda of the European Union demonstrates that the rapid transformation of the EU's financial system was a clear choice of Europe's political elite. Their objectives were various but certainly not incompatible with those of neoliberalism and the adulation of the US economy they exhibited was hardly consistent with their professed attachment to the European Social Model.

However, this interpretation, although not wrong, may be incomplete and this is what the present chapter has tried to suggest. Particularly at the international level, we observe a massive growth in the scale and intensity of economic interactions which seems to go well beyond the scope of any of

the political strategies referred to (Grahl 2005). Indeed, although the opening up of markets to external forces is very frequently part of neoliberal strategies, not all aspects of the global economy are welcome to neoliberals since overwhelming pressures are released in a way which tends to undermine the stable and conservative social order which most of them wish to combine with the market economy.

Many developments in the global economy are the result of basically economic forces and this is true of global finance as well. Indeed, when unrealistic notions about the appropriate scale of the financial sector are discarded, then global finance—in today's world inevitably *market* finance, can be seen to be intrinsic to emerging structures of international trade, international production, and international resource flows.

But, just because there are powerful economic forces working to transform financial systems, it is important to distinguish which features of the transformation are necessary and which are more or less contingent. This involves an assessment of finance in the United States where most of the ongoing changes began. The United States holds this pioneering position because the scale of its continental economy worked to promote deep and liquid financial markets. But this does not mean that financial markets in Europe have to replicate every feature of the US system. On the contrary, if the emerging European system builds in effective measures for the social control of corporate behavior and for the stabilization of investor expectations, then it may be able in some ways to outperform its US rival.

This argument applies to European employment relations. It cannot be denied that financial integration and the dissolution of existing financial structures are often a threat to employee interests. But it is suggested that this threat is not inscribed in financial market relations as such. More ambitious European strategies are possible which would combine the construction of an integrated financial system with effective measures for its social control.

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Chapter 11

Financial integration in the EU: Policy issues and proposals

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Financial integration in the EU: Policy issues and proposals☆

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Abstract

The integration of financial markets is at present a central policy objective of the EU. The actual policy priorities of the EU in this context have been to accelerate integration and to reduce transactions costs in financial markets. The present paper starts from the view that the minimisation of transactions costs is too narrow an objective in the sphere of financial policy. It seeks to specify other objectives, which should be pursued in the course of financial integration. These objectives include *stability*, *consumer protection* and the assertion of *the public interest* in the financial sector. The paper then links the process of financial integration with other problems in European policy: taxation and the threat of tax competition, changes in corporate governance and pressures on social protection. It is argued that policies for financial integration should be formulated with these connections to other policy fields in mind.
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1. Introduction

The integration of financial markets is at present a central policy objective of the EU. The nature of the new financial structures, which are emerging, is conditioned by the recent introduction of a single currency and by the wider process of financial globalisation. The actual policy priorities of the EU in this context have been to accelerate integra-

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tion and to reduce transactions costs in financial markets. Such objectives predominate in the EU's financial action plan and in the Lamfalussy Report, which attempted to identify obstacles to the action plan and ways to surmount them (Committee of Wise Men, 2001).

The present paper starts from the view that the minimisation of transactions costs is too narrow an objective in the sphere of financial policy. It seeks to specify other objectives, which should be pursued in the course of financial integration. These objectives include *stability*, *consumer protection* and the assertion of *the public interest* in the financial sector. The paper then links the process of financial integration with other problems in European policy: taxation and the threat of tax competition, changes in corporate governance and pressures on social protection. It is argued that policies for financial integration should be formulated with these connections to other policy fields in mind.

2. Changes in European finance

2.1. Ambiguous developments in the financial sphere

Although there is no doubt that changes are taking place, it may be too early to draw strong conclusions about the pattern of financial change in Europe today. There is certainly some evidence of a move to financial structures and processes which would be closer to the US model than to the traditional practices of the continental European countries (particularly as regards disintermediation), but it is difficult to say how far this shift will go. There are several reasons for this. Some developments are so recent that it is impossible to say whether they represent permanent changes—this is the case, for example, with the recent growth of corporate bond issues, which is dominated by the purchase of new mobile telephone frequencies. Again, it is likely that some practices adopted during the stock market boom of the late 1990s will not survive the downturn in equity prices: even in the US itself, for example, it is likely that business start-ups will depend rather more on bank credit and rather less on early floatation. It is also true that financial developments in different EU countries are somewhat divergent: a rapid move away from traditional bank intermediation in France is not matched in Germany.

2.2. A necessary consolidation

Thus, policy guidelines have to be developed without making very strong or simplistic assumptions about the current pattern of change. However, there can be little doubt that the introduction of the euro, together with continuing pressures in global finance, has promoted a more rapid integration of EU financial systems. In general, a certain consolidation of EU finance seems to be necessary, even though some of the effects of consolidation require to be challenged. This is because, in the absence of such consolidation, external pressures on European systems are likely to be even more intense and the possibilities for autonomous development even more constrained than they are at present. Clearly, one key advantage enjoyed by the financial system of the US is its sheer *scale*, which tends to increase the power and scope of dollar-based financial markets even if these are often inefficient in their

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detailed functioning. A consolidation of European finance could tend to redress the EU's disadvantage in this respect, always on the condition that the consolidation in question does not simply take the form of an uncritical internalisation of US procedures and practices (Grahl, 2001).

2.3. *The public interest*

The view taken here is that, as with many other spheres of policy, what is needed today is consistent promotion of the public interest and of public service, in a context which continues to be characterised by the reinforcement of private interests and the pursuit of private advantage.[1] Although there remains, as has been said, considerable doubt about the direction and the speed of financial change, it is clear that both the financial consequences of monetary union and certain on-going changes in financial structures – such as disintermediation, the increased importance of organised equity markets and the rise of fund-managing enterprises – threaten to compromise important general interests at the same time as they widen the scope for the pursuit of private interests by, in particular, the strongest and wealthiest agents in European economies. The following discussion considers first some important issues within the financial sphere itself, and then goes on to examine some of the broader social and economic issues related to financial developments.

3. Stability

In a world of competitive finance, the stability of financial markets is the responsibility of no private agent. Both in theory and, as the recent upheavals in equity markets have shown, in practice, there are grave dangers to financial stability in some newly emerging financial structures. And it is now clear that such financial instability can have devastating consequences for employment and economic development. Yet, the existing monetary constitution of the EU recognises only price stability as the central objective of ECB policy. There are dangers on both sides from the narrowness of the ECB's mandate: on the one hand, insufficient attention might be paid to signs of growing financial fragility, such as rapid inflation of asset prices; on the other, the ECB might not react with sufficient speed or determination to widespread financial distress and the threat of systemic collapse.[2]

In the longer term, there can be no full solution to this problem without a fundamental reform of the statutes, objectives and practices of the ECB, which would reassert democratic control over the common monetary policy and thus permit a wider conception of general interests to inform monetary policy decisions. (As is well known, the US central bank itself operates with a much wider mandate and under much more effective public scrutiny than the ECB; although this has prevented neither the huge speculative bubble of recent years

[1] It is important in this respect that the notion of the general good has been given more recognition in EU policy. See, in particular, European Commission (2000).

[2] Fayolle (2001) presents clear evidence that the policy so far of the ECB has been pro-cyclical: reducing credit costs in the accelerating stock market boom of 1999 and raising them in the incipient recession of 2001.

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nor its unavoidable collapse, it has at least allowed the US authorities to respond vigorously to the subsequent economic downturn.)

Meanwhile, it is necessary to reinforce the EU's central capacity to confront issues of systemic stability and to undertake active, macro-prudential, measures in response to malfunctions in the increasingly integrated European financial sector. Mechanisms for the collective supervision of financial actors and markets – such as the European Committee on Banking Supervision – should cease to be purely consultative and be accorded actual responsibility for system-wide stabilisation. Clear contingency plans are needed to deal with possible banking crises—both those which might impact on one member country and thus lead to very sharp asymmetries in the effects of common policies, and those which might exceed the intervention capacities of individual countries and threaten an EU-wide process of contagion. In either situation, confusion as to responsibilities for intervention or delay in taking emergency measures could have the most serious consequences.

3.1. Instability in financial markets

The expansion of organised asset markets means that prudential stabilisation policy has today to be concerned not only with possible crises within the banking system, but also to consider the potential impact of a collapse of asset prices. Interactions between banking and asset market crises can run in both directions—a shortage of bank credit can impair the functioning of stock markets, for example, while a collapse in asset prices can provoke a wave of bad debts, undermining the balance sheets of the banks. In this context, the narrow conception of securities market integration which at present informs the Lamfalussy process needs to be widened. The focus of the Lamfalussy agenda is exclusively on the transactions costs faced by those private agents who make use of securities markets. The stability of these markets should become a key concern in the integration process. One way in which this can be done is to take asset market developments into account in the formulation of general monetary policy and the level of interest rates; the possibility of more targeted measures should also be explored—such as an increase in the capital required to support bank loans to asset market operators in the case of an inflation of asset values.

3.2. External dimensions of stability

There is an important external dimension to the issue of stability. At present, the ECB has no real concern with the evolution of global financial relations, even though it represents by far the most important financial system outside the US itself. Similarly, the Lamfalussy Report almost unquestioningly adopts US practices and standards as the models for reform within Europe. However, financial integration may increase Europe's capacity to define and enforce its own objectives in the financial sphere, if these objectives can be embodied in common policies. This applies firstly to international monetary relations—a huge lacuna in the mandate of the ECB. The need for a reform of international financial institutions in order to promote stability has been widely recognised since the East Asian crises. The IMF, which takes primary responsibility for the refinance of governments, has no real purchase on international financial linkages among private agents, which are today a menacing source

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of instability.[3] The BIS has promulgated rules to lower the risk of international banking crises but there are no clear provisions for collective response to a crisis once it has broken out.

The hegemony of US finance makes for major asymmetries—the very scale of the dollar-based system tends to reduce the impact of disturbances which have devastating consequences within smaller or less developed systems. The EU and the ECB ought to be consistent advocates of a more multilateral approach to international financial stability—an approach which would emphasise the costs of disruption to smaller and more vulnerable economies rather than repeating the demand for ever more liberalisation. Institutional reform in this field will, in any case, be slow and difficult. If the ECB is silent, and preoccupied only with internal issues, then reform will be almost impossible.

3.3. Reform of cook committee ratios

The revision of international capital adequacy ratios which is now being prepared within the BIS raises two problems. Essentially, banks are being offered two ways of calculating the capital necessary to protect depositors from the risks which the banks assume. The first method continues the present practice of applying fixed capital ratios to specific exposures, but with the quality of the debtor, rather than simply the debtor's status, being taken into account. This procedure seems relatively acceptable, although it continues the trend towards more and more influence for a handful of private credit-rating agencies. It is becoming necessary to scrutinise the work of these agencies very closely because they are acquiring immense power over the allocation of financial resources.

However, it is the second proposed method of calculating capital requirements that seems more problematic. This would allow the banks themselves to determine the risk of their exposures and thus the capital needed to cover these risks. Supervisors would no longer examine the banks' portfolios directly—it would only be the adequacy of their internal risk-assessment procedures which was subject to external control.

Now it is certainly the case that banking supervisors need to examine the internal control procedures of banks—the recent example of AIB shows that banks may run huge risks of which they are unaware when internal control breaks down. However, if banks themselves are given freedom to assess risks they may tend to reduce the capital they hold to dangerously low levels and thus compromise both microeconomic and systemic stability. Further, it would be the largest banks which are most able to maintain elaborate internal risk-assessment procedures and thus the proposed reform could encourage further concentration in the banking sector. This is highly undesirable, since there is already an alarming tendency towards very high levels of concentration in this sector.

3.4. European standards of practice

More generally, EU authorities can promote financial stability by seeking to define high standards of practice for corporations raising or investing capital on European securities

[3] See Aglietta and Boissieu (1999).

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177 markets. The Lamfalussy Report is correct to suggest that EU decision-making has been
178 confused and inefficient in the field of financial integration. However, the aim of accelerating
179 financial integration must not be allowed to compromise wider objectives such as stability or
180 to reduce the integration process to a mere internalisation of US standards and procedures.
181 In recent years, the US has taken a unilateral position on financial practices: for example,
182 the US has imposed its domestic accounting and reporting procedures on all enterprises
183 seeking access to US stock markets; recent scandals make clear that these procedures may
184 leave a lot to be desired; the growing scale and liquidity of European capital markets make
185 possible a European initiative in this field.

186 4. Consumer protection

187 There is no good reason to reject the Commission's view that, in general, micro-prudential
188 policies and the detailed supervision of individual financial actors can usefully be assigned
189 to the national authorities who are best placed to observe and regulate their activities. But
190 the trend towards increasing competition in retail finance carries certain dangers of a general
191 decline in consumer protection. The British case is illustrative in this respect because it is
192 in Britain that many current financial changes in Europe have gone furthest. One episode of
193 particularly unscrupulous behaviour by British pension funds has led to the ad hoc definition
194 of a new civil offence: the "mis-selling" of financial products.

195 Although detailed regulation of retail finance is best left to national authorities, the EU
196 should promulgate general principles to assure that standards converge upwards towards a
197 high level of consumer protection. The often very wide information asymmetries between
198 powerful financial enterprises and vulnerable households make this a necessary condition
199 for an effective and socially responsible financial system. Clear general principles should
200 cover both lending – making it impossible for enterprises to recover funds advanced to
201 households when it is clear that it was against the interests of the borrowers to assume
202 excessive levels of debt – and saving – placing a responsibility on financial companies
203 not to market savings schemes or investment products when the companies themselves
204 are aware that they are not in the best interests of the customers: the rule in these retail
205 markets should be *caveat vendor*. National authorities should be constrained to adhere to
206 such principles in the operation of their supervisory systems.

207 *4.1. Standardisation of retail financial products*

208 In general, financial globalisation may be increasing competitive pressure on banks
209 and other financial institutions. One way in which they are responding to these pressures
210 is by increasing product differentiation. This can damage consumer interests when the
211 differentiation is more apparent than real, because there is no genuine widening of consumer
212 choice and because high marketing costs and excess capacity prevent price reductions. Credit
213 cards are a very good example of this process; rather than cutting their usual interest rates,
214 card issuers multiply the number of "special offers," "low introductory interest rates," and
215 so on. The result is that the general level of interest rates remains too high that there are too
216 many card issuers and that resource are wasted in huge marketing expenditures.

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More damaging, perhaps, is the existence of intense product differentiation in medium- and long-term retail savings products, which seems to be confirmed in the British case by the recent report (Sandler, 2002). The effects are the same: to sustain excess capacity, to increase marketing costs, to push up prices.

Regulators can protect consumers in this kind of situation by imposing a certain standardisation of retail financial products. The aim should be to reinforce genuine price competition and to limit the "Chamberlinian" competition where spurious differentiation confuses consumers and wastes resources. The prevailing approach to retail financial regulation until recently has been to permit this unlimited product differentiation and to control only the sales process itself. It seems that consumers will pay excessive prices unless there is a certain regulation of the products themselves.

4.2. Distance provision of financial services

The internet is beginning to have an important impact on retail finance and may lead in coming years to much larger cross-frontier provision of financial services. Current EU policy, with the notion of *e*-Europe, is to accelerate such developments. However, it is also necessary to anticipate the problems that may emerge in the field of consumer protection with widespread distance selling of insurance, credit and savings products. To the extent that such cross-frontier activity does emerge, there will be new regulatory problems which essentially national authorities will be ill equipped to handle. It is difficult to say whether the appropriate response would be reinforced co-operation or the creation of some more centralised structure. But it is important to address these potential problems today and to make it clear that the new technologies will not be permitted to undermine levels of consumer protection. In fact, if a strong policy in this field is adopted, it would tend to build consumer confidence in new forms of financial service.

4.3. External trade in financial services

Here again there is a significant external dimension to European policy. The liberalisation of trade in services is high on the agenda of the WTO, and in the financial sphere as elsewhere, such liberalisation can threaten important general interests in patterns of public provision. The EU is the best placed trading bloc to resist the introduction of liberalisation rules which compromise consumer protection and to ensure that financial companies entering the European market are constrained to observe the highest possible standards. This approach would in the long run reinforce European competitiveness in the sector and attract customers for European financial services.

5. Mutuality

The rapid integration of, and the increasing role of market forces within European financial systems have placed increasing pressures on many institutions – such as German *Sparkassen* and British building societies – which have in the past combined financial services to individuals with important public service functions. These include, for example,

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the provision of savings and credit facilities to households which might otherwise have faced financial exclusion;[4] support for undertakings with a positive impact on the quality of life within local communities; certain redistributive functions or types of collective insurance which go beyond what would be achieved by individuals on competitive financial markets.

These are important public service functions and must not be compromised by the process of European financial consolidation, or by the competition rules which govern this consolidation. A network of branches providing financial or banking services, for example, gives rise to important public goods. Banks or other financial companies, which consult only their shareholders interests, are likely to close branches in localities with an insufficient number of high-income households and this is exactly what has happened in Britain.

5.1. Demutualisation in Britain

In Britain, 8 of the 10 largest (mutual) building societies in 1994 were demutualised and floated on the stock exchange by 2001, in a move which deprived the sector of some two-thirds of its assets. The motive was to realise immediate cash gains by the issue of equity. Long-term impacts on standards of customer service have been uniformly adverse to the extent that the demutualised mortgage providers have in fact lost market share.[5] At the same time, demutualisation has resulted in a lower commitment to local communities, and has impaired the systematic efforts of the mutual sector to reduce financial exclusion. The present British government is now attempting to address financial exclusion in a process of negotiation with the big commercial banks, but these efforts have made little progress and the previous weakening of the mutual sector has made the task much more difficult. In fact, the publicly owned Post Office, although it is currently subject to a privatisation policy, offers the most convincing opportunities for effective measures against exclusion.

5.2. The German case

In the case of the German Landesbanken and Sparkassen, pressures took a somewhat different form since the European Commission played a direct role in the events leading to the reforms of 2001, which placed many new constraints on the activities of this sector. The issue was the ability of publicly financed banks to challenge commercial banks in wholesale markets. According to one study (Smith, 2001), the impact of the reforms "is potentially dramatic for German federalism, the social market economy and Germany's overall economic performance." However, the retail activities of the *Sparkassen* do not seem to have been threatened.

5.3. Defending the public interest

A double response to these problems is needed. Firstly, national and local governments must be entitled to support, or themselves to provide, retail financial services with a significant public service function and must not be prevented from doing so by competition rules

[4] See Kempson and Whyley (1999).
[5] For details, see *The Case for Building Societies*, Building Societies Association, London, 2001.

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which ignore the difference between private and social advantage. A regime, which permits and even encourages such intervention, would have the additional benefit of compelling profit-seeking financial agents to meet higher standards of consumer service.

Secondly, the profit-making financial actors should be constrained to respect social objectives in their commercial activities, for example, to avoid discrimination against lower income customers. French enterprises, which close production facilities, are required to draw up “social plans” in the interests of their employees. Similar rules should apply, on a Europe-wide basis, to the withdrawal of financial services from communities with inadequate alternative provision.

Once again, it is important that the EU does not concede, in the context of international commercial negotiations, the ability of national and local governments to promote the role of non-profit and public service agents in the financial sector.

In fact, the EU does recognise, both in fundamental texts, such as the Treaty of Amsterdam and in the Directives, which install competition regimes for public services, social constraints on the behaviour of service providers. At EU level, a minimum set of services can be defined as “universal,” that is, as being available at low cost to everybody regardless of location, and member states are free to enhance this definition for their own countries. In addition, social constraints may be introduced at national level by specifying tasks to be carried out by service providers, be they private or public enterprises. However, these limitations to profit-seeking, competitive behaviour in service markets have so far been introduced on an ad hoc basis, sector by sector, and this in itself tends to narrow their impact on market processes. There exists no general specification of social responsibility either in finance or in production and this works to minimise the social content of the new financial structures as a whole: specific questions, such as financial exclusion, may be addressed, but there is no attempt to grapple with the overall social consequences of the transformations which are under way. A more holistic approach, which would anticipate the general impact of financial integration and of such related phenomena as financial disintermediation (the switch from bank-based to market-based security finance) on European societies and economies and then attempt to steer the whole process in socially desirable directions, is highly desirable but, at present, beyond the horizons of EU leaderships.

6. The taxation of financial assets and activities

Commission spokespersons insist that their strategies for financial integration will lead to a more efficient allocation of capital within the EU. It is argued in Grahl et al. (2002, Chapter 2) that this claim is inconsistent with wide divergences in the taxation of capital and capital revenues. There is certainly a view, among the corporations and wealthy individuals who stand to gain, that this problem is best resolved by tax competition, in a process which would induce member governments to lower profits tax, for instance, in a scramble to attract inward investment. Such a process can already be seen in the general lowering of corporation tax rates across the EU.[6] Some of the most significant reductions in corporate

[6] For a full analysis of tax competition, see Schratzenstaller (2001).

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taxation have taken place in Germany, and this is particularly worrying because of the scale and importance of the German economy.

This kind of process is a negative-sum game, which can only have immense costs in terms of social inequality and the gradual erosion of social expenditures. Thus, financial consolidation strategies must be complemented by a process of fiscal convergence concerning, above all, the taxation of corporate profits. Commission and Council strategies do not represent an adequate approach to this problem; the Commission does indeed envisage a harmonisation of the corporate tax structures, but not of tax rates, such strategies must be interrogated with the greatest diligence as to their implications for the distribution of income and for the development of European social models.

The taxation of individual incomes from financial assets is a less urgent issue in general, but it is still necessary, at the very least, for the EU to confront the long-standing question of off-shore placements and tax havens—many of the latter being under European flags, especially the Union Jack. Recent evidence has emerged of tax avoidance on an astonishing scale by the wealthiest individuals resident in Great Britain.[7] The key element in these avoidance strategies is the use of off-shore tax havens. Companies are making use of the same avoidance strategies: "Rupert Murdoch's media empire has hardly paid any taxes in the UK since 1988 . . . Nearly a quarter of the US top 500 companies paid no tax in 1998 . . . The use of off-shore tax havens by global corporations is depriving developing countries of some US$ 50bn of revenues each year."[8] If this problem is not dealt with, member states will be faced with a gradual erosion of their fiscal capacity and of their ability to influence the distribution of income.

Once again there are significant implications for external policy. The Bush administration recently rejected the OECD plan for the reporting of off-shore financial revenues. The US government, no doubt responding to pressure from some of its most powerful supporters, rejected the notion of a "world tax policeman." The EU has more possibilities to challenge this line of US policy, and to insist on a multilateral approach to global economic issues, than any other actor on the world stage. It can only negotiate effectively if it stands ready to imitate the US and impose unilateral measures on an extraterritorial basis in the event of multilateral agreement not being reached.

It is difficult to exaggerate the importance of an intra-regional and inter-regional initiative to restore the ability to tax capital and wealth. If this issue does not become a key priority for the European Union then the rest of its integration strategies will lack both social content and political legitimacy.

7. Financial integration and corporate governance

A further significant implication of current financial developments concerns the nature of the European enterprise, in particular of the larger corporations which make most use of security markets. The new salience of shareholder interests calls into question the diverse arrangements which have developed in member states to give some role to other interests in

[7] Nick Davies, "How the Richest Man in Britain Avoids Tax," *Guardian*, 11-04-2002-04-12.

[8] Sikka et al. (2002) provide a dramatic account of tax avoidance in Britain.

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369 the formation of corporate strategy: the interests of workers, customers, suppliers and the
370 local community. Current financial developments, encouraged by Commission integration
371 strategies, threaten both to multiply inequalities in economic life and to deprive relatively
372 weak groups of the limited ability which they sometimes possessed in the past to influence
373 corporate decision-making. The German *Mitbestimmung* model, imitated by several other
374 member countries, may be a case in point. These institutions are not about to collapse, but
375 shareholder interests are increasingly dominant within them.[9]

376 One clear example of the impact of the shareholder movement on European social mod-
377 els concerns job security. Shareholder value doctrines emphasise risk avoidance through
378 *portfolio diversification* rather than through diversification at enterprise level; companies
379 come under pressure to divest "non-central" branches and to focus on the most profitable
380 activities. There may also be pressure to increase financial gearing by taking on debt. The
381 logical consequence of such strategies is to increase the risks facing individual enterprises
382 and therefore to reduce the job security of employees.[10]

383 Another clear danger from these shareholder pressures is a tendency to increase inequal-
384 ities within the enterprise. In an attempt to align company managements more closely with
385 shareholder interests very high rewards, linked to profits and share prices, are offered to
386 higher management and other key groups while less powerful categories of worker are
387 driven closer to the reservation wages which are available on external markets.[11]

388 Trade unions and other social movements within and across the EU need a stronger
389 legal framework in which to address such developments. The long-delayed introduction
390 of a European company status seems to represent a purely permissive compromise to the
391 disputes which have been seen in this area. It does not involve any social constraints on
392 corporate governance; several European directives in the field of employment law help
393 to establish certain minimum standards in corporate practice, but employment directives
394 are not a substitute for clear legal constraints on corporate practice which should be built
395 into company law itself. Throughout the implementation of the Lamfalussy agenda, every
396 opportunity should be taken to assert the values of the European social models within the
397 new structure of regulations.

398 *7.1. The market in corporate control*

399 The refusal of the European Parliament to accept the Takeover Directive has a positive
400 aspect in this respect. The Commission's drive for an ultra-liberal regime for mergers and

[9] Consider, for example, the assessment in Jacobi et al. (1998, pp. 190–238): "There is little prospect that the post-war German industrial relations system will simply collapse or disintegrate, but its foundations are in some respects being eroded. The system seems to be undergoing a gradual but cumulative change of character; in the new century, it is likely to be more decentralised, more fragmented, less legalised, less cohesive, and more internally differentiated. The virtuous circle of stable industrial relations institutions and economic success is no longer the obvious starting point for students of the German model."

[10] For an account of the impact of the shareholder value drive on British employees, see Froud et al. (2000).

[11] A study by Glyn (in press) shows that wage inequality has grown fastest in countries where financial liberalisation has gone furthest, such as Britain, the US and New Zealand. Contrary to a widespread misperception, these increased wage inequalities have not been compensated by reduced inequalities as regards employment opportunities. If anything, the two types of inequality tend to be cumulative and mutually reinforcing.

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401 acquisitions was inconsistent with European conceptions of the employee's role within the
402 enterprise. The Commission asserted, in defence of the draft Directive, that "the disposal
403 of securities affects only the holders of these securities." This position is as cynical as it is
404 illogical. The declared intention of "protecting minority shareholders" referred, in practice,
405 to the shareholders of target enterprises, who constitute the only group which invariably
406 gains from acquisitions. Since what is being ceded in a takeover is control over the enterprise,
407 all the stakeholders must be concerned employees, related enterprises, the local community,
408 and so on. However, the current stalemate is not particularly desirable in that it accords, by
409 default, a certain veto power to the managements of target enterprises without specifying
410 how that power is to be used or in whose interests.

411 What is needed is no less than a European Restructuring Code, which specifies clear
412 constraints on all mergers and takeovers. These should include a comprehensive audit of
413 the impact of the proposed restructuring on key stakeholders, the duty to inform and con-
414 sult with interested parties and minimum measures to compensate affected employees and
415 communities. It might be objected that such constraints would inhibit necessary restruc-
416 turing but in fact the evidence that merger and acquisition activity generates big economic
417 advantages is very flimsy. If institutional shareholders were to focus less on such operations
418 and more on the long-term health of their enterprises in consequence of such measures then
419 this would be all to the good.

420 8. Challenges to social protection

421 Across the whole range of social protection and social services, but in particular as
422 regards retirement pensions, a shift towards private provision is taking place. Although offi-
423 cial accounts of this shift do not recognise the fact, there can be little doubt that it is closely
424 connected to the ambition to develop the role of equity markets and of the institutional
425 investors which are the most prominent participants on these markets. In fact, the discourse
426 which presents capitalisation and individualisation of pension provision as a solution to
427 current difficulties in European pension systems is fundamentally incoherent. Making ade-
428 quate provision for the needs of the generations who will retire over the coming decades is
429 not, in any important sense, a financial problem: it is a problem of *resources*. A shift from
430 public pension systems to dependence on the performance of fund-managing enterprises
431 does nothing to resolve this problem, although it does transfer responsibility for it from
432 society onto individuals who will often be completely incapable of an effective response.

433 A recent study confirms that the privatisation/capitalisation strategies, which are being
434 put forward at present, fail to resolve this key issue of resources.[12] The study posed the
435 question of whether "individuals would, voluntarily, save enough for retirement, when
436 'enough' was defined in terms of life-time consumption smoothing with an exogenous
437 retirement age. The UK and US evidence cast doubt on this. There was also evidence that in
438 countries with significant privatisations, many members of the new funded schemes were,
439 for one reason or another, not contributing and therefore presumably not accumulating
440 pension rights in retirement."

[12] See Disney (2000) for an assessment of the adequacy of market-based pensions in Britain and the US.

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441 The distributional consequences of a retreat from public provision hardly need to be
442 spelled out; in all countries wealth is much more unequally distributed than is income.
443 Pension provision geared to individual wealth accumulation can only increase inequalities.[13]
444 But, even apart from distributional issues, the efficiency of private pension provision
445 is open to question. It is extremely difficult for market-based pension systems to protect
446 individuals against such contingencies as prolonged ill-health or unemployment, whereas
447 public provision can easily do so. (British experience is particularly important in this respect
448 because it is in Britain that pensioners are most important on market-based products.)
449 The values of the European social models, which have from the start been associated
450 with the project of European construction, are inconsistent with the capitalisation and pri-
451 vatisation of pensions and other social protection functions which are now being promoted
452 in many European countries.

453 **9. Socially responsible finance?**

454 A discourse has developed recently which finds certain possibilities of enhanced social
455 control over economic life in the emergence of institutional investors. Two themes tend to
456 appear—the notion of "ethical investment" and the idea that the aggregation of interests
457 within pension funds might permit the beneficiaries of these funds to exercise influence
458 over the conduct and strategies of corporations in which they invest.[14]
459 In abstract terms, such possibilities may exist and it would certainly be valuable to
460 explore very thoroughly the conditions under which they might be realised. However, in
461 terms of current structures and practices within institutional investment, the actual potential
462 for a reassertion of social control by these means is extremely limited. An over-optimistic
463 assessment of these strategies could even be dangerous if it diverted attention from other
464 strategies of control in the fields of taxation, regulation and legislation.
465 The "ethical" investment notion imposes only the loosest and most nebulous constraints
466 on investment and investment products with this label are generally marketed on the basis
467 that they achieve the same rates of return as standard products. While this is the case, such
468 products will reallocate holdings among individual customers of the institutional investors
469 but have no influence on the supply of capital to even the most "unethical" corporations.
470 There are certainly conditions under which the aggregated power of employees' pension
471 funds could be an important lever of social control. The Meidner plan for workers' pension
472 funds to be built up through contributions of their own equity from Swedish enterprises
473 would have represented a real redistribution of economic power if it had been implemented
474 in anything like its original form. But today's institutional investors are operating in a
475 competitive environment, characterised by continuing financial liberalisation, in which they
476 appeal essentially to individuals as consumers of their products. The situational logic of these
477 investors pushes them always to interpret their functions according to purely market criteria,
478 to give priority to portfolio management rather than to seek to influence the enterprises in

[13] The recent pension reform in Germany represents a significant move away from public provision. For a critical account, see Steffens (2000).
[14] For the case of pension funds, see Aglietta (1998) and Blackburn (2002).

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479 which they invest. According to a comprehensive survey of British fund managers, there
480 are strong tendencies to conformism and "herding" in the allocation of funds and existing
481 incentive structures are leading to a "misalignment of the ultimate investors – the millions of
482 consumers and pension fund members – and the agents investing on their behalf."[15] Unless
483 and until there are major changes in the legal framework governing institutional investment,
484 it will be illusory to think that these "ultimate investors" could use such institutions to control
485 or direct the economic environment.

486 ## 10. Conclusion

487 A consolidation of European financial systems is necessary. External pressures have been
488 building up on existing national and local financial mechanisms and a coherent response
489 at European level seems to offer the best possibility of redesigning financial systems so as
490 to secure an increased autonomy from developments in, above all, the US. However, the
491 agenda for financial integration which was ratified at the Stockholm council is profoundly
492 inadequate. It amounts to the uncritical *internalisation* of US procedures and practices,
493 divorced from any social project. The consequence of this strategy can only be to exacerbate
494 the dangerous alienation of European citizens from the institutions of the EU.

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Chapter 12

Capital trading market volume: an overview and some preliminary conclusions

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Capital market trading volume: an overview and some preliminary conclusions

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This paper suggests an explanation for the heavy trading volume observed on the US capital markets, the world's largest. Heterodox economic theory puts much of this volume down to speculation. Mainstream theory tends to support this thesis, either directly or indirectly, by giving space to the idea that trading activity is for the most part exogenous to the functioning of the capital markets. The central hypothesis of this paper is that the trading volumes observed are an endogenous feature of the capital markets, because they are to a great extent determined by the needs of the institutional investors who predominate on these markets. This endogeneity of trading is posited in connection with the emergence of a new 'core–satellite' paradigm in institutional investment, a development that essentially manifests the asset-management industry's transformation from a small industry serving a few wealthy clients to a mass industry serving large sections of the population.

Key words: Capital markets, Trading volume, Institutional investors, Core–satellite paradigm
JEL classifications: G10, G20

1. Introduction

A key characteristic of the ongoing transformations in financial systems is the huge growth of trading volume in the financial markets. Current developments in the US economy, the world's largest, illustrate the point. Money market flows through the US payments systems are enough to circulate annual US GDP in under three days. As these flows are much too great to be put into any meaningful relation with GDP or with current incomes and expenditures, the only possible explanation is that they are needed to support trading volume in the securities markets. There is abundant direct evidence that growth in these volumes has been phenomenal. Daily trading in US treasury bonds is now close to $500 billion, enough to turn over the entire outstanding stock of US Treasuries in under ten days. On the US equity markets, the growth in trading has outstripped the strong growth of

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capitalisation so that average turnover rates (trading volumes divided by capitalisations) are now close to 100%.

These developments pose a problem of interpretation for contemporary political economy: while the growth in short-term money market activity can be readily explained in connection with the massive and continuous turnover of debt and equity instruments on the securities markets, this latter phenomenon is more intractable. Among heterodox economists, the prevalent view is that the turnover on capital markets is essentially a matter of *speculation*.[1] Mainstream analysis of financial developments seems to confirm this view in that some theoretical approaches ('efficient markets' theory or 'microstructural' analysis of security trading) offer no general explanation of the volume of trading, while the one approach which does so ('behavioural finance') offers a psychological account of trading activity which largely coincides with the heterodox critique of speculation. But how valid is this critique? At its core is the same logic which leads popular opinion to construe the volume on the foreign exchange markets as 'excessive':[2] any trading of financial instruments that is not related in some way to the more fundamental activities of commerce, production or investment must *ipso facto* be speculative.[3] Now in the case of the FX markets, this logic was found to be flawed. Although the sheer scale of daily FX turnover causes it to appear excessive, it becomes clear when FX trades are broken down by instrument and counter-party that speculation can only play a relatively minor role. On the contrary, as the present writers have shown in a recent paper,[4] the dominance of FX swap transactions suggests that much of the turnover on the foreign exchange markets is driven by money market objectives and is completely unrelated to speculation on exchange rates.

The picture as regards the capital markets is bound to be more complicated, because one cannot, as in the case of the FX markets, identify specific instruments with specific trading motives. Thus any attempt at explaining capital market volume must inevitably contain a strong element of conjecture. Nevertheless, enough information can be extracted from empirical observations of the equity and bond markets to adjudicate between alternative suggested explanations for trading volume and to judge which are plausible. The speculation thesis does not fall into this category. Trading activity is in fact concentrated on a small number of markets and a small number of securities and is carried out by a relatively small group of agents: none of these regularities can be easily reconciled with a simple view of security trading as driven by speculation.

This paper seeks to lay down the basis for further exploration and detailed explanation of this issue. It has five main sections. Section 2 provides data for trading volumes in the US capital markets and highlights certain trends in these data. Section 3 gives a brief overview of what can be called 'market' perspectives on securities' trading volume. Sections 4 and 5 provide an outline of what may be termed 'institutional' perspectives on trading volume. Section 6 provides some policy-relevant considerations. Section 7 concludes.

[1] See, for example, Baker (2000), Davidson (2002) and Pollin *et al.* (2002).

[2] It is interesting to note how many papers on capital market trading volume set the scene with observations on the 'excessive' or 'bloated' nature of FX daily turnover. Dow and Gorton (1997), Odean (1999) and Glaser and Weber (2003) are a few examples.

[3] The following statement by Davidson (2002) exemplifies this logic: 'For the most part financial market activity is speculative and independent of both real investment activity and the rate at which new securities are being floated since the latter is very small relative to the total number of transactions and the outstanding stock of existing securities' (p. 107).

[4] Grahl and Lysandrou (2003).

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2. US capital market volume

We shall focus on US security markets, because these easily dominate world capital markets as regards both equities[1] and debt securities.[2]

2.1 US bond markets

Table 1 shows that there has been rapid growth in daily trading volumes of US Treasuries and near substitutes such as municipal or Federal agency debt. Trading turnover, that is the ratio of trading volume to the outstanding stock of debt securities, has been more stable, although there was a rapid increase in turnover for US Treasuries at the beginning of the new century.[3] Trading in corporate bonds is much less intense, although here also there has been recent growth, focused on the most liquid issues of the largest issuers. In all classes of bonds, trading is concentrated on specific issues—for each maturity, the most recently issued 'on the run' instruments are by far the most heavily traded. Finally, this is an institutional market; virtually all trading involves either institutional investors or specialist bond dealers with no significant participation by individuals.

2.2 US equity markets

In equity markets, we observe analogous patterns in trading activity. Table 2 shows that NASDAQ volume is much more volatile than that of the NYSE: NASDAQ attracted a large number of individual investors during the dot.com bubble, but trading volume has since fallen off sharply while the NYSE saw a much smaller decline in volume and, in terms of turnover, has already regained its previous level.[4] Although the share of block trading has recently declined,[5] the institutions in fact account for a rising share of total volume (according to some commentators as much as 80%) because they use many other

Table 1. *Average daily trading volume in US debt securities ($billions)*

	US Treasury	Federal Agency mortgage backed	Federal Agency	Municipal	Corporate
1992	95.7	17.0	6.1		
1994	116.1	30.4	16.0		
1996	117.3	38.1	31.1		
1998	226.6	70.9	47.6		
2000	206.6	69.4	72.8	8.2	9.3
2002	366.4	154.5	81.8	11.3	17.8
2004	497.9	207.4	77.5	16.9	21.2

Source: Bond Association.

[1] Market capitalisation on the NYSE in 2003 was $11,329 billion and annual trading $9,691 billion; the next largest equity market was Tokyo with $2,953 billion capitalisation and $2,109 billion annual trading.

[2] In 2004, US debt securities outstanding amounted to $18,647 billion, 44.7% of the world total. Bond trading in the US is primarily over-the-counter, unlike in Europe, for example, where it is exchange based. However, the domination of US bond volume over that in other markets can be seen when setting the €26 billion average daily turnover for all European public sector bonds (Federation of European Stock Exchanges, March 2005) against the $498 billion figure for US treasury bonds, or when setting the €7.8 billion average daily turnover for all European corporate bonds against the $21.2 billion for US corporate bonds.

[3] From an average of 6% in 2000, the daily turnover ratio for US Treasuries rose to 12% in 2004.

[4] The turnover ratio dipped to 90% in 2001, but has been close to 100% since then.

[5] Block transactions (10,000+ shares) accounted for 37% of reported volume on the NYSE in 2003, down from the 55% average figure for the 1990s.

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Table 2. *Average daily trading on NYSE and NASDAQ ($millions)*

	NYSE	NASDAQ
1994	9,740	5,751
1995	12,234	9,517
1996	15,999	12,999
1997	22,836	17,714
1998	29,040	22,851
1999	35,497	43,484
2000	43,889	80,934
2001	42,296	44,090
2002	40,917	28,458
2003	38,462	26,810
2004	50,348	34,188

Source: *NYSE Factbook*.

techniques to execute their trades, notably 'slicing and dicing' large orders and feeding them into the market piecemeal.[1] Finally, Table 3 shows that it is high-cap stocks that are most actively traded—the liquidity and relative stability of these issues make them easier to trade, while issues by newer and smaller corporations have much lower turnovers.

We can summarise recent trading patterns in the US capital markets in the following way:

(i) There is a trend increase in trading across all security types, but equities are much less traded than debt securities and, among the latter, private issues much less than public ones.
(ii) The institutions dominate in all markets, although less in equity than in bond markets and less on the NASDAQ than on the NYSE.
(iii) Trading is focused on the largest, most standardised and least volatile securities, whether these be recent Treasury issues in debt markets or large-cap stocks in the equity markets.

3. 'Market' perspectives on trading volume

The question of the scale of capital market trading can be viewed from two alternative positions: a market-based perspective which focuses on the interrelated activities of all participants in the financial markets, and an institution-based one, which concentrates attention on the activities of the large investors. The market approach divides into three distinct strands, one emphasising the 'efficiency' of financial markets—'the Efficient Markets Hypothesis (EMH)—and the other two emphasising possible sources of 'in-efficiency', the difference here being that 'microstructure' theory (MS) traces inefficiency to the presence of various objective barriers to the frictionless execution of trades, whereas 'behavioural finance' theory (BF) interprets inefficiency in the 'subjective' sense of the

[1] See Stoll (2003, p. 6), Madhaven (2002, p. 30) and Schwartz and Wolf (2003, p. 8).

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Table 3. *Distribution of volume in most active stocks on NYSE (%)*

	Most active 50 issues	Most active 100 issues	Most active 250 issues
1985	24	37	62
1990	24	38	61
1995	23	34	54
2000	29	42	62
2003	31	43	63

Source: *NYSE Factbook*.

influence of psychological factors and limits to rationality. All three market approaches have problems explaining scale.

3.1 Efficient Markets Hypothesis

The problems facing the EMH are very clear. Although the EMH *presupposes* trading in that security markets are taken to be liquid and competitive, it finds it difficult to *explain* trading because it tends to suggest that a 'buy-and-hold' strategy would be optimal for the representative agent.[1] From the assumptions that the representative investor is rational (investors may make mistakes, but these will be unbiased) and that security prices reflect all available information, it follows that situations of informational asymmetries (where some investors have private information) do not provide a sufficient basis for security trading.[2] If one seeks a motive for security trading, it has to be sought in the *heterogeneity of endowments* (agents have an exogenous need to trade because of shocks to their wealth or liquidity) or in the *heterogeneity of preferences* (agents have differing attitudes to risk).[3] The introduction of 'noise' traders (whose motives for trading are not information related) may help EMH theory to explain the occurrence of security trading as such, but not the scale of trading: it is hardly feasible to attribute the huge trading volumes to changes in the personal circumstances of investors. As De Bondt and Thaler (1995) put it, the high trade volume observed in financial markets is 'perhaps the single most embarrassing fact to the standard finance paradigm.'(p. 392)

3.2 Microstructure theory

The MS approach to securities markets is not appreciably more successful in explaining trading volume. MS removes one of the key idealisations of the EMH in that it is no longer assumed that trading is frictionless; transactions costs are present, their nature and scale depending upon the specific trading structure of the market concerned. This makes the role of dealers (market-makers) in facilitating security transactions very important.[4] Like the EMH, the MS approach cannot postulate trade on the basis of informational

[1] Indeed, it has been argued by Grossman and Stiglitz (1980) that a completely efficient market might be an impossible object, because it leaves no incentive for any agent to uncover the information which is assumed to be costlessly disseminated.

[2] See Milgrom and Stokey (1982) for an early statement of the 'no-trade' theorem.

[3] See Grossman and Stiglitz (1980), Milgrom and Stokey (1982), Kyle (1985) or Black (1986). See Brunnermeier (2001) for an overview of attempts to circumvent the no-trade theorem. For a more recent summary, see Cochrane (2005).

[4] See O'Hara (1995), Madhaven (2000) or Stoll (2003) for a general overview of the microstructure approach.

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differences alone: no trade would be possible if we simply had a confrontation between informed traders and uninformed dealers, as the latter would never be prepared to trade. It must again be assumed that there are market participants who have non-information-related motives for trading; it is in balancing the trading needs of informed and uninformed investors that dealers are able to obtain positive returns. To this extent, some trading is endogenous to the MS approach, even though it must presuppose exogenous trading; in contrast to EMH theory, volume here has informational value as dealers try to distinguish informed from uninformed orders to trade and to facilitate price discovery by initiating trades themselves. However, it is doubtful that one can use this price discovery story to explain the current scale of equity trading; there appears to be much more trading than can be accounted for by dealer-initiated volumes, even when these are added to those arising from endowment or taste shocks.[1] Note also that the MS approach runs counter to the known pattern of equity trading, since it is large-cap stocks, that is, those for which information problems are minimal, on which transactions are concentrated.

In public debt markets, the problem of private information is less central because the relevant information is essentially macroeconomic and public. Here, MS theorists tend to emphasise a different problem for market-makers—that of balancing their security inventories in the presence of unpredictable order flows.[2] Once again, dealers will initiate trades, this time to reduce the exposures resulting from unbalanced holdings. However, the same two limitations can be found as in the equity market: on the one hand, a certain volume of unexplained trading has to be presupposed; on the other, the approach does not accord well with what is known about the pattern of fixed-income trading, where transactions are concentrated on Treasuries and near-substitutes which have the highest degree of transparency and where the share accounted for by inter-dealer transactions has been falling continuously with improvements in communications and market organisation.[3]

3.3 Behavioural finance theory

As opposed to MS's focus on the objective limitations of the EMH, its idealisation of the *market*, behavioural finance addresses its subjective failings, its idealisation of the typical *investor*. Isolated and individual departures from full rationality hardly pose a problem for the EMH; it can be argued, first, that the losses suffered by consistently irrational investors will lead to their elimination from the market and, second, that the price distortions they introduce will quickly be corrected by arbitrage. Aggregate failures of rationality, however, are a different question. It is one of the key insights of behavioural finance that large and persistent evaluation errors cannot easily be arbitraged away, because there is always the possibility that security prices will diverge even further from 'fundamental' values before a correction takes place. Some of the trading volume in this context can appear to be self-generating, as the exploitation of the opportunities for trade occasioned by price deviations from fundamentals causes further deviations which offer further trading opportunities and so on.[4]

[1] O'Hara (2001) writes: 'For all that we have learned, there remain several puzzling issues concerning the trading process. Foremost is what determines volume' (p. 3).

[2] See Gravelle (2002) for an overview of how the microstructures of equity and bond markets differ.

[3] Dealers accounted for approximately 50% of daily trades in US Treasuries in 2004, appreciably down from the 65% level which was the average in the 1980's.

[4] See Stiglitz (1989), De Long *et al.* (1989,1990), Shleifer and Summers (1990) and Shleifer (2000) for statements of this position.

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While there is no doubt that BF theory can contribute to our understanding of what causes fluctuations in trading volumes at particular periods, its explanations for the trend growth in trading volume over the longer term invite more scepticism. To see why, we begin by noting that BF theory identifies two kinds of departure from full rationality. There are, first, various kinds of *heuristic decision processes* (the use of rules of thumb and other mental shortcuts to simplify decisions in complex and uncertain environments) which give rise to cognitive illusions such as 'representativeness' (the tendency to make decisions based on stereotypes), 'gambler's fallacy' (the mistaken assumption that a trend will reverse) and 'overconfidence' (individuals overestimate the precision of their private information). There is currently very strong support for the idea that overconfidence can provide a major explanation for excessive trading and thus for trading volume:[1] as Barber and Odean (2001) put it, 'overconfident investors believe more strongly in their own evaluations, and concern themselves less about the beliefs of others. This intensifies differences of opinion. And differences of opinion cause trading' (p. 263). This explanation for trading volume stands close to that put forward in the 'differences of opinion' literature, which posits a strong correlation between trading volume and the degree to which investors differ in their prior beliefs or in the way that they interpret public information.[2] Once again, the highly focused nature of actual trading seems to work against these views as a central explanation of trading volumes; heterogeneity of opinions would presumably make for a greater dispersion of trading across securities carrying different characteristics and yet trading is concentrated on a few types which exhibit many common characteristics.

The same criticism can be applied to a more recent explanation for trading volume that also lies firmly in the heuristics branch of BF theory: the 'trading rule' explanation.[3] Central to this approach is the same assumption that individuals use rules as mental shortcuts to reduce complexity, although the rules in question have a more formal character in that they involve a fixed and clearly specified link between security selection and the publicly observable characteristics of securities (for example, the price/earnings ratio which indicates whether a specific equity is a 'value' or a 'growth' stock). Investors following a particular rule or 'style' rebalance their portfolios in accordance with changes in the characteristics of individual securities. As with the overconfidence and differences in opinion literature, trading volume here is predicated on the heterogeneity of investors, the difference being that heterogeneity pertains not to beliefs as such but to trading rules. But again the observed pattern of trading in the capital markets goes against this explanation. Recall that we are dealing with *daily* trading volume, much of which is concentrated on a few agents and on a few securities: while there has been a proliferation of trading rules among the investor community, and while security characteristics do change over time, the scale of daily volume and its concentrated nature are orders of magnitude above that which

[1] De Bondt and Thaler (1995): 'the key behavioural factor needed to understand the trading puzzle is overconfidence'(p. 393); Shiller (2000): 'Overconfidence, however generated, appears to be a fundamental factor promoting the high volume of trade we observe in speculative markets. Without such overconfidence, one would think that there would be little trading in financial markets' (p. 23); Shefrin (2000): 'There are two main implications of investor overconfidence. The first is that investors take bad bets because they fail to realize that they are at an informational disadvantage. The second is that they trade more frequently than is prudent, which leads to excessive trading volume' (p. 300); Barber and Odean (2001): ' We believe that there is a simple and powerful explanation for high levels of trading on financial markets: overconfidence'(p. 261); Statman *et al.* (2004): 'The proposition that investors are overconfident about their valuation and trading skills can explain high observed trading volume' (p. 1).

[2] See Varian (1989), Harris and Raviv (1993) or Kandel and Pearson (1995).

[3] See Barberis and Shleifer (2003) or Nagel (2004) for statements of this position.

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can be accounted for by the range of trading rule heterogeneity or by the pace of change in security characteristics.

The second kind of departure from full rationality, *prospect theory*, relates to biases stemming from an inability to cope fully with problems of uncertainty. Examples are 'mental accounting', which leads to an inappropriate separation of various decisions, and 'regret aversion', a psychological reaction to realised losses which adds to the financial penalty involved. In certain cases, these 'framing effects' can lead to herding behaviour with implications for trading volumes. Herding of this kind might come closer to the observed patterns of trading on equity markets in that it might tend to focus on 'respected companies'. There may well be, in these behavioural effects, an important contribution to our understanding of fluctuations in trading activity.[1] However, there would be major empirical difficulties in any attempt to account for the *trend* growth of trading volumes in these terms.

To summarise, in the analysis of security markets, all three approaches are valuable, with MS and behavioural finance complementing, at a more concrete level, the powerful but very abstract account offered by the efficient market hypothesis. But none of the three gives a clear explanation of the known facts about security market trading. The difficulties are clearest in the case of EMH, where the paradox of an active market based on a general tendency to buy and hold is well known. But the microstructure and behavioural approaches also have difficulties—they can explain some fraction of transactions only by taking the rest as given; they do not usually match the known pattern of security trades, with its focus on high-cap equities and on-the-run Treasuries; they either have to assume a high degree of heterogeneity among investors, or they fail to specify clearly who are the counterparties to a given type of trade. Above all, however, none of the three approaches is sufficiently *dynamic* to address the strong trend growth in security market trading which is a key empirical characteristic of the phenomenon.

4. 'Institutional' perspectives on trading volume: churning and hedge funds

The past two decades have witnessed strong growth in the role of institutional investors in the US financial markets. The major contributory factors to this growth include the increase in the financial wealth of US households,[2] the increase in the proportion of household wealth held in securities as opposed to bank deposits,[3] and the increase in the proportion of household assets that are externally managed.[4] In quantitative terms, there is no doubt that the rapid increase in US security market turnover can be associated with the rise of institutional investors. Over 50% of equity is now held by the institutions,[5] although, as noted earlier, a much larger share of equity trading can be attributed to them. In the fixed-income markets, moreover, securities are almost exclusively in the hands of the institutions who are also responsible for virtually all of the trading.

[1] See Shleifer (2000) or Brunnermeier (2001) for a discussion of herding behaviour and its impact on trading volume.

[2] The net financial wealth/GDP ratio for households in 2004 was 2.22% compared with 1.99% in 1970.

[3] In 2004, institutional investors held 73% and banks held 27% of all intermediated claims; this compares with a 50:50 ratio in 1980.

[4] In 2004, institutional investors had 42% of all household assets under management as compared with 22% in 1970 and 32% in 1990.

[5] The Conference Board (2002) reported that institutional equity assets as a percentage of total outstanding equity rose from 37.2% in 1980 to 55.8% by year-end 2001.

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In the light of these developments, it may seem surprising that, in the theoretical approaches to trading volume reviewed above, little attention is paid to the distinction between individual and institutional investors. The efficient markets hypothesis refers, in the abstract, to a representative rational investor whose motives and procedures are not affected by the indirect nature of the holdings concerned. Analysts of micro-market structure have to take the scale of trades into account, but they focus on the distinction between informed and uninformed investors rather than on the motives for individual and institutional trades. As for behavioural finance, many of its practitioners seem to assume that the cognitive biases and psychological effects which this approach emphasises are applicable in the same way and to the same extent to both individual investors and the agents employed by institutions.

Some commentators have attempted to link trading volumes to the rise of the institutions by focusing on principal-agent problems that are specific to the delegated fund management process.[1] This choice of the agency theory paradigm as the broad framework for discussions on institutional trading explains why the characteristic feature of these discussions is the notion of security market *churning*; that is, trading by fund managers which is, in one way or another, excessive in relation to the interests of their clients. The churning story can be approached from other perspectives, but agency theory brings an added dimension to the link between institutional trading and trading volume when it makes the claim that turnover is high because contractual problems not only give scope to the propensity for churning (which may be motivated by fund managers' attempts to boost fees, reputation or career prospects) but also may directly encourage churning as a second-best solution to these problems.[2]

Although the phenomena adduced to support the churning notion are certainly real,[3] it is unlikely that it can account for a substantial part of daily trading volume. Churning signifies managerial discretion for trading, and while contractual problems may encourage or give room to such discretion there are today even more powerful counteracting forces at work. Chief among these is the increased use by institutional investors of market benchmarks for setting the terms of investment mandates and assessing fund manager performance.[4] It can be argued that passively managed funds (where discretion over security selection is virtually eliminated) still represent the minority part of all institutionally managed assets in the US, but with the continuing trend towards the tiering and narrowing of mandates, now characterised by tight constraints on allowable deviations from a given market benchmark, the scope for managerial discretion is also reduced for active mandates.[5] If there is a connection between delegated asset management and

[1] See Dow and Gorton (1997) or Dasgupta and Prat (2003).

[2] Dow and Gorton (1997) argue that, because employers of portfolio managers find it difficult to distinguish 'actively doing nothing' (in the sense that managers cannot uncover any mispriced securities) from 'simply doing nothing', and thus do not write contracts that allow a reward for not trading, managers are induced to trade actively so as not to appear incompetent or to be shirking.

[3] Walter (2003) gives a comprehensive overview of the subject.

[4] See Bernstein (2003) for a discussion of the increasing popularity of benchmarking as an element in performance measurement and the implication this has for managerial discretion.

[5] A recent Bank for International Settlements (BIS) (2003) report on institutional asset management states: 'More recently, the dividing line between active and passive mandates has tended to become increasingly blurred. Contractual and regulatory constraints, for example, when used together with limits on tracking error, can eat significantly into the asset manager's room for manoeuvre, potentially converting active funds into quasi-passive funds' (p. 15) Tracking error, defined as the standard deviation of excess returns over a sample period (typically a year), is a measure of the divergence of a portfolio's return from that of a selected benchmark.

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trading volume, it has to be explained in terms of the constraints binding on portfolio managers rather than in terms of voluntary behaviour.

Another explanation for equity trading volume that tends to be advanced in connection with institutional investors emphasises the role of hedge funds. Subject to much lighter regulatory and investment management constraints than are institutionally managed funds, hedge funds have been well positioned to take advantage of the progressive reductions in brokers' commissions and other transaction costs and, moreover, they have had the motive to do so, as many of their strategies involve vast numbers of transactions which aim to make small gains on average.[1] Taken in conjunction with the observation that in recent years (and particularly since the end of the bull market in US stocks in 2000) institutional investors have increased their use of hedge funds to help boost overall returns, these points have induced some commentators to see hedge funds as providing an important clue to the trading volume puzzle. We are sceptical. Despite their recent growth in the US, the proportion of institutional assets assigned to them still remains extremely small.[2] Even allowing for the fact that some hedge funds have extremely high rates of turnover of shares, it is unlikely they account for anything like the 50% of daily trading volume on the New York Stock Exchange as has been suggested; more likely is the maximum figure of 20% quoted in recent testimony to the US Securities and Exchange Commission.[3] A further reason for our scepticism is that it is difficult to reconcile the heavily concentrated structure of equity trading with the sheer diversity of hedge fund investment strategies. These strategies, which include macro, long/short, distressed debt, convertible arbitrage, multi-strategy, market neutral and event driven, presumably involve substantial differences not only in the techniques used but also in the types of securities traded. Since 63% of the daily trading volume on the NYSE in 2003 consisted of trades in just 250 securities, it would seem to follow that hedge funds can only account for a minority, if not insubstantial, proportion of this volume.

When all is said, the hedge fund theory of trading volume can be seen as an example of the market-based perspectives reviewed above. The churning theory is also more to be identified with, than differentiated from, these perspectives. While it makes the case that the increase in delegated asset management provides an important clue to understanding the increase in trading volume, its portrayal of institutional trading as largely dysfunctional places it on a par with those views that ascribe trading volume to various structural inefficiencies or pathological disorders. In our view, the strong correlation between the trend growth in trading volume and the trend growth in delegated investment management, coupled with the apparent inexorability of these trends, point to the likelihood that

[1] The fact that hedge funds avoid stamp duty in the UK has been cited as another reason for their important contribution to trading volume; this argument, however, does not apply to the US as there is no stamp duty here.

[2] *Pensions & Investments* reports a figure of just $38.2 billion for 2004. The total amount of assets managed by US hedge funds at the beginning of 2004 on behalf of all institutions and wealthy individuals was in the region of $820 billion (FT, 23 March 2005), a sum that is roughly equivalent to just 10% of institutional tax exempt assets.

[3] Owing to the lack of transparency of hedge funds, it has been extremely difficult to reach agreement on their precise contribution to trading volume. *The Economist* (February 2005) reports that hedge funds 'can account for more than half the daily volume on the New York Stock Exchange' (p. 60). The Financial Services Authority (April 2005) puts the figure at between a third and a half (p. 13). US sources tend to go for a lower ratio. Thus Black (2004) gives a figure of 25%. Paul Roye (October, 2004), the former Director of Investment Management at the SEC, stated in his testimony to the SEC that ' hedge funds are responsible for up to 20 per cent of equity trading volume' on the NYSE.

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institutional trading practices and heavy daily volume are now symptomatic of the routine operation of an advanced economy. This issue is explored in the next section.

5. 'Institutional' perspectives on trading volume: the 'core–satellite' paradigm and portfolio rebalancing

All the accounts of security markets considered so far have two key elements in common. First, trading is largely *exogenous*; it is inessential to the various theories which are advanced. Second, such explanations of trading as are given stress the *heterogeneity* of investors with respect to the individual security concerned, whether this heterogeneity relates to information or investor requirements. These elements are most clearly seen in the efficient markets approach where trading is basically presupposed: liquid markets in securities must exist in order for investors to hold securities, but typical investor strategies do not involve much trade. But the other theories also display the same two features. Market structure theories can explain some trading (on the part of dealers) but only because they presuppose the rest—the exogenous trading requirements of the other investors. Here, heterogeneity of information as to the expected returns on a specific security motivate the trading strategies of market actors. The behavioural approach, on the other hand, appeals to the heterogeneity of investor motives, for example, the different biases inherent in investor *styles* to account for some trading, while again assuming that exogenous factors (for example, the wealth and liquidity shocks which are assumed to give rise to noise trading) are sufficient to constitute liquid markets. Finally, prevalent accounts of trading by institutional investors, with their emphasis on portfolio churning or on the use of hedge funds, again display the same two elements. Trading may result from heterogeneous assessments, whether objectively or subjectively based, by the various institutions, or it may represent a malfunction on their part, a failure of the institutions as agents to represent the true interests of their principals, and thus a feature which is not intrinsic to the market.

All the above accounts raise a central empirical difficulty in that they correspond neither to the huge *scale* of security trading nor to its skewed *structure* which is heavily concentrated on just those securities where there is least scope for differences in assessment or for idiosyncratic judgements. On the contrary, the data suggest that the bulk of security trading is *endogenous* to the markets in the sense of being an essential activity of the institutions as major participants and is characterised by *homogeneity* in that the exchange of a security rests more often on an equivalent valuation by buyer and seller than on divergence of their opinions. This is not to deny that some trading is clearly based on such divergences and on exogenous forces—but the greater part of security trading cannot be understood in those terms. While all the established accounts of security turnover rule out the possibility that trading volume is largely endogenous, our argument is that it can be given scope and credibility by directing attention to the newly emerging 'core–satellite' paradigm in institutional fund management[1].

The core–satellite paradigm essentially represents the fund management industry's response to the new problems and responsibilities it faces as it makes the transition from a small industry catering to the needs of a few wealthy clients to a mass industry serving the

[1] Because the core–satellite paradigm is relatively recent (although fully established among US and UK institutional investors, it is only now making its appearance in continental Europe (Amenc *et al.*, 2003, p. 19)) discussions of this paradigm are still confined to industry practitioners (see the BIS survey, 2003) and have yet to filter through into the academic literature.

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requirements of broad sections of the population. The basic function of delegated fund management remains the same: unlike banks which provide a maturity transformation giving depositors an asset of guaranteed immediate value, institutional investors provide their customers with long-run positions without such a guarantee but with the basic rationale of exploiting opportunities of size and expertise so that individual clients obtain a better return subject to given levels of risk than would otherwise be possible. However, with the popularisation of fund management, and with the intensification of competition that inevitably accompanies such popularisation, institutional investors have come under far greater pressure to show that the returns on investment management are commensurate with the risks taken and that fees are commensurate with the results delivered. The advantage of a core–satellite approach is that it enables them to cope with these pressures in a disciplined and cost-effective way. In elaborating on this point, and drawing out its implications for trading volume, we look, first, at equity funds, and second, at bond funds.

5.1 Institutional equity funds

One of the most striking developments in the US equity markets over the past two decades is the rise in the proportion of institutional assets that are tied to various market indices.[1] In an important sense, this trend vindicates both the EMH and its offshoot the Capital Asset Pricing Model: the latter because the rise in indexation brings actual investor practice into accordance with the central theory of asset evaluation, which can only be made fully operational through the portfolio diversification that large institutions can achieve; the former because the rise in indexation bears testimony to institutional investors' acceptance of the view that capital markets are sufficiently efficient as to make it difficult for most fund managers to outperform them consistently over the longer term. However, the very process by which institutional investors have sought to give systematic practical application to the insights of theory also creates certain difficulties that impede its full application.[2] To illustrate, we can look at the major domestic equity strategies of the top US money managers as documented in Table 4.

The data in Table 4 confirm the new core–satellite structure in US institutional equity fund management, where the 'core' consists of portfolios benchmarked against a given market index, and the 'satellite' portfolios consist of particular subsets of the market selected either according to a given specialisation strategy (the two most prominent being the 'growth' and 'value' investment strategies)[3] or by simply attempting to identify undervalued securities. As is also clear from the data, the core–satellite structure preserves the passive/active dichotomy but in a way that brings these traditionally opposed investment strategies closer together. Thus in both the core and satellite strategies, we find a continuum stretching from passively managed portfolios that stay very close to their relevant benchmarks to more actively managed portfolios that give some scope for discretion. Figure 1 helps to illustrate the point that it is through the twofold division of individual portfolio managers into 'core' versus 'satellite' and 'passive' versus 'active', that fund management firms can keep tight control over return–risk correlations, on the one hand, and managerial cost and performance correlations, on the other. Core-passive and

[1] *Pensions & Investments* (2004) reports that the amount of indexed institutional tax exempt assets rose from approximately \$400 billion in 1994 to approximately \$1.75 trillion in 2003.

[2] These difficulties seem to be closely related to those identified by Grossman and Stiglitz (1980).

[3] Money managers also further subdivide core and style portfolios into capitalisation boxes (large cap, mid-cap and small cap). For purposes of simplicity, we have abstracted from this subdivision.

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Table 4. *Equity strategies of the top 25 US money managers (sums in $millions)*[a]

	Manager	Strategy							Total
		Core-passive	Enhanced index	Core-active	Value-passive	Value-active	Growth-passive	Growth-active	
1	State Street Global Advisors	206,279	12,111	960	182		1,050	56	220,638
2	Barclays Global Investors	262,592	64,447		13,993	2,691	10,172		353,895
3	Fidelity Investments	16,966	16,356	143,819		27,265		66,974	271,380
4	Northern Trust Global	85,779	3,822	2,322	8,999	2,026	8,174	1,218	112,340
5	Mellon Financial Corporation	60,963	1,985	16,385	1,863	14,605	507	956	97,264
6	TIAA-CREF	7,428	62,059	24,624				11,003	105,114
7	PIMCO		22,174						22,174
8	Vanguard Group	83,351		238	1,975	664	2,418	1,248	89,894
9	Legg Mason		2,643	13,605		23,869		142	40,259
10	Alliance Capital	14,777	2,531	1,838	723	30,228	200	37,650	87,947
11	Capital Research								
12	Prudential Financial	11,905	2,211	2,158		3,296		14,808	34,378
13	Capital Guardian			25,701		1,602		182	27,485
14	Evergreen Investments	6,350	1,375			4,319		1,282	13,326
15	Banc One Investment	3,457		4,194		3,723		4,800	16,174
16	INVESCO	955	2,964	16,948		1,152		5,486	27,505
17	J.P.Morgan Fleming		11,225	7,372		1,111		348	20,056
18	Blackrock		1,837			625		171	2,633
19	Morgan Stanley Investment					1,914		3,627	5,541
20	Dodge&Cox					46,052			46,052
21	Wellington Management		5,887	15,579		1,318		3,182	25,966
22	ING	717	5,173	5,752		619		2,919	15,180
23	Franklin Templeton			9,367		3,954		8,861	22,182
24	T.Rowe Price	3,245		5,230		6,575	1,900	7,125	24,075
25	Principal Global Investors	6,726		3,166		2,068		1,506	13,466
Total		771,490	218,800	299,258	27,735	179,676	24,421	173,544	1,694,924

[a]Sums refer to institutional tax exempt equity assets. The top 25 money managers of the 803 profiled by *Pensions & Investments* in 2004 had approximately $3 trillion of institutional tax exempt assets (equities and bonds) under their management, just over a third of the total of $8.98 trillion

Source: *Pensions&Investments.*

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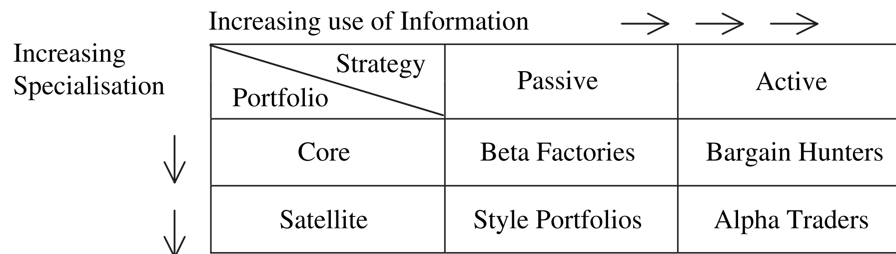

Fig. 1. *The core–satellite approach to asset management.*

style-passive portfolios represent low-risk and low-cost strategies for gaining broad market and sub-market exposures, respectively. Funds placed in portfolios that deviate from their benchmarks represent attempts to attain yields above the average while incurring extra risks and managerial costs. However, the imposition on managers of very precise limits of allowable tracking error manifests the new forensic approach to risk management, as additional levels of risk are closely monitored and precisely measured, unit for unit, against any corresponding additions in yield. Similarly, as regards managerial cost control, the use of benchmarks against which individual performance is measured enables fund management firms to distinguish ordinary beta-factory and style portfolio managers from genuine bargain hunters and alpha creators, thereby enabling cost and performance to be more closely aligned.

It is by following this same twofold categorisation of management strategies as ‘core’ versus ‘satellite’ and ‘passive’ versus ‘active’ that we can begin to see clearly the implications of this approach for the scale and structure of equity trading volume. Trading in connection with the maintenance of satellite portfolios can indeed be characterised by the twin elements of ‘exogeneity’ (trading is not essential but reflects rather the search for alpha) and ‘heterogeneity’ (traders expecting ‘growth’ stocks to outperform ‘value’ stocks sell the latter to, and buy the former from, traders who expect the reverse). But the volume of funds placed in satellite portfolios is much lower than that placed in core-passive portfolios, and these are associated with an entirely different approach to trade. It is not trading so much as the avoidance of trading that is a key objective of these portfolios: apart from the trades required to construct them, and to alter their composition as and when there are changes to the index taken as a benchmark, no further trades are required. Indeed, a key implication of the capitalisation-weighted indices serving as benchmarks is that, in the absence of changes to the index, fully replicated portfolios are essentially self-balancing and thus cheap to manage. The question that arises of course is why, given the cost advantages of a purely passive strategy, are not all core portfolios run in this way? The answer lies in the gap between theory and practice.

In theory, the optimum solution to maximising return for a given level of risk is to maintain a portfolio that duplicates the entire range of equities in the market. In practice, institutional investors find it too complex and too expensive to construct and maintain such a portfolio. They attempt rather to replicate the behaviour of the whole market with a much smaller sample of stocks. The most popular benchmark used for this purpose is the S&P500.[1] However, while replicating a narrow market index such as the S&P500 resolves one set of problems, it gives rise to another. Heavy concentration on placements closely

[1] Assets benchmarked against the S&P 500 totalled $1,431.8 billion in 2004. For a comprehensive overview of US equity index benchmark usage, see Smith and Lert (2004).

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representative of the market tends to lower the yields of the securities selected by such a strategy and thus to create opportunities for the use of research and information to seek some gains either by accepting limited departures from the benchmark index in the search for higher yields or by the use of specialisation strategies.[1] It is clear from Table 4 that even the largest fund managers find it too costly to hold their entire funds in core-passive portfolios and diversify their strategies to seek some informational gain. But where the larger fund managers can exploit their scale economy advantages and hold the bulk of their funds in passive portfolios, the smaller managers have to apply a lighter touch to indexation and concentrate more on bargain hunting. This is confirmed in Table 4 by the strong negative correlation between the volume of the funds under management and the ratio of actively managed funds to the passive component: the larger the fund, the larger the proportion of assets held in more passive portfolios and vice versa.

Trading may not be essential when portfolios fully replicate a market index, but it certainly becomes so as soon as limited departures from an index are accepted. Even for those core-passive strategies that allow for the smallest of deviations from full replication, trading is endogenous to portfolio maintenance. The same applies to a greater extent for enhanced index and core-active strategies. Managers following these strategies hold the principal components of a given index but vary the weights from those in the index to make space for the inclusion in portfolios of close, but cheaper, substitute securities to represent particular sectors. Any deviation of these sample values from the values of the sectors on the whole market requires a rebalancing exercise to replicate the changed market situation. If rebalancing is not undertaken, the fund managers in question are speculating in the sense of hoping for exceptionally favourable outcomes from the particular stocks that are held. It might be argued that, in accepting departures from the index, these managers are already speculating. This is not the case if by speculation we mean the exercise of discretion on the part of investors in an attempt to outperform the market by generating above-average returns. Not only do managers of enhanced index and core-active portfolios have very limited discretion, but such discretion as they do have is aimed at enhancing yield, not by *beating* the market, but by *holding* the market in a reduced cost form. What would amount to speculation in the usual sense of the term would be the failure to rebalance enhanced index and core-active portfolios continually, thereby allowing their reward–risk structures to stray too far from the index which is being tracked.

Given the allocation of a substantial proportion of funds to core portfolios that track indexes with varying degrees of tracking error, and given that these portfolios have to be continually rebalanced to stay within tracking error limits, there is a case for saying that the rebalancing thesis provides a good explanation for the rise in daily trading volume observed on the equity markets. However, what really strengthens the case in favour of this thesis is that it can explain the *homogeneous* nature of much of this volume. To see this, let us go back to the argument that even the slightest deviation of sample values from the values of the sectors on the whole market necessitates a rebalancing exercise. This rebalancing can take one of two forms: trade the existing sample securities for alternative securities whose characteristics more closely represent particular sectors or keep the existing sample securities but again vary the weights of the principal components to compensate for their changed characteristics. The latter strategy is by far the more cost-effective, because smaller cap securities, although cheaper to hold are more costly to trade on account of their relative illiquidity, while the largest cap securities, although more costly to hold are cheaper

[1] See BIS (2003, pp. 19–20).

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to trade on account their superior liquidity.[1] The homogeneity of trading essentially comes down to this fact that it is the *liquidity* of large cap securities that institutional investors value identically. Heterogeneity of interests may form the basis of trades, even while these are characterised by homogeneity, in so far as different sampling strategies are followed; although fully indexed portfolios are identical,[2] less than fully indexed portfolios are obviously different, in that choice is exercised over the nature and degree of variation from full indexation. The important point, however, is that whatever other securities are *held* in enhanced index and core-active portfolios, it is the principal components of the index that are being *traded* in order to control the costs of tracking the index.[3]

The above discussion points to what has to be the major stumbling block standing in the path of all other theories of equity trading volume. These do not explain the scale and structure of this volume, because they do not allow for the endogeneity and homogeneity of trades, and the reason for this is because they all start from the premise that *trading is a key objective of investment strategy*: investors trade because they want to trade, and they want to trade in order to take advantage of some opportunity or other. The rebalancing thesis advanced here turns this logic on its head, in that it argues that a substantial proportion of trades actually form part of an investment strategy that has the *avoidance* of trading as a central objective. To say that investors trade because, in some sense, they do not want to trade may seem illogical, but this paradox is not a reflection of irrational or inconsistent behaviour so much as the result of the collective and entirely rational behaviour of institutional investors. It is logical for them to try to track the market, while driving trading costs towards zero, by holding a given index. However, the practical problems associated with a purely passive, 'no-trade', investment strategy, compel institutional investors to supplement their core strategies to include enhanced index and active portfolios which then entail both continual rebalancing and the continual effort to keep the cost of this rebalancing down. In our view, the heavy concentration of NYSE trades on the most liquid and public of stocks, on those stocks, in other words, which yield the least possible informational advantage, is a clear indicator of the 'endogeneity' of trading, the fact that trading is not itself a strategic aim so much as an unavoidable aspect of a strategy that has an entirely different aim.

5.2 Institutional bond funds

Even more than in the case of equity trading, transactions in the bond market have to be related to institutional behaviour. Data on bond turnover show that levels are very high but relatively stable, since the rapid growth rates of both overall capitalisation and trading have been approximately equal in recent decades. Given that there is no ongoing transition to institutional dominance, as for equities, but rather a complete dominance of the institutions, this pattern corresponds to the general position taken here that security trading is largely an institutional phenomenon. This said, there are important aspects of this trading that can only be properly understood with reference to the fact that the bond portfolios of institutional investors are also increasingly organised in a core–satellite structure. Table 5 confirms this development.

[1] The fact that institutional investors have to trade shares in above-average size blocks also explains why trades tend to be concentrated on those securities which have the deepest markets and where, in consequence, the price impact of trades is lowest.

[2] Assuming that the same index is chosen as the benchmark.

[3] This represents the reverse, upside, effect of the growth in the demand for large cap securities that correlates closely with the rise of indexation strategies; while making large cap stocks more costly to hold, this growth in demand also makes them, by increasing their liquidity, cheaper to trade.

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Table 5. *Bond strategies of the top 25 US money managers (sums in $millions)*[a]

	Manager	Strategy							Total
		Core-passive	Enhanced index	Core-active	Stable value	Market timing	Sector rotation	Other	
1	State Street Global Advisors	41,148	17,013	6,149	10,865			41,148	116,324
2	Barclays Global Investors	53,471	5,300						58,773
3	Fidelity Investments	3,779	7,221	4,078	39,319			5,503	59,900
4	Northern Trust Global	25,295			699		9,073		35,067
5	Mellon Financial Corporation	21,562			10,029		96,698		128,289
6	TIAA-CREF			4,566		380	2,658	18,009	25,613
7	PIMCO		1,019	155,957	11,032			29,763	197,778
8	Vanguard Group	13,675		21,354	24,062			819	59,918
9	Legg Mason		811	66,287	4,284		11,651	8	83,041
10	Alliance Capital	884		1,056	1,505		6,313	12,931	22,689
11	Capital Research								
12	Prudential Financial	4,518	6,844	14,046	8,128			29,189	62,737
13	Capital Guardian			2,685		239		530	3,467
14	Evergreen Investments			17,436				37,138	54,588
15	Banc One Investment			42,685					42,700
16	INVESCO	531		5,502	39,937			6,887	52,873
17	J.P.Morgan Fleming			35,344	6,151				41,512
18	Blackrock		6,799	51,125	14,849		22,093		94,884
19	Morgan Stanley Investment			24,026		1,083		5,749	30,877
20	Dodge&Cox			34,914					34,934
21	Wellington Management			16,872				1,878	18,771
22	ING	361	5,233	3,796	6,997			6,718	23,127
23	Franklin Templeton			6,081				1,312	7,416
24	T.Rowe Price	15	1,630	3,055	10,255				14,979
25	Principal Global Investors			4,648	13,115			1,120	18,908
Total		165,239	51,870	521,662	201,227	1,702	148,486	198,702	1,288,888

[a]Sums refer to institutional tax exempt bond assets.
Source: *Pensions & Investments*.

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As with equity portfolios, US fund management firms are being driven by competitive forces to divide portfolio managers into two distinct groups, a 'core' group of low cost/low risk managers who are charged with matching average market returns by tracking a broad bond index, and a 'satellite' group of higher cost/higher risk managers who are given a little more licence to try and generate above-average returns. In the case of bonds, this means exploiting interest rate predictions as regard changes in their level ('market timing') or structure ('active duration') or in the risk premiums attached to corporate debt instruments ('sector rotation'). As with equities again, satellite portfolios account only for a small fraction of institutional holdings. When core bond portfolios are examined, however, an important difference with equity portfolios emerges: core-passive strategies, those which most closely approach full indexation are less common and core-active strategies, where some attempt to use information is involved, are more so. The key reason why core-passive strategies are relatively less prominent in institutional bond investment is that there are immense practical difficulties surrounding bond indexation.

For a start, there is a vast universe of debt instruments[1] which means that even the broadest of bond indices come nothing like as close as the equity indices in representing the full opportunity set. Further, not only are the components of the major bond indices changed more frequently than those in equity indices (owing to redemptions, new issues and so on), but the indices include many securities that are either not available or available at huge cost, which means that full replication of these indices is practically impossible. In this situation, although indices are widely used as benchmarks, only a few, very large and conservative institutions, actually attempt anything like index replication, typically through stratified sampling. Rather, limited departures from benchmark performance are traded off against attempts to reduce costs and increase yields. Finally, it can be noted that even if full replication of bond indices were possible in practice this may still not be desirable as it would restrict the ability of managers to adjust the risk structures of bond portfolios in accordance with changes in macroeconomic conditions and monetary policy. Since publicly available information is a major determinant of bond prices, it is hardly possible for fund managers to abstain completely from information seeking.

The distinctive features of debt securities help shape the precise form taken by the core–satellite approach in institutional bond management, and they similarly influence the particular pattern of bond transactions. These transactions, for example, are affected by the fact that the characteristics of a bond change with the mere passage of time, in a way that equities characteristics do not, as redemption approaches and coupon payments are made. Transactions are also affected by the fact that bonds give rise to pre-determined cash flows which makes them particularly valuable for investment strategies where risk avoidance and value conservation motives prevail. However, *mutatis mutandis*, the structures of institutional trading in equities and bonds are very similar. As with equity funds, the 'satellite' bond portfolios are characterised both by exogeneity of trading (trading is not essential to the maintenance of these portfolios but rather reflects the attempt to generate 'alpha') and by heterogeneity of judgements over the securities traded. But as with the bulk of equity funds, the 'core' bond portfolios are on the contrary characterised by *endogeneity* of trading activity and by *homogeneity* with respect to security evaluation.

[1] Approximately 180,000 issues are currently available in the US with different maturities, call features, coupon structures and credit protections as opposed to some 15,000 equity issues.

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For core portfolios which track an index with varying degrees of permissible tracking error, trading is endogenous in that constant rebalancing is necessary to keep these portfolios in line with their mandates. As in the case of equities, this endogeneity of core portfolios helps to explain the heavy daily volume in bond trading. However, there is a further consideration that also explains why this volume is orders of magnitude above that in the equity markets. Because systemic risk, linked to general changes in interest rates, is so important in bond markets, the main rebalancing operations are linked to interest rate exposures. The classical form of rebalancing, still predominant as a trading motive, is 'immunisation'. Except in very unusual cases, bond portfolio managers are unable to match exactly the time pattern of their assets and that of their liabilities, that is, of their payments to customers. Coupon and redemption payments which arrive 'too soon' are subject to reinvestment risk, that is to a decline in interest rates; on the other hand, bonds with later pay-offs will have to be sold before maturity in order to meet liabilities which means they are subject to 'market risk', that is, the risk of a rise in interest rates which will depress their value. Thus a standard rebalancing strategy is to control the 'duration' of a bond portfolio so as to offset reinvestment and market exposures.

The large volumes of trading that arise, as a matter of routine, out of the rebalancing operations necessary for index tracking or for immunisation purposes may give the impression that the bond markets are characterised by widespread speculation, but the opposite is in fact the case. If a portfolio replicating the risk structure of a more comprehensive portfolio (through stratification or some other optimisation procedure) is not continually rebalanced in line with changing market conditions, then the manager is speculating, calculating that a different risk structure is more advantageous. The same logic applies to a manager following an immunisation strategy. The manager has to respond to every change in the level of interest rates; for example, a general rise in rates requires the replacement of near-term by more distant cash flows. If this is not done, the manager is adopting a speculative position, relying on an ability to reinvest approaching coupon and redemption payments on better terms. Changes in term structure will involve more complex, but equally necessary, rebalancing operations. The upshot is that core bond portfolios, those which actually predominate, are constantly rebalanced precisely in order to avoid speculative exposure to the main risks in the debt securities market. As with equity portfolios, it is not security trading but a failure to undertake rebalancing trades which would amount to speculation.

If the *endogeneity* of security trading by institutional investors is just as clear in debt markets as in equity markets, so also is this true of *homogeneity.* Heterogeneity of motives must of course be presupposed as the basis for trading. The buyers and sellers of a given debt security have differences which relate to their portfolios, to the time structure of liabilities and to the levels of risk which are acceptable. However, what does not differ is the assessment of the traded security by the buyers and sellers concerned. Just as equity portfolios are rebalanced, wherever this is possible, by buying and selling the most liquid, high-cap stocks, so bond portfolio adjustments are also concentrated on the most liquid debt securities, above all Treasuries. Even when, for yield motives, other bonds are held, it tends to be Treasuries and near substitutes which are traded in order to control exposures and track benchmark indices.[1] The specific characteristics of debt securities reinforce

[1] US Treasuries are extremely attractive to institutional investors because of their greater homogeneity as compared with corporate securities (they are completely free of default risk, have no call features etc.) and because they are issued in very large volumes, at regular intervals and across a range of maturities See Dupont and Sack (1999) and Joint Economic Committee (2001).

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concentration in yet another way. For each bond issue, the fraction which is actively traded tends to decline over time as maturity approaches; thus, even trading in Treasury securities is concentrated on 'on-the-run' issues.[1]

To summarise this section: the 'macro' data on US security markets suggest that transactions characterised by endogeneity and homogeneity dominate those characterised by exogeneity and heterogeneity; at the same time, the 'micro' data profiling the top US money managers suggest that the organisation of institutional investors into core–satellite structures corresponds to this pattern. It is straightforward to relate 'satellite' portfolios to trading activity which is exogenous and based on heterogeneity of security evaluations. The correspondence between 'core' portfolios and the endogeneity and homogeneity of trades is less straightforward, in that such portfolios are tied to market indices, and indexation in theory signifies minimal trading. However, the practical problems associated with indexation, particularly acute in the case of bonds, mean that a substantial proportion of 'core' funds are allocated to portfolios which track but do not fully replicate the indices chosen as benchmarks. The need for the constant rebalancing of these portfolios is, we contend, a major factor behind the current levels of daily trading volume, and the attempts by fund managers to contain the costs of rebalancing can provide a major explanation for the concentrated structure of trading. The final point is that the emergence of the core–satellite paradigm reflects the fund management industry's response to the new pressures and responsibilities that accompany its increasing popularisation. It follows that any evaluation of current financial market trends for policy purposes must depend on how this expansion in institutional fund management is interpreted. The next section briefly discusses this question.

6. Policy implications of institutional trading

The steep rise in capital market trading volume in recent decades has inevitably led to an ongoing and very intense debate over its likely impact. Where some commentators see the rise in this volume as necessary to the stable and efficient functioning of the wider economy, others see in this rise a source of greater systemic instability.[2] Intense as it is, this debate is nevertheless one-sided in that, while the effects of liquid capital markets are discussed, the question of whether these markets are indeed liquid is not. On the contrary, because of the tendency to identify rising capital market trading volume with rising capital market liquidity, this liquidity is generally treated as a fact to be taken as given rather than as an issue to be explored. This position links strongly with the failure to draw a fundamental distinction between the trading motives of institutional investors, on the one hand, and those of individual investors, on the other.

A completely different take on the liquidity of the capital markets is necessitated as soon as the distinction between institutional and individual investors is taken seriously. From the point of view of the individual investor, this liquidity is certainly a fact; but from the perspective of the institutional investor, things are completely different. Since core portfolios presuppose necessary and continual trading for the reasons given above, the sheer size of these portfolios means that this trading comes up against the liquidity

[1] Dupont and Sack (1999) report that in recent years more than half of reported interdealer broker trading in Treasuries took place in on-the-run securities, even though off-the-run issues outnumbered on-the-run issues more than twenty to one (p. 795).

[2] For brief surveys of the debate on the effects of liquid capital markets, see Honohan (2003) or O'Hara (2004).

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constraints in the capital markets. From a historical perspective, trading volume appears high, but the past can often be a poor guide to the present where rapid economic and institutional change is involved, and the US fund management industry is a case in point. In contrast to the past, this is now a mass industry serving large sections of the US population, which means that, no matter how vast may be the trading taking place on the US security markets, from the point of view of the largest institutional investors these markets are characterised by a *chronic lack of liquidity*.

The concentration of institutional trading on the most standardised and liquid securities, which offer institutions the possibility of minimal price disturbance when trades are executed, is one particular manifestation of attempts to overcome the shortage of liquidity. Other manifestations are to be found in the host of reorganisations in trading methods and market structure to cater to the needs of the institutions. These are especially pronounced in the equity markets, where individual investors still have a significant presence.[1] To limit the price impact of their trades and to avoid 'pilfering' by fast-moving small investors who try to anticipate their portfolio alterations, the big funds 'slice and dice' their trading orders. They attempt to match their trades against those of other institutions in 'upstairs' markets before committing them to the trading floors of the exchanges. They establish parallel, purely institutional trading networks—'crossing systems'—to bypass the public markets. They resort as much as is possible to the use of derivatives in order to rebalance their portfolios without costly exchanges of the underlying securities. In the case of bond markets, which have always been the preserve of the institutions, the attempts by the latter to overcome liquidity constraints manifest not only in the restructuring of these markets but also in the parallel growth of the short-run money and repo markets. The constant rebalancing of institutional bond portfolios creates huge needs for short-run transactions balances; only the rapid and low-cost recycling of monetary surpluses permits these massive operations to take place.[2]

The above argument suggests that any policy initiatives aimed at reducing capital market liquidity, such as taxing security transactions,[3] would have a severe impact on the large investment institutions. In the current debate on such initiatives, attention is focused chiefly on the effects of controlling financial market liquidity on the manufacturing and other non-financial sectors of the economy, with opinion divided as to whether these effects are, on balance, positive or negative. There can be no such ambiguity, however, as regards the detrimental impact of such policy measures on the institutional investors. If fund managers currently find it difficult to execute rebalancing trades smoothly or cost efficiently, the introduction of liquidity curbing measures would render that task virtually impossible. This serious disruption to the ability of fund managers to fulfil their function

[1] For general overviews of how institutional investors attempt to overcome the liquidity constraints of current market structures, see Economides and Schwartz (1995), Davis and Steil (2001), Schwartz and Steil (2002) and Schwartz and Wolf (2003).

[2] An anonymous referee has pointed out, first, that increasing turnover is to a substantial extent attributable to the declining costs of trading stocks and bonds (the increased use of computerised trades being a key factor here) and, second, that it is the fact that transaction costs are negatively related to the size of companies which explains why turnover is positively related to size. These propositions are correct. However, causality runs in both directions: on the one hand, reduced transaction costs for the large institutions help them to trade more frequently than individual investors; on the other hand, given that they have to trade more frequently because this is essential for portfolio maintenance, it is the institutional investors who lead the drive to introduce new technologies, instruments and organisational arrangements aimed at lowering trading costs.

[3] Those who have suggested taxing security transactions include Stiglitz (1989), Summers and Summers (1989), Baker (2000) and Pollin *et al* (2002). See Haberler and Kirilenko (2003) for an overview of the positions for and against securities transactions taxes.

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would have wider ramifications. Given that the rise of the institutional investors, providing mass access to the security markets on standardised terms, is inseparable from the linked processes of disintermediation and securitisation which are transforming financial systems based on inside investors and bank credit into market-based systems, it follows that policies for reducing capital market liquidity would strike at the very core of this systemic transformation. To those who construe this transformation to be more the result of historically contingent factors than a logically necessary counterpart to other wider changes in the modern economy, this outcome may be desirable. Our position is different.

While it is clearly the case that some of the forces behind the shift towards a market-based financial system were historically contingent,[1] the shift is also an expression of the persistent advantages of that system, in terms of cost and scale, as against one based on classical bank intermediation. These advantages seem to be cumulative in that the growth of security markets to which they give rise enhances the scale effects which are a key source of that growth itself. The institutional investors are the central actors in this dynamic process, because they are well placed to exploit the growth of security markets to obtain levels of diversification which are otherwise impossible thereby magnifying the risk-return advantages of security-based systems *vis-à-vis* classical bank-based investment. But other financial actors are also driving the process forward; not only issuers and investors, whose defection originally put pressure on the banks as depository institutions, but also the banks themselves, which are increasingly oriented towards security-market activities of all kinds.

The point of this argument is not that there is no room for policy initiatives aimed at improving the efficiency or stability of the financial system. The point, rather, is that liquidity reducing policies should not be among these initiatives. The very high levels of security trading observed are an endogenous aspect of contemporary security markets because this trading is an inescapable necessity for the institutions which are the main players on these markets. Only if it were thought possible to reverse the whole historical process of financial change and restore the primacy of 'relational' bank-based finance would such a strategy make economic sense. If, on the other hand, the rapid growth of trading is seen as a necessary feature of current financial developments, then such a response might seem inadequate to the challenge which is posed in that it merely disorganises rather than improves the working of financial mechanisms.

7. Conclusion

This paper has made an attempt to characterise one of the most prominent, but least understood, phenomena of the modern economy: the massive scale of trading on financial markets. In the heterodox tradition, many commentators tend to see, in the huge scale of contemporary financial transactions, the 'whirlpool of speculation' denounced by Keynes in his *General Theory*, an unhealthy development which subordinates the long-term needs of the productive system to the pursuit of short-term capital gains. Mainstream theory tends to support this view, either directly by endorsing the speculation thesis or, as is more generally the case, indirectly by giving space to the idea that trading activity is for the most part exogenous to the functioning of the financial markets. These incorrect and very misleading assessments arise out of a failure to draw a fundamental distinction between

[1] For example, the attempt to circumvent certain aspects of US banking regulation, such as the interest-rate ceilings imposed by Regulation Q, lay behind moves to disintermediation in the 1950s and 1960s.

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individual and institutional investors or, if such a distinction is made, to differentiate historically the role currently played by the institutions in the financial system from that played by them in the past.

The central hypothesis of this paper is that the large trading volumes observed are an intrinsic and necessary feature of the contemporary financial landscape, because they are to a great extent determined by the inescapable needs of the institutional investors which now predominate on the capital markets. This endogeneity of trading is inextricably linked to the emergence of a core–satellite paradigm in institutional investment, a development that essentially represents nothing other than the fund management industry's response to the increased pressures on it as it takes centre stage in the functioning of a market-based system of finance. It follows from this whole line of reasoning that proposals to curtail capital market liquidity in the hope of reigning in speculative activity or dysfunctional churning would, on the contrary, disrupt the operation of the financial system, thus holding out the prospect that more problems are created than are resolved.

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Chapter 13

Global finance after the credit crisis

The text here is a late draft of the paper later published as "Global Finance after the Credit Crisis" *Journal der Entwicklungspolitik* (Vienna), 2009.

Introduction

The vast financial disturbances which broke out in 2007, leading to unprecedented state intervention to rescue financial systems in 2008, surely necessitate a reconsideration of the role and prospects of the global financial system which has developed over the last decades. That system is widely recognised to be both a central component of the global economy as a whole and a key driving force in its emergence and transformation. For example, only the enormous financial recycling operation linked to China's export surplus has permitted the exceptional growth of the Chinese economy.

The continuing crisis of major banks, other large financial corporations and capital markets clearly impairs core functions of the financial system. Both political reactions to the crisis and the reactions of market participants themselves are bound to enforce major changes in the system. These are difficult to foresee — the present essay only sketches some possible lines of development.

The next section looks at certain features of the crisis and suggests that it represents not simply another financial crisis but a crisis of finance itself. The following section argues that neither financial globalisation nor the increasing importance of financial markets are likely to be interrupted by the crisis; rather will both market actors and regulators have to grapple with the introduction of specific public goods, without which both the stability and the efficiency of

the global financial system will be permanently at risk. The concluding section speculates on the possible long-run consequences of the crisis.

A Crisis of Finance

The liberalisation of finance, from the 1970s onwards, in most advanced economies, together with the removal or attenuation of many regulatory restrictions and controls, led to a chronic destabilisation of finance from the beginning of the 1980s onwards. From the start the main victims of crises were in the developing world. Indeed, the most serious such episode, in 1982, was the outbreak of a crisis of third world indebtedness which, aggravated by harsh and misguided policies at the IMF, had grave and long-lasting effects across much of Africa and Latin America.

It is not yet clear whether the financial turbulence which broke out in 2007 will have such devastating social consequences. However, to a much greater extent than previous crises, it calls into question the global financial system as such. There are several reasons for this.

Scale

Firstly, where several of the previous crises were centred on peripheral or emerging markets, or on the high-technology sector of developed economies, the latest crisis is clearly centred on the financial sectors of the United States and Western Europe. Moreover, most of the problematic financial claims relate to the finance of US real estate — this is by far the biggest financial market in the world. Outstanding household mortgage debt, on its own, is much larger than either government or corporate debt (and the latter also includes large amounts of mortgage debt).[1] The understandable interest of many researchers in corporate finance and in international financial transactions should not obscure the sheer scale of North American real estate finance.

Of course, to begin with, only a small fraction of these real estate claims were called into question — the subprime mortgages which, repackaged and resold, became the collateralised debt obligations at the centre of the subsequent turmoil. But more and more mortgages were affected, partly by the contagion of doubt among similar assets, partly by the fall in real estate prices which undermined previously adequate collateral.

Leverage undoubtedly contributed to the enormous profits of major banks during the bubble. The "big five" British banks, for example, declared profits of 37 billion in 2006 — the year before the crisis broke out. This sum represented nearly 13% of all corporate profits in the UK and nearly 4% of total UK GDP.

The sheer scale of the crisis was then multiplied by the same leverage mechanisms which had expanded and intensified the subprime bubble. Losses relative to the own capital of the banks and hedge funds concerned were multiplied because so much borrowed money had been used to obtain increased subprime exposure.

This effect in turn was aggravated by the break-down of tactics widely used by the banks to avoid capital adequacy regulations. Most of the dubious mortgage-backed assets had been moved off the balance sheets of the banks themselves into various "conduits" or "Special Investment Vehicles" (SIVs). This meant that the banks themselves did not have to raise capital to match the risks involved. Most of the SIVs, however, were funded by short-term borrowing which became difficult or impossible to roll over as the quality of their assets was called into question and alarm spread through the credit markets. Thus banks had to take the mortgage-based assets back onto their balance sheets and ensure that enough risk-adjusted capital was in place to meet regulatory requirements. These risks, of course, were growing at the same time. The ratings agencies, which had initially given astonishingly high credit-worthiness ratings to sub-prime-based and similar assets, now rapidly downgraded them, increasing the capital needed.[2]

The move to highly leveraged positions had been very general and had affected other sectors besides residential mortgages. Thus the rapid expansion of both hedge funds and private equity investment in Europe towards the end of the bubble period was part of the same general attempt to increase the yield on financial assets by assuming more debt. Hedge funds and private equity are two very different types of investment vehicle — but they do have in common the use of very high gearing and this accounts for the simultaneous expansion in the years up to 2006 (in the European Parliament), 2007). In the subsequent crisis, many of these positions also had to be unwound because the assets were losing value and the credit by which they were funded was drying up.

For all these reasons, the credit crisis involved losses on an unprecedented scale. The main factor involved, however, seems to have been the very general move to highly leveraged positions.[3] This in turn reflected a general reluctance to accept what would otherwise have been much lower rates of return on financial assets than had been the case over the previous twenty-five years.

When an individual bank takes a more leveraged position, it increases its own exposure to systemic risk, but that risk as such does not necessarily increase. However, when the sector as whole does so, the risk of system-wide disturbance is bound to grow. Central banks and other regulatory authorities around the world seem to have been aware that this was happening but were reluctant to respond by higher interest rates or tightened regulatory constraints because of the wish to extend the macroeconomic upturn. The consequence was a system

breakdown on such a scale as to constitute a very serious threat to production and employment.

The deregulatory Zeitgeist was also a factor: the banks and other financial corporations have been powerful forces behind the continuing drive to dismantle many forms of social control over economic life. One consequence of such lobbying was the promulgation of new, and much less restrictive, capital adequacy standards for international banks (Basel II) at just the time when the bubble burst. Regulators had been repeatedly warned that Basel II would aggravate the cycle by requiring banks to raise additional capital in economic downturns, that it gave far too much scope to banks to disguise the risks of their positions and that it did not impose sufficient transparency on bank accounting practices. The neglect of these prescient criticisms means that Basel II will almost certainly be rapidly superseded by new, more rigorous, regulatory arrangements.

Impairment of the Banks

Secondly, the crisis struck at the central actors of the global financial system — the banks. It has been a central feature of financial globalisation that classical bank intermediation has to some extent been displaced by the growth of security markets. This never meant, however, that the banks were less important as financial actors — on the contrary they have played a leading role in the security markets — as market-makers, market analysts and fund managers as well as in their more established functions of underwriting security issues and financing security trading (Plihon et al., 2006).

A necessary condition for the banks to play this key role has been the globalisation of interbank relations. In fact the money markets of the advanced economies, largely dominated by inter-bank credit flows, are the most completely globalised component of international finance and the major international banks which are active lenders and borrowers across currency zones could be regarded as the core of the global system.[4]

The banks concerned, which it is plausible to take as those linked to the CHIPS payment system, have undergone a ferocious concentration process bringing down their number from 142 in 1985 to 46 today.[5] The crisis has accelerated this process because even among these giants there are banks which have been badly affected by the credit crunch and the associated write-downs of assets and which are looking for safety in a merger.

These giants have the closest interconnections, supported by the deployment of extremely powerful information and communication technologies. Together they form a coherent system at the core of global finance. The fact that they use different currencies has disguised these close interdependencies from some commentators, but in fact the huge amounts of currency traded on foreign exchange markets represent, much more than "casino" speculation, a vast international interbank credit market. (The frequent misinterpretation of FX trading

as essentially currency speculation is discussed in Grahl and Lysandrou (2003).) The growth of security trading around the world is completely dependent on the functioning of these interbank markets because this is how the banks are able to finance security trading.

The impairment of this system through the crisis was never the "paralysis" sometimes evoked in the press, because that would have meant a catastrophic breakdown of the entire economy. At the start, problems were confined to unsecured term interbank credit and what happened was a rise in the risk and liquidity spreads in the interest rates concerned, rather than a cessation of lending. Most interbank lending is against collateral and these markets continued to function more or less normally.

However, as bank balance sheets continued to deteriorate, problems of illiquidity were combined with a growing threat of insolvency. (See the commentaries by Willem Buiter on the Financial Times website.) The failure of the investment bank, Lehman Brothers, seems to have concentrated minds and tensions spread to interbank relations as a whole while the banks perceived as most vulnerable suffered runs on their credit which they could no longer roll over at any interest rate.[6]

In general, financial crises tend to be more or less severe according to whether or not risks are concentrated in the banking system (Boyer et al., 2004). Such a concentration was certainly the case here, with an IMF estimate that, out of some $1.4 trillion of losses and write-downs through the crisis to October 2008, the banks had incurred at least some $725 billion and possibly as much as $820 billion (IMF, 2008, p9). In principle, a fraction of the losses by banks and other agents were insured either through "monoline bond insurance companies" or the use of credit default swaps, but the authorities, by buying many of the most dubious assets, tried hard to avoid too much stress being placed on these insurance systems for fear of another wave of failures and asset price falls.

Interbank credit represents an enormous economy of monetary resources, with a relatively restricted aggregate deposit base supporting a vast and rapidly growing amount of financial transactions. By the same token its collapse would be the equivalent of an immense monetary deflation. By the autumn of 2008, however, only unprecedented and coordinated interventions by governments prevented such a collapse. Many of the giant banking corporations at the centre of global finance were now subjected to political tutelage.

Loss of Control

A third novel feature of the crisis was the loss of control by central banks. Macroeconomic textbooks usually assert that monetary policy is implemented through the central bank's control over short-term interest rates. By the summer of 2007 this truism was being re-examined as it became clear that the interest

rates charged to households and businesses had become detached from the official rates set by central banks. As the latter were eased in response to financial distress and weakening economic activity, the former remained stubbornly high.

It is here that interest rates on unsecured term interbank lending become highly significant because these rates such as LIBOR or EURIBOR (London or Euro interbank offered rate, respectively) are the benchmarks used to set interest rates on a very large amount of private lending. The banks were not prepared to reduce the rates at which they lent to their customers in step with reductions in central bank target rates.

In fact, central banks are relatively small players in credit markets. (For example, the Bank of England in 2007 had assets totalling 39 billion, although this grew in the crisis to 73 billion in 2008; compare Barclays — one of the "big five" British commercial banks, with assets of 1.3 trillion in 2007.) They typically target directly only one very short-run interest rate, that in unsecured overnight interbank lending, and rely on substitution among the different credit markets to influence the general level of short-run rates in the economy as a whole. Implicitly, this depended on the strength and stability of the big commercial banks as well as their confidence in one another. Given those conditions, the commercial banking sector as a whole came close to being part of the state in that it could borrow on approximately the same terms as could central government.

The impairment of the big banks put an end to this situation. A huge spread opened up between one-month and three month interbank interest rates and those in the overnight markets still, more or less, under central bank control. (It is interesting that this happened at virtually the same time and to approximately the same extent in dollar, euro and sterling money markets, testifying to the close, global, integration of the financial sectors concerned. That the Japanese banking sector escaped the credit crisis with relatively limited damage seems to be due to the severity and persistence of the Japanese banking crisis from the late eighties onwards.) These spreads correspond to the liquidity and risk premia exacted by the banks' creditors. (For a detailed analysis, IMF, 2008, chapter 2). At the same time, the interest rates on lending to the government went very low indeed as wealth-holders sought a safe haven. (Late in October 2008, the annual yield on three month US Treasury Bills was below 1% while the corresponding rate in Germany was 1.75%.)

These gaps persisted, and even widened, in spite of big moves by the central banks to re-establish control. They started lending much greater sums to the banks, for longer periods and accepting a much wider range of assets as collateral. Thus a central tool of macroeconomic policy has itself been impaired by the crisis. In a deteriorating macroeconomic climate, where interest rate reductions for household and business borrowers would normally be a key policy response, this situation eventually provoked quite radical proposals. Suggestions include channelling all interbank lending through the central bank or expanding the

scope and scale of central bank lending in other ways. In any case it seems likely that central bank balance sheets will grow substantially relative to those of commercial banks and other financial corporations, leading perhaps to a permanent shift in the balance between public and private power in the financial sector.[7]

Such a development would to some extent at least reverse the monetarist reassignment of macroeconomic functions which began in the 1980s. The sole goal of monetary policy was to be price stability, rather than either financial stability or support for general macroeconomic policies. The minimalist central bank — with a very limited balance sheet — is to some extent a consequence of the approach to monetary policy adopted at that time. To that extent, central banks may be recovering some of their previous functions, although in a very different context.

Reform, not Fragmentation

The argument so far has merely been to characterise the credit crisis as being, in at least three important respects, different from and more severe than previous crises: the combination of the scale of the disturbances, the impairment of the large banks at the centre of global finance and the weakened control of central banks suggests that this is not simply a financial crisis, but a crisis of finance, calling into question the both structure and the functioning of the financial system.

It is much more difficult to go beyond these descriptions to assess the possible nature and direction of future changes to this system. Any such assessment has also to consider the new political situation. The financial débacle is the biggest blow ever suffered by neoliberal ideology and the biggest ever setback for the neoliberal project.[8] Thus a much wider range of economic strategies are now becoming politically possible than in the recent past where neoliberalism has dominated and this makes future developments even more uncertain.

However, some implications of the crisis already seem relatively clear. Firstly, the financial sector, and especially major banks, are likely to be subjected to much closer, more intrusive and more comprehensive regulation. Some obvious examples can be given. (It has to be acknowledged that some regulatory issues raise technical difficulties beyond the expertise of the writer. For a recent account, responding to the first phases of the crisis, Davies and Green (2008).) Reforms to bank accounting will be used to control off-balance sheet assets and liabilities and to reassert capital requirements over the entirety of a banks' positions. The conflicts of interest which have clearly distorted the work of the ratings agencies will be addressed. There will be a push for more complete and up-to-date reporting of the positions taken by banks and hedge funds. Some reforms also seem likely to reduce the immense incomes enjoyed by those at the

head of financial corporations. Many of the parameters of regulation are likely to become cyclically variable to avoid the exacerbation of cyclical upswings and downswings by existing regulatory structures.

Secondly, it seems already clear that the crisis has not called into question but rather reinforced the global character of the financial system. One aspect of this is the serious attempts that were made, in spite of a some initial disarray, to coordinate the official responses to the crisis. Central banks, firstly, organised a series of simultaneous monetary policy changes and other coordinated interventions; central bank literature shows that, although little action was taken during the subprime bubble, there was a growing concern with stability issues and intense communication and debate among central banks about them. (For an account of arrangements in Europe see ECB (2006).)

Serious government intervention began in the autumn of 2008 with the rescue package proposed by US Treasury Secretary Henry Paulson and eventually adopted by the Congress and a rescue package, including the provision of new capital for the banks from the government, in Britain. Coordination of such policy interventions seems to have begun almost at once, both within the EU and among the G7 group of the largest economies. There were clearly dangers of spillover effects from some types of intervention, such as the Irish government's guarantee of bank liabilities, and some clashes, notably between Britain and Iceland, but in general the international nature of the crisis and the need for an international response seem to have been recognised early (Iceland's appeal for credit from the Russian Federation is an interesting illustration of the geo-political shifts which may be accelerated by the crisis). Reference to global forces might also, of course, be an attempt to evade responsibility by national political leaders, but on the whole the political language used seems to be justified by economic and financial events.

The responses to crisis in the private sector also seem to have reinforced the global character of the system. Protectionist tactics were hardly to be expected from the big banking corporations who surely place a very high value on their freedom of action, but there were some indications that the banks were mobilising international resources to meet the crisis. The intervention of sovereign wealth funds to supply new capital to Western banks went very badly for the former, who came in too early, bought bank equity too dear and suffered huge losses in consequence (Demarolle and Johanet, 2008). Nevertheless, these actions may foreshadow larger shifts in the ownership and control of the global financial system in the future.

It was mentioned above that the globalisation of finance has been marked by a substantial change in the structure of finance, away from classical bank intermediation and towards a much bigger role for organised security markets — for both company shares and, especially, bonds. Does the "securitization" fiasco

mean the end of this trend? The view taken here is that such an outcome is extremely unlikely. A security is a marketable claim. It is necessary to distinguish between the legal and economic interpretations of this definition. The whole range of "toxic" assets arising from the subprime bubble had the legal form of marketability but they often lacked its economic content — the markets for such paper were thin and inadequate even towards the end of the bubble when the absurd AA and AAA ratings had not yet been exposed. (For just this reason these assets had yields well in excess of what could normally be expected from high-grade paper.) It was pointed out above that much of the risks involved stayed with the banks — this in itself indicates that formal securitization did not really correspond to the creation of a functioning market.

To function in effective way, asset markets require a certain standardisation. The possibility or otherwise of such standardisation determines whether the widespread recognition of the asset which is needed for tradability exists. The key advantages of traditional "relationship" banking over the public issue of securities arises where credits or investments are too specific to permit a wide market to develop. As Michel Aglietta (2008) points out, when such standardisation is not possible, securitization destroys information. The thin, fragile markets for subprime-based collateralised debt obligations destroyed it on an enormous scale, with potential buyers knowing less and less about the nature of the claims being offered.

Similar considerations apply to the huge growth of financial derivatives. Those which have given rise to most difficulties are OTC (over-the-counter) instruments rather than the much smaller total of standardised, exchange-traded derivatives where big defaults are unlikely because changing prices are rapidly reflected in payments by counterparties with deficit positions. In the case of both asset-based obligations and OTC derivatives, the danger was a confusion between types of claim. Those which are highly specific or which depend on detailed knowledge of a particular agent should stay with or close to the original creditor because information will be destroyed by secondary trading; those which are effectively standardised can be safely traded on secondary markets. What is to be avoided is a confusion whereby claims are moved off banks' balance sheets without being effectively distributed across liquid secondary markets. Regulation should perhaps encourage a certain standardisation of claims; this is often said to discourage innovation but, in both retail and wholesale financial markets, it is now clear that many supposed innovations are either exercises in spurious product-differentiation or, quite simply, scams. A somewhat slower pace of financial innovation is perhaps desirable.

The broad trend from classical bank intermediation to security markets is not yet fully understood. On one view, the main reason for it is regulatory — the imposition of risk-adjusted capital requirements on the banks. However, it is also possible to interpret the shift in terms of economic development — as supporting financial relations among a very large number of agents and on a

very great scale. Thus the clear lead of the US in the development of security markets could reflect the fact that, even before the era of global finance, this was a vast economic system spread over a huge area (Grahl, 2001; Lysandrou, 2005).

Thus, although one can be certain that much tighter controls will be put on bank activities, both the global character of financial systems and the increased role of security markets seem likely to survive the crisis, and indeed may even be advanced by it.

Two Conjectures

The predictions made in the previous section are already somewhat tentative. At the time of writing the end of the crisis is not yet in sight and there is no possibility of any definitive assessment of its course and consequences. Instead of attempting to reach clear conclusions, two possible lines of development will be sketched in this last section — both of them speculations but with a certain rationale.

Firstly, there now seems to be a real possibility that the world economy is entering a period of cheap capital and low rates of return. Since the Volcker shock of 1979 (the drastic change in US monetary policy with very high interest rates) the potential abundance of investible funds has been prevented from driving down target rates of return in industry and commerce. During the 1980s, very tight monetary policies and a general search for liquidity by potential investors kept interest rates at very high levels. Real (that is, inflation adjusted) rates were driven higher by the fact that disinflation ran ahead of monetary policy relaxation. In the 1990s, rates on government debt came down markedly, but the very high rates of return sought by investors in the equity markets prevented this from lowering the cost of risk-bearing capital. These unsustainable conventions as to rates of return were shaken by the dot.com crash when it turned out that in many cases high reported shareholder returns were illusory. Then in the subprime bubble banks used massive leverage in an ultimately futile attempt to raise the return on their capital.

One lesson of these episodes is that a sustainable convention, among investors, of a general rate of return has something of the character of a public good. The authorities might in the future use their analytical and research resources to diffuse realistic expectations as to yields; they will certainly try to police the use of leverage by major financial corporations. One result could be a general decline in yields and interest rates, not simply on government debt, but also on industrial investments and consumer credit. If this happened the social consequences, particularly in labour markets, could be dramatic. The persistent deterioration in the relative bargaining position of employees has been caused to

a considerable extent by the high rates of return which were routinely pursued on industrial assets. It is impossible to predict how such a change in the balance of power in the labour market would be expressed — a revival of traditional trade unionism seems rather unlikely. But a reassertion of employee interests in some form would most certainly be encouraged by cheap capital. One of the main forces pressing down on the confidence and the ambitions of the popular classes would be weakened.

The second conjecture is even more speculative. At present the global financial system is being rescued by governments and at public expense. This is bound to lead to reforms — the way the system works will change. It is at least conceivable, however, that change will go further than this — that there will be a challenge to the finalities of the system, to its goals and the priorities among them. To envisage such a development is certainly to take a sanguine view of the global economy and global financial relations. But, whether or not such a transformation is feasible, it is most certainly necessary. The key priorities of development in the poorest countries and of environmental protection cannot plausibly be asserted in economic life unless they shape the financial constraints on households and businesses. Only if the global financial system becomes the bearer of these objectives do they have the slightest possibility of realisation. This is a long way from the speculation and excess which has disfigured Western financial centres in recent years. But it is to be hoped that the end of that world may make another possible.

Notes

[1]At end 2007, household mortgage debt in the US stood at $10.5 trillion; corporate debt was $6.3 trillion; government (Federal, State and local) $7.3 trillion; claims on foreign debtors $1.9 trillion. Federal Reserve (2008) p8.

[2]For the disastrous role played by credit rating agencies in the assessment of sub-prime mortgages and the collateralised debt obligations based on them see, IMF (2008) chapter 2, box 2.2, "When is a AAA not a AAA?"

[3]It should be noted that, contrary to the declarations of the European Commission (D.-G. Internal Market press release, 27th February 2008) and some political leaders in Europe, the drive for high leverage was even more marked in Europe than in the US itself. Daniel Gros and Stefano Micosi report that, "the dozen largest European banks have now on average an overall leverage ratio (shareholder equity to total assets) of 35, compared to less than 20 for the largest US banks." These economists recognise that the leverage numbers reported to regulators are much lower, but they explain this by the "massive in-house investment banking operations of European banks" which "are not subject to any regulatory capital requirement." They give the following figures for the leverage ratios of European banks as of 30th June 2008: UBS, 46.9; ING 48.8; Barclays, 61.3; Crédit Agricole, 40.4, Deutsche (2007) 52.5. (Gros & Micosi, `www.voxeu.org`).

[4]Globalised money markets require huge amounts of collateralised foreign currency trading: the key instrument involved, the FX swap, accounted for the first time for more than half of all FX trading in 2007, some $1.7 trillion per day (out of a total of $3.2 trillion). Dollar trades against the euro, the yen, sterling, Swiss francs, Australian and Canadian dollars and Swedish krona made up two thirds of all FX trading, again relating it to the activities of Western financial centres. Data from BIS (2007)

[5]This concentration was until recently dominated by mergers between banks in the same currency zone and this may have disguised the increasingly global nature of the system as a whole. The recently announced Commerzbank, Dresdner Bank continues this pattern, but the crisis has also seen a number of large international mergers and takeovers such as Mitsubishi's stake in Morgan Stanley.

[6]The account in the text is based on the supposition that the monetary flows through wholesale payment systems can be taken as a reasonable proxy for interbank lending (it is difficult to imagine what else these enormous flows can represent). For example, the flow of funds through the ECB's inter-bank payment system, TARGET, continued to grow throughout 2007 (from 2.19 trillion euro per day in January to 2.69 trillion in December). However, in 2008 actual falls are recorded from 2.76 trillion in January to 2.32 in August — the first such contraction in the system's history. Flows through the New York-based CHIPS system, however, which handles dollar payments among 46 of the very biggest international banks, continued to grow at annual rates of 12.1% in 2007 and 9.6% in the first half of 2008.

[7]In Ireland, for example, the government issued a blanket guarantee of all bank borrowing, which comes close to moving, at least temporarily, the banking system as a whole into the public sphere Of course this measure, which has several precedents in, for example, Italy in the 1930s or Sweden in the early 1990s was taken to rescue the banks rather than to re-establish central control over interest rates, which are set by the ECB. But similar measures are being proposed to secure a general decline in market interest rates to combat recession.

[8]The neoliberal project is understood here as a political strategy which uses the intensification of certain market processes to roll back many of the gains achieved by the workers' movement and other social movements in the first seventy years of the twentieth century. It is important to add that this definition excludes the use of the term, "neoliberalism" to cover all important developments in contemporary capitalism. In particular, the emergence of a global financial system is not seen basically as a consequence of neoliberalism, but rather as a necessary and functional aspect of globalisation in general, which is itself perceived as a new stage in the socialisation of production.

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Chapter 14

The official case for financial integration

The references cited in the text can be found in a list of all references from items 14–18 on page 326.

6. The official case for financial integration

Thorsten Block and John Grahl

6.1 INTRODUCTION

This chapter looks at some of the studies of financial integration sponsored by the European Commission. It is argued that most of the claims they put forward on the benefits of financial integration are, to say the least, exaggerated.

The plan of the chapter is as follows: there is firstly a brief characterization of the general position of the Commission on markets and integration; then a look at the viewpoint taken by European leaderships on financial integration in particular; next there is a discussion of market liberalization in general; this discussion is then related to the financial sphere; there is then a critical assessment of three economic studies which make the case for financial market integration. It is not denied that a certain consolidation of European financial systems may be necessary as a response to the ongoing process of financial globalization; this latter argument for integration, however, which is developed throughout this book, depends on market integration being combined with effective measures for social control over the financial sphere. It is concluded that the use of technically sophisticated but in fact quite unrealistic studies to suggest that major economic gains can be achieved without such control amounts to a distortion of democratic debate.

6.2 THE COSTS OF 'NON-EUROPE'

It is well known that, in recent decades, the integration strategy adopted by the leadership of the EU has been strongly biased towards 'market creation' rather than 'market correction' (see Scharpf, 1999). For this reason, EU policies have tended to reinforce neoliberalism, in the sense of a political project which deliberately intensifies certain market pressures in order to block, or even reverse, forms of collective action and state intervention which were seen as threatening by dominant interest groups.

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In some respects, however, decision makers in the Commission and the Council of Ministers have been more royalist than the king. Even those who are most committed to the market economy normally recognize that some markets do not exist simply because there is no need for them. The Commission on the other hand tends to regard the absence of any Europe-wide market as being necessarily the consequence of damaging 'barriers' which must be levelled to avoid 'the costs of non-Europe'.

This was the title given to the Cecchini Report, a series of studies commissioned by the EU in the late 1980s and purporting to show that the liberalization strategy launched by the Single European Act would lead to massive economic benefits. These, it is generally acknowledged, never materialized.[1]

However, the almost routine falsification of such claims never holds the Commission back from the next assault on 'non-Europe' or from the extravagant promises which are made to justify it.

6.3 THE GENERAL CASE FOR LIBERALIZATION

The standard argument for trade liberalization is that the removal of barriers or the reduction of tariffs will increase the scope for advantageous exchange: a country which imports more of the commodity concerned will do so because it is cheaper for it to import than to produce at home; a country which exports more will likewise find that the returns from so doing are higher than from using the same commodity at home. This standard case is sometimes referred to as the theory of comparative advantage but in fact it is no different from the usual argument for specialization: the case for free trade is simply the case for market exchange.

This case is subject to the usual caveats on markets. Three important qualifications of the case for free trade are:

- it is subject to the full use of resources; a country which reduces its home production of a product in favour of imports obtains no advantage from so doing unless and until the resources no longer used in that industry are redeployed more effectively;
- there must be no adverse developmental effects, as when specializing in a low productivity industry prevents a country from moving into more advantageous specialisms at a later date, or when a country, by importing a sophisticated product, makes it difficult for domestic firms to acquire expertise in its production;
- adverse distributional effects from trade liberalization must be avoided – an example might be when wealthy consumers benefit

from imported luxury goods while low-income producers suffer losses; to ensure that free trade is advantageous in such a case, the winners from liberalization must compensate the losers.

Many studies of trade liberalization neglect these important qualifications or assume them away. Even when such assumptions are made, however, standard studies usually indicate that the gains from liberalization are small, and this is especially the case in the EU.

There are two reasons for this. The first, which applies very generally, is that in market economies there are usually many substitutes for any given good or service; it may be damaging to suppress market interactions as a whole, but if only a single market is suppressed the impact on welfare is likely to be small. If one can't get apples, one eats pears; if one can't go by train, one takes a bus and so on. Thus GATT studies of substantial tariff reductions rarely showed very large benefits, even when very optimistic assumptions were made.[2]

The second reason relates specifically to the EU. This is already an extremely liberalized economic bloc, far more so than any other trading bloc, and the barriers to free exchange among member state are already very low. In particular, the Single European Act and further Treaties since enshrine the 'four freedoms', the right of all persons, corporations and other organizations legally present in the EU to move goods, services, capital and labour across member state borders. These are effective rights, upheld not simply by the European Court of Justice but also within national judicial systems. If, therefore, barriers between member states prevent a corporation from making money, it has an effective remedy, even against the government of its home country. This unique legal structure has led to a very high degree of integration. In spite of endless complaints from the Commission about 'non-Europe' it is probably already the case that in those areas where cross-border transactions are limited this is because there would not be much advantage in increasing them.

6.4 THE NEW INTERNATIONAL TRADE THEORY

In the last two decades a further rationale for trade liberalization has been developed on the basis of the linked phenomena of imperfect competition and scale economies. The two phenomena are linked because in a competitive industry enterprises can achieve the optimum level of output; where competition is limited, however, and enterprises have significant influence over prices, there may be unexploited economies of scale – countries may be too small to achieve the optimum scale of output.[3]

In a situation characterized by unexploited scale economies and imperfect competition, the gains from free trade may be much larger than in the standard argument because, firstly, trade may increase the level of competition and align prices more closely on costs and, more important, the creation of a larger market may permit the scale of production to increase and thus drive down costs. (Note that the same caveats as to full employment and so on apply as in the standard case.) However, the case becomes much more complex because the way the gains from trade are divided between the countries involved is now much more complex. The existence of monopoly revenues means that countries which specialize in the activities concerned may profit at the expense of their trade partners.[4]

It was this line of reasoning which was used or abused in the Cecchini Report to promise the huge gains mentioned above. The difficulty was that in most of the sectors where big scale economies are to be found, usually manufacturing sectors, the level of European integration was already very high prior to the Single European Act.

6.5 FINANCIAL LIBERALIZATION

Mutatis mutandis, the same kind of argument for free trade applies to the financial sector as to the rest of the economy. The standard case for financial liberalization is that it would lead to a better allocation of capital by inducing flows of capital from countries where interest rates and yields on financial assets are low, to countries where they are high. This kind of reasoning is hardly pertinent to the situation in the EU, however. Individuals and enterprises in EU countries have the legal right to invest in assets or to issue liabilities in any member state they choose; in principle, they have had this right since the Treaty of Rome, fifty years ago. In practice, some member states restricted access to foreign exchange into the 1980s, but these restrictions were removed between 1990 and 1992. There are no pools of excess capital trapped in individual member states nor are there member states suffering capital shortage. Fifteen member states, accounting for well over half EU output and employment, belong to a monetary union within which there are no longer any exchange rate risks attached to international finance.

Of course, just as with trade in goods and services, there may be situations where local solutions are superior to international ones. Some types of risky investment are difficult to assess without local knowledge – this may be the case not only for countries but also for regions, cities and smaller communities. Only the Commission, however, would find

anything inefficient as such in the use of local knowledge to make a local investment rather than a cross-border one.[5]

In fact, contemporary financial systems are often marked by a hierarchical structure which combines an integrated, centralized allocation of standardized financial claims (bank deposits, government bonds, the shares of big multinational corporations) with decentralization of many decisions requiring local knowledge, such as investment in small businesses – the branch networks of efficient commercial banks may function in this way, as may also networks of independent local banks.

In any case it is impossible to claim that levelling barriers to capital movement would produce major benefits simply by evening out the supply of and the demand for capital across member states. The official case for financial integration is much more analogous with the 'new international trade theory' – it rests not on allocative efficiency but on competition and technical change.

All the caveats and qualifications to liberalization mentioned above continue to apply but now with a crucial addition – the problem of macroeconomic stability. Much more than the liberalization of exchange of goods and services, capital market liberalization can lead to acute problems in the foreign exchange market and the banking system (see also Chapters 7 and 14).

6.6 COMPETITION, EFFICIENCY AND FINANCIAL TRANSFORMATION

Thus the rationale put forward for the financial integration programmes in the EU has less to do with the allocation of capital than with the transformation of financial systems. The argument is made that regulatory barriers and differences in financial practice have allowed inefficient financial systems to survive. The integration process is seen as transforming the weaker and less efficient financial systems and bringing them up to the standards in those Northern European countries which are regarded as the most advanced.

One objection to this view is that the measures proposed – regulatory harmonization and so on – might simply be too weak to produce the postulated effects. In other sectors – manufacturing for example – there remain very large differences in productivity across member states after more than five decades of integration; it seems doubtful that much more rapid change can be obtained in the financial sector.

A second objection can be derived directly from the new international trade theory. The 'transformation' of the weaker financial systems may

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take the negative form of penetration by foreign financial enterprises, a centralization of financial activities in the stronger countries and a high level of dependence on external financial markets. In such a case, there might still be some growth of productivity in the domestic financial sector, but this sector would remain small and the main benefits from integration would accrue to the stronger countries.

This is not a hypothetical pattern of events: it is an accurate account of what has already happened in those member states which used to be in the Soviet bloc.[6] Their banking systems have been taken over by West European banks and their security markets seem likely to go the same way and become mere branch offices of the big Western markets. This would represent 'modernization' of a kind and many services might be provided in a more efficient way after the old domestic financial enterprises have been closed, but this kind of dependence will not contribute to economic development, since it confirms the exclusion of the country concerned from the most complex and profitable activities in the financial sector. As will be seen below, there is a considerable body of evidence linking financial *development* to economic development in general. There is no evidence, however, that mere financial *openness* has similar effects – in fact several researchers report the contrary.

6.7 FINANCIAL DEVELOPMENT, FINANCIAL INTEGRATION AND ECONOMIC GROWTH

The academic literature on the finance–growth link has so far mainly focused on the role that financial development, rather than financial integration, plays in the process of economic growth. In this literature, financial instruments, markets and institutions may arise to mitigate the effects of information asymmetries and transaction costs. By ameliorating market frictions, financial arrangements alter agents' incentives and constraints, thus influencing savings rates, investment decisions, technological innovation, and consequently long-run economic growth. In a recent survey of the role of finance in growth Levine (2005) identifies, *inter alia* (i) the generation of *ex ante* information about possible investments and the allocation of capital; (ii) the monitoring of investments and the reinforcement of corporate governance after funds have been provided; and (iii) the facilitation of the trading, diversification, and management of risk as important functions performed by the financial system and as mechanisms whereby finance can promote general economic development.[7]

Now, a key part of the Commission's case for the FSAP and other financial integration strategies is to suggest that financial *integratio*n and

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financial *development* are the same thing. The Commission's Economic and Financial Committee (EFC) in its report on financial integration nicely summarized the argument (European Commission, 2002, p. 10):

> 'Financial integration = a more efficient financial market.'

More precisely, increased competition among financial service providers will compress the margins levied by intermediaries and thus lead to a lower cost of capital for borrowers and higher rates of return for investors. A larger internal market allows financial service providers to exploit economies of scale and scope, and increases the liquidity and depth of capital markets which also drives down the cost of capital. A more efficient financial market thus translates directly into better economic performance.

A pervasive weakness in the studies to which the Commission appeals is that they all tend to make this very dubious assumption that integration and development are identical. In so doing they beg one of the key questions raised by the financial integration strategy.

6.8 IRRATIONAL EXUBERANCE AND THE LISBON STRATEGY

The financial transformations discussed so far relate to differences in the efficiency of Europe's own financial systems, to the gaps in financial development between North-West Europe on the one hand and Southern, Central and Eastern Europe on the other. In this context the main problems with the integration strategy are firstly that it may take very much longer to change systems than policy-makers suggest and secondly that integration may not lead to widespread financial development but to an increased dependency of the weaker systems on the stronger ones.

However, by the late 1990s a very different concept of financial transformation had come to dominate the thinking of EU leaderships – a concept based on the US financial system. The rapid growth of the US during the 1990s was perceived as resulting from its successful transition to a 'knowledge-based economy'.[8] The Lisbon Strategy, adopted in 2000, was essentially an attempt to replicate US success, based on the adoption of certain features of the US economic model, notably its financial system.

What was at stake now was no longer the level of financial development in Europe; by most indicators the financial systems of France, Germany and the US are roughly equivalent in their levels of development. Rather, European leaderships decided to promote a change in the nature of the

financial system and to enhance the role of stock markets. It was thought that stock markets in the US were making a massive contribution to economic growth and to the knowledge-based economy, especially in the support of innovative new enterprises in high technology sectors.

It will be remembered that the year 2000 saw the peak of a stock market bubble, well described in the expression of Alan Greenspan, head of the US central bank, as due to 'irrational exuberance'.[9] There can be little doubt that EU leaderships were affected by the same euphoria.

Now, there has been a great deal of discussion and debate in recent years about different types of financial system, but it can be emphasized that comparisons are extremely difficult. A Commission economist ends his survey of the issue with a simple statement: 'Evidence that market-based systems are constantly superior to bank-based financial systems does not exist.' (Thiel, 2001, p. 45).

One of the many difficulties in making such an assessment is to decide on the appropriate criteria. Several commentators (for example, Dore, 2000) suggest that the financial systems traditionally found in continental Europe, with powerful inside investors and a heavy reliance on bank credit, may achieve a very precise and efficient matching of the interests of investors to those of the users of funds. On the other hand, this micro advantage may be associated with weakness on a larger scale – it is often thought that the immense security markets which have developed on an international scale are more effective in bringing about major reallocations of capital from region to region or sector to sector (Grahl, 2001).

There are also of course very important social questions, explored throughout this book, relating to these patterns of financial development.

None of these points implies that the attempt to build big integrated security markets in Europe was an irrational policy. The general shift from financial systems based on bank credit and powerful 'inside' investors to systems making much more use of security markets may prove to be irreversible. In that case, a failure to build big, open, liquid security markets in Europe would simply drive every investor and every issuer on the planet into the North American markets. This outcome might deprive Europe of influence over financial developments and of highly remunerative financial business.

Thus it is most certainly not claimed here that the financial integration strategy was irrational. But it is asserted that the benefits of integration were grossly exaggerated and that the potential problems of financial transformation, in both the social and the economic sphere, were understated.

This assertion can be supported by an examination of some of the

most influential studies used by the Commission to justify its financial strategy.

6.9 THE LONDON ECONOMICS STUDY

The procedure adopted by London Economics (2002), in a study commissioned by the European Commission, is as follows:

- A relationship is estimated linking trading costs in equity markets to the size of the markets (measured by *capitalization*, that is the value, at prevailing prices, of the shares issued by corporations which are traded on the given market). As one would expect, trading costs are lower in bigger markets.
- This relationship is used to estimate the reduction in trading costs which would come about with complete integration, that is if all the equity markets in Europe were replaced by a single, aggregated, market.
- A relationship is then estimated between trading costs and the cost of capital to corporations – the latter being measured by the returns received by shareholders. It is found that the cost of capital is lower when trading costs are lower; this is to be expected because many investors prefer to hold securities which are easy to trade and they are therefore willing to accept slightly lower returns on more tradable shares.
- This second relationship is used to estimate how much the cost of capital would fall in consequence of the total integration postulated above.
- This reduction in capital costs is plugged into a complex macroeconomic model, to see how much investment, and consequently production, would rise in the event of full financial integration.

The methods used in this study are open to the following objections:

- The capitalisation data used to predict future trading costs in Europe come from the period 2000–2001, that is the high point of the stock market bubble. If later figures were used the effect would be much less.
- An implausible degree of integration is predicted which would mean a downward convergence in dealing costs for shares all over Europe. It is not clear how competition among different stock markets could be combined with such a high degree of integration.

- In any case not all share trading is necessarily desirable – over-liquid markets can lead to volatility; if corporations then focus on short-run changes in their share price, their strategies may become distorted.
- The link between the postulated fall in capital costs and investment may be exaggerated. The London Economics model involves an unusually large response of investment to a small reduction in the cost of capital; in other models this parameter is much lower.

The London Economics study, like the Cecchini studies in the past, illustrates one of the pitfalls of buying research on the market, which is that the buyers may get what they want. The existence of independent research institutes, committed to the critical study of public policy, may be threatened by the commercialization of research.

6.10 THE GYLLENHAMMER REPORT

A report to the European Financial Services Round Table (Heinemann and Jopp, 2002, known as the Gyllenhammar Report) contains another extravagant estimate of the benefits of financial integration. This is derived quite uncritically from a previous study by De Gregorio (1999) which found a large effect of financial integration on growth.

However, De Gregorio's study does not estimate a direct relationship between financial *integration* and economic growth – in fact he fails to find any such relationship. Like many other researchers he does find a positive association between financial *development* and growth and he also finds an association between financial *openness* and financial development and he then puts these two associations together, even though he has no empirical justification for so doing, to deduce a relationship between openness and growth.[10]

The Gyllenhammar Report then makes an estimate of the growth impact of financial integration in Europe. This is done by assuming that an arbitrary (but supposedly 'plausible') increase in integration will take place and then using De Gregorio's estimates of the impact on financial development and then onto economic growth. This gives the enormous figure of a € 42 billion annual bonus for the EU economy. A further difficulty of this procedure is that the De Gregorio study included many developing countries, where financial development, starting from a very primitive financial system, is likely to have a big impact. There is no reason to believe that the further expansion of Europe's much more developed systems would lead to outcomes on the same scale.[11]

6.11 A SECTORAL STUDY

Another study, commissioned by the EU and frequently used to support current strategies for financial integration, is that of Giannetti et al. (2002). This uses an approach pioneered by Rajan and Zingales (1998) who explored the effect of financial development on growth, sector by sector, on the basis that companies in different sectors had different needs for external finance. In the Giannetti study it is again the case that the empirical estimates refer to the relationship between financial *development* and economic growth, not to financial integration as such.

To simulate the effect of financial *integration*, these authors *assume* that it translates into development. They have identified the US as having the most developed financial system; they *assume* that EU integration measures suffice to raise all member countries to the same level. On this basis, impressive gains result – the growth rate in many countries increases by over 1 per cent per year!

Gains of this magnitude arise as countries with less developed financial systems are assumed to converge rapidly on the highest standards. The authors recognize that in practice integration may well take the form of penetration of foreign banks and financial corporations and that this would skew the distribution of benefits towards the financial sectors of the stronger economies. However, they argue that such a development would still be desirable because households and non-financial companies in the weaker economies would still gain from better and cheaper financial services. This proposition, however, is simply stated, not demonstrated.

A second simulation attempts to measure the potential impact of legal and regulatory harmonization on economic growth. For this, numerical indicators have to be found for such intangibles as the 'rule of law' or 'creditor rights'. In fact the most important such variable turns out to be 'accounting standards'. These are specified as: Sweden, 84; UK, 78; Finland, 77; France, 69; Netherlands, 64; Spain, 64; Germany, 62; Denmark, 62; Italy, 62; Belgium 61; Greece, 55; Austria 54; Portugal, 36; Ireland and Luxembourg, no data. It is doubtful whether such numbers signify anything more than a typical vote in the Eurovision song contest; they are obviously exposed to many challenges. Accounting standards in the US are put at 71, that is as superior to those in France, Germany and the Netherlands, but in the wake of recent revelations in the US that figure may seem a little high.

In any case an association is found between these indicators and financial development and this permits a simulation in which 'integration' is assumed to raise these institutional factors to the highest level in Europe (thus, in the case of accounting standards, to Sweden's 84). The benefits from so doing are again massive – but this is only to say that a completely

successful modernization of Europe's financial systems would produce large benefits.[12] So also would, for example, a convergence of industrial productivity throughout the EU on the existing levels in France and Germany. What remains to be shown is how specific policy moves, such as those in the Financial Services Action Plan (FSAP), will have concrete effects on the functioning of European financial systems.

6.12 CONCLUSION

The economic studies used by the Commission to support its case for financial integration are very sophisticated in technical terms – they deploy state-of-the-art modelling techniques and statistical procedures. But their strength in technical terms does not in itself justify their extremely optimistic conclusions which rest, in every case, on heroic assumptions – for example, when it is assumed, without any empirical evidence at all, that the limited harmonization and liberalization measures in the FSAP could miraculously bring about full financial integration and a level of financial efficiency equal to that in Germany or the US[13].

Indeed, the very technical sophistication of these studies becomes dangerous in such circumstances, since it may seem to endow their conclusions with a scientific status they do not, in fact, possess. Public discussion and scrutiny of EU policies are not furthered, but are in fact distorted, by such procedures.

The European Commission frequently resorts to the purchase of technically sophisticated but basically tendentious studies from commercial research organizations who seem to know very well what their paymaster wants to hear. Over time, this practice can only serve to further undermine public confidence in, and public respect for, the European project.

NOTES

1. This was officially recognized. The Cecchini report in 1988 had projected that the 'single market' would add 4.5 per cent to the GDP of the 12-nation EU, adding 1.8 million jobs. Four years later, the EU released a report on the impact of the single market and it estimated that the GDP of the now 15-nation EU was 1.1 to 1.5 per cent higher than it would have been without the removal of market barriers and that a net 300,000 to 900,000 new jobs were created (European Commission, 1996). These much more modest claims themselves are open to question. The Cecchini Report itself is a massive multi-volume work; its key arguments can be found in Emerson et al. (1988).
2. This argument, although it is based on the strength of the market economy, is often embarrassing to neoliberals, who want to argue that every single control or regulation is a costly impairment of free exchange.

3. For the new international trade theory see Krugman and Obstfeld (2007).
4. Thus, this kind of situation may justify industrial policies designed to change a country' pattern of specialization.
5. Even in a perfectly integrated market local financial services might still play an important role in providing finance to small-scale borrowers. Small business lending involves the production of soft information that cannot be easily collected by loan officers external to the local community. This type of information is also not easily shared with outsiders. This implies that in specific segments of the credit market integration would be less relevant (Guiso et al., 2002).
6. Thus by 2004, foreign banks accounted for almost all banking assets in the ex-Soviet transition economies of the EU: 92 per cent in the Czech Republic; 98 per cent in Estonia; 77 per cent in Hungary; 58 per cent in Latvia; 93 per cent in Lithuania; 68 per cent in Poland; and 97 per cent in Slovakia. See Allen, et al. (2005).
7. These studies adopt an orthodox view of finance, as facilitating transactions over time. From the heterodox position discussed in the introduction, the role of finance may be even more important in that financial mechanisms are needed to handle the huge imbalances and disequilibria which arise in the course of economic development.
8. EU leaders persistently refuse to acknowledge that the higher employment levels and more rapid economic growth achieved in the US are due to a more expansionary macroeconomic regime.
9. Greenspan had actually used this term some years earlier, but had then retreated somewhat from his critical view of behaviour in the stock market.
10. In fact, the correlations found by De Gregorio suggest the following: that financial development is associated with economic growth, *to the extent that it is indigenous financial development and not simply induced by the entry of foreign financial corporations following capital market liberalization*.
11. The report makes no use of the study by Neimke *et al*. (2002) even though this study was specially commissioned for it. Neimke actually defines integration as the penetration of foreign banks and suggests that countries where penetration is high display more rapid gains in economic efficiency. The statistical basis of these claims is weak, however, because there are only 13 observations, and the estimated relationship is a poor fit to the data. It is probably because of these statistical weaknesses that Gyllenhammar does not cite the study.
12. Sweden also has a highly concentrated banking sector and very concentrated family-based ownership structure of firms. This fact obviously influences the role of good information availability for the functioning of the stock market in comparison, for example, with the United States.
13. Thus the Commission (2003a) is hardly justified in characterizing such assumptions as 'conservative'.

Chapter 15

Lisbon, finance and the European social model

The references cited in the text can be found in a list of all references from items 14–18 on page 326.

5. Lisbon, finance and the European social model

John Grahl

5.1 INTRODUCTION

The European Commission's (2000a) contribution to the Lisbon Council opened with a self-congratulatory account of economic progress in the EU. The 'best economic conditions for a generation' were signalled in terms of disinflation, the stabilization of public finance and lower interest rates. However, weaknesses, 'in spite of this positive outlook', were acknowledged in growth and employment, especially in comparison with the US. The expression, 'in spite of' might be considered tendentious in that the severe monetary and fiscal stabilization measures of the 1990s are regarded by many as, at least, the proximate cause of slow growth and high unemployment. But the relative lack of employment and output dynamism in the EU was traced not to any macroeconomic circumstances but to inadequate technological progress. The 'knowledge economy', centred on information and communication technologies (ICT) and the Internet, was seen as the sphere in which Europe needed to catch up.

Transformed *financial relations* were to be a key linkage in the catch-up strategy. Within a 'sound macro-economic environment', policies for social inclusion, investment in human capital, integrated research policies and so on were to promote a surge in innovation, while finance was essential to the successful introduction of innovation into the economic system. 'An integrated capital market and a dynamic financial services industry' would translate these more fertile and entrepreneurial conditions into success on EU and global markets by widening financial options for enterprises and driving down the cost of capital (Figure 5.1). Specific dimensions of this financial component in the strategy ran as follows:

- The relatively low capitalization of EU equity markets and their fragmentation were to be overcome by integration and the removal of administrative and legal obstacles.

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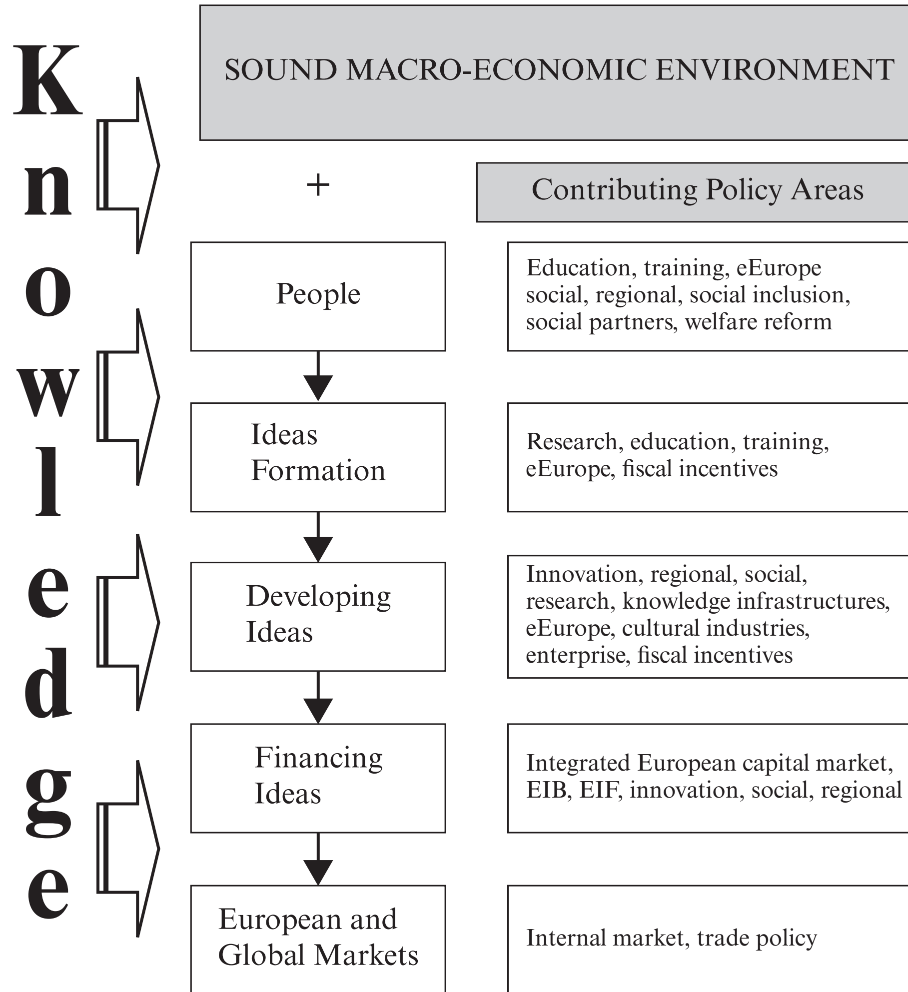


Source: European Commission (2000a, p. 10)

Figure 5.1 Finance and the Lisbon strategy

- The removal of portfolio restrictions on pension funds; if these funds in other member states were to reach the level achieved in the Netherlands, five trillion euro could be placed on EU capital markets.

These were the main considerations which made the already established financial integration policies (the general Financial Services Action Plan

and the Risk Capital Action Plan) into indispensable components of the agenda.

As regards the first issue, the scale of security markets, a judgement was implied that the bank-based systems of many EU countries were inferior to the more equity-based US system in terms of both the general cost of capital and the finance of innovative start-ups. This judgement might well be questioned because, although there is a lot of evidence that financial deepening is necessary to economic development, the evidence on the importance of particular financial structures is much weaker.

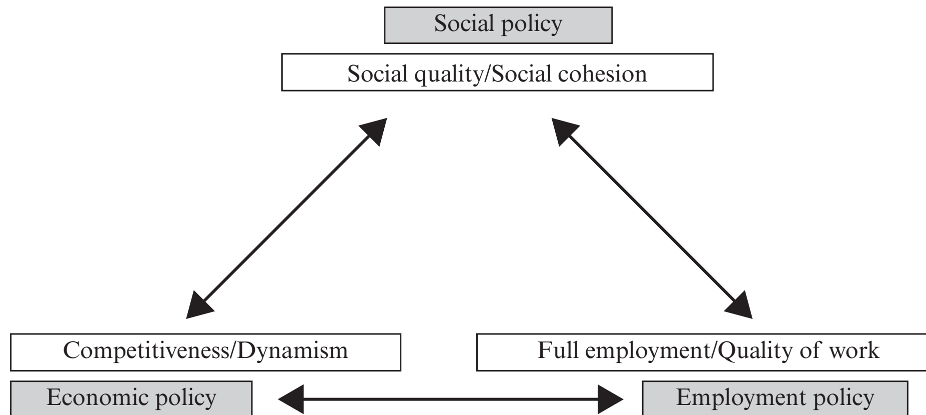
The subsequent European Council (2000) completely endorsed these Commission proposals, adding the famously ambitious goal for the coming decade 'to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion.' The only significant difference from the Commission document was a particularly heavy emphasis on the role of small and medium enterprises (SMEs) as bearers of the innovations leading to the knowledge economy. The financial paragraph began:

> Efficient and transparent financial markets foster growth and employment by better allocation of capital and reducing its cost. They therefore play an essential role in fuelling new ideas, supporting entrepreneurial culture and promoting access to and use of new technologies. It is essential to exploit the potential of the euro to push forward the integration of EU financial markets. Furthermore, efficient risk capital markets play a major role in innovative high-growth SMEs and the creation of new and sustainable jobs.

There followed a repetition of the need for rapid implementation of the Financial Services and Risk Capital Action Plans.

5.2 THE SOCIAL POLICY AGENDA

The Commission (2000b) developed its view of the social policy content of Lisbon a few months later in its *Social Policy Agenda*. It is interesting that the introduction to this document put forward two motives for social policy: social cohesion and 'fairness'. In the tradition of Rawls (1971), fairness is a term which can be given a clear meaning and as an objective it might imply a very ambitious policy indeed. However, this was the only such reference in the document, which subsequently spoke only of 'cohesion'.[1] But social policy was not only seen as serving social objectives; we also find the claim that social policy is to be seen as a productive factor. Thus it was asserted that the economic, social and employment strategies



The policy mixes to be established to create a virtuous circle of economic and social progress should reflect the interdependence of these policies and aim to maximize their mutual positive reinforcement.

Source: European Commission (2000b, p. 6).

Figure 5.2 Social policy and the Lisbon strategy

reinforced each other through a virtuous cycle (in fact, in Figure 5.2, two such cycles – clockwise and anticlockwise).

One key concern was the anticipated difficulty in paying for social expenditures – especially pensions and age-related health care – in European countries. Another was that social protection regimes were not sufficiently supportive of employment. The social strategy as defined in this document in fact included employment policy (essentially the European Employment Strategy, EES) as its main content, on the grounds that 'raising the employment rate will underpin the sustainability of the financing of social protection systems' and that employment was the main route to social inclusion.

The EES as such is discussed below. Apart from a restatement of the Luxembourg process and its employment objectives, the *Social Policy Agenda* did recognize that other social policies were necessary because fuller employment could not in itself resolve such problems as poverty (Figure 5.3).

Thus, besides reiterating the Luxembourg employment targets, the *Social Policy Agenda* specified two further objectives:

- **Quality of social policy** implies a high level of social protection, good social services available to all people in Europe, real opportunities for all, and the guarantee of fundamental and social rights. Good employment and social

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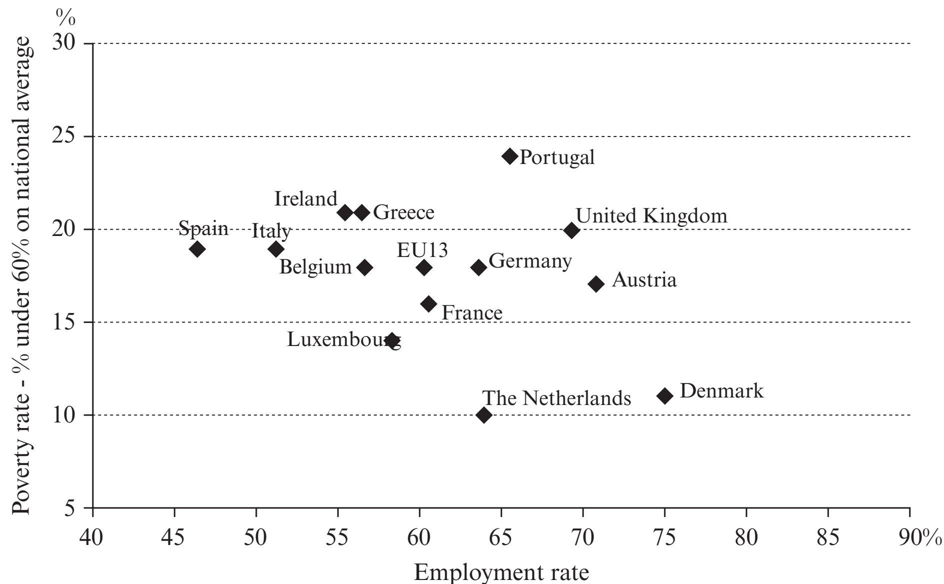


Source: European Commission (2000b, p.12)

Figure 5.3 Poverty and employment in the EU

> policies are needed to underpin productivity and to facilitate the adaptation to change. They also will play an essential role towards the full transition to the knowledge-based economy.
>
> - **Quality in industrial relations** is determined by the capacity to build consensus on both diagnosis and ways and means to take forward the adaptation and modernisation agenda.
>
> This also includes coping successfully with industrial change and corporate restructuring. (European Commission, 2000a, pp. 13–14)

The gloss on the first of these objectives moved to a generally more defensive specification but with a very surprising exception. Improving the quality of social policy included: firstly, 'modernising' and 'improving' social protection (it being added that, in practice, this means 'making work pay', 'making pensions safe and pension systems sustainable'); secondly, 'preventing and eradicating poverty'; thirdly, promoting 'full participation of women in economic, scientific, social, political and civic life as a key component of democracy' (again the benefits of such participation for production are emphazised); finally, the 'development and respect of fundamental social rights' with emphasis falling on tackling discrimination and xenophobia.

We have here important objectives to counter discrimination but which, in themselves, are market-conformable. Few large enterprises today, for

example, are without equal opportunities policies. The specification of 'safe pensions' and 'sustainable pension systems' conspicuously failed to add 'better pensions'. The notion of 'making work pay' is, of course, a classical EU ambiguity – which might and probably does connote completely opposed labour market interventions at one and the same time, that is, both higher minimum wages and reduced support for the unemployed.

The most far-reaching of the social objectives was therefore most certainly the second on the list – the 'eradication of poverty'. This wholly laudable target, which together with the near simultaneous commitment to 'full employment' gave the EU a surprisingly ambitious social policy, will be examined below.

The second objective, of 'quality in industrial relations' reminds us that the 'Cologne Process', involving improved employment relations was, in principle at least, part of the overall agenda, but the development of this theme was very sketchy. The Commission limited themselves to a call for 'social dialogue at all levels (to) contribute in an effective way to the challenges identified. To promote competitiveness and solidarity and the balance between flexibility and security.' But this early allusion to the holy grail of 'flexicurity' was not translated into any concrete policy orientations besides the ever-present need for 'dialogue''.[2]

5.3 CONSISTENCY: THE SAPIR REPORT

Almost from the launch of the Lisbon agenda both its main components and the strategy as a whole were subject to repeated review. Many specific anxieties lay behind these repeated reassessments, but the failure to close the gap in GDP growth between EU and US was always part of the picture.

The Sapir Report (Sapir, 2003), was an early attempt to address this core problem of slower growth. The report had the merit of emphasizing the possible inconsistencies of the agenda – indeed it offered a typology of such inconsistencies, which might impair:

1. coherence at the level of instruments and objectives,
2. coherence at the level of decision-makers and jurisdictions, and
3. coherence over time for a given decision-maker and/or jurisdiction.

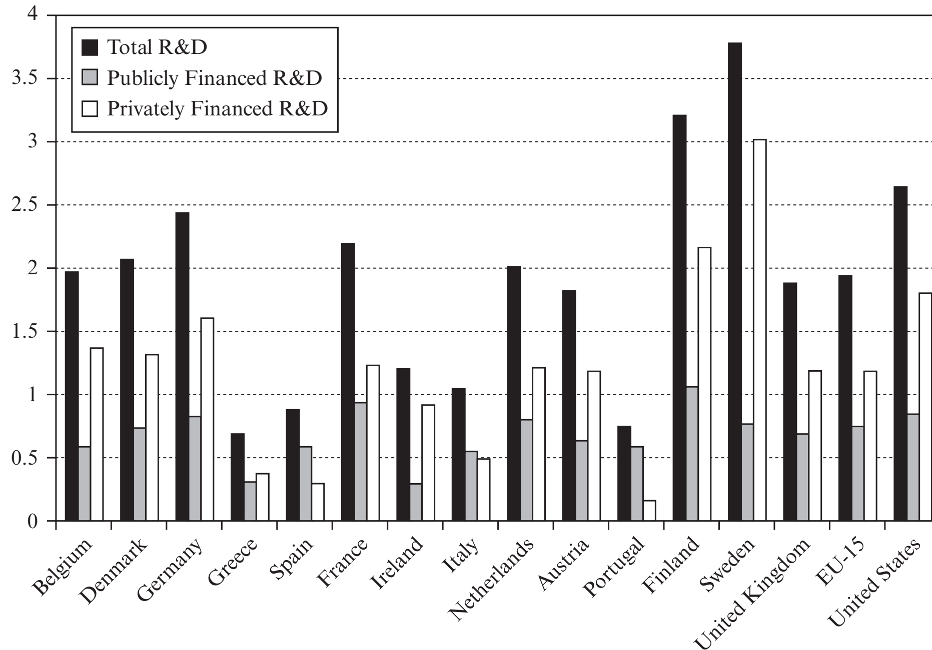
In general, however, the resolution of inconsistencies was to be sought by a strong emphasis on growth, since this was a necessary condition for the achievement of all the other objectives of the strategy. Growth might raise certain problems of cohesion (especially among regions) but the

main notion was that a rising tide floats all ships. And growth was to be pursued essentially by way of structural reforms and further liberalization. (The Report began to problematize the EU's macroeconomic framework, but in the limited terms that have since become standard: the Growth and Stability Pact might indeed represent an obstacle to expansion, but if this was so it was because member state budgets had failed to build up sufficient surpluses during the boom to allow for fiscal relaxation in the downturn.)

According to the report, the European Social Model (ESM) was in deep trouble. In what was soon to become the new orthodoxy, both technological change and the rise of the Chinese economy were seen as lowering the relative demand for unqualified labour. In these circumstances, labour market regulation and social protection which raised the price of such labour would only generate unemployment and destabilize the public finances. Population ageing exacerbated these problems. It should be remarked, however, that the empirical support for these explanations of widening labour market inequalities is fragile. Glyn (2001) reported that increasing wage inequalities were by no means a simple question of declining fortunes for the less qualified – they pervaded the entire distribution and were in fact more marked *among* highly qualified workers than between them and the unskilled. At the same time, the high risks of unemployment faced by workers with low bargaining power were not a European phenomenon: although general rates of unemployment were often lower in the US than in the EU, the concentration of unemployment on the less skilled was just as marked across the Atlantic.

In considering finance, the Sapir Report stressed the issue of risk capital. Between 1995 and 2000 the growth of labour productivity in the US outstripped that in the EU for the first time since the second world war, 'an extraordinary performance for a country at the leading edge of the production possibility frontier'. The previous catch-up in European productivity levels had been to a great extent based on imitation; in the 1990s, however, innovation became much more important. Among the conditions of research investment is 'good access to risk capital by new start-up firms'. Thus the lack of risk capital had become a serious obstacle to European growth (Figure 5.4). The report gave the following details:

> In 1999, total US expenditure on R&D at 2.6% of GDP was over a third higher than that of the EU. Nearly all of the difference can be attributed to a substantially higher investment in R&D by business (1.8% against 1.2%). Within the EU, the low level of business R&D reflects a general north–south divide. Finland and Sweden have both overall and business-financed R&D expenditures exceeding those of the US, while Germany is not far behind. At the



Source: Sapir (2003) High-level Group

Figure 5.4 R&D Finance by Source, 1999, as percentage of GDP

> other extreme, all EU Mediterranean countries have low overall and business-financed levels of R&D. Nor are trends in R&D expenditure favourable to Europe. The US increased its lead in R&D expenditure by €95 billion between 1996 and 2000, of which €20 billion was publicly financed. Between 1991 and 2000, public research budgets in Europe declined from 0.91% to 0.73% of GDP. (Sapir, 2003, p. 34)

The Sapir Report also gave a strong endorsement of the FSAP, while insisting that the integrated capital markets which should emerge be lightly regulated.

> Given the crucial role of financial integration for growth, completing the Single Market for financial services is crucial. A number of specific proposals currently in the pipeline address issues identified in this Report. For example, credit markets and the financial system for innovation are the subject of the Risk Capital Action Plan and Financial Services Action Plans. We support the accelerated implementation of both these actions rather than bringing forward new recommendations in these areas. An effective regulatory system for financial services, such as that proposed by the Lamfalussy Report on securities markets, represents a requirement for the efficient functioning of the financial system. In general, the regulatory process needs to become much closer to, and more aware of, market developments in service sectors and utilities. Possibilities for

> self-regulation as a partial or complete substitute for statutory regulation need also to be explored. (Sapit Report, 2003, p. 130).

In its general orientation, the Sapir Report, having given detailed consideration to possible inconsistencies in the Lisbon agenda and to trade-offs among the various Lisbon targets, came down decisively in favour of growth: 'there is a need to give higher priority to growth, because it is the means to achieve the economic, social and environmental objectives of the enlarged Union. Growth is also crucial to help the Union fulfil its political objectives' (Sapir, 2003, p. 124). And the way to achieve that growth was essentially to learn from US experience:

> The main reason for disappointing growth in the EU is quite clear. During the past decades, the economy has been confronted by a series of long-lasting shocks – the information technology revolution, German re-unification, the opening up to the new market economies of central and eastern Europe, globalisation – which called for new organisational forms of production. The situation demanded less vertically integrated firms, greater mobility within and across firms, greater flexibility of labour markets, greater reliance on market finance and higher investment in both R&D and higher education. In other words, this required massive change in economic institutions and organisations, which has not yet occurred on a large scale in Europe. (Sapir, 2003, p. 123)

As will be seen below, the Sapir report could be taken as forecasting the actual evolution of the Lisbon strategy towards an essentially economic programme in the tradition of EU since its inception. Other targets were to be made possible by achieving growth, while growth itself would follow from market-oriented integration. It was suggested therefore that some temporary sacrifice of other priorities, such as 'cohesion', would in the longer term be rewarded by more abundant resources to sustain the ESM. An appeal was made in this context to the experience of the post-war decades, when high growth rates went together with social progress. But, since the report also recognized that the nature of the growth process had changed and since it advocated economic policies very different from those of the *trente glorieuses*, it is not clear that such a comparison was relevant.

5.4 REASSESSING THE SOCIAL AGENDA

The Social Agenda was revisited by a group of experts (European Commission, 2004b). Following the Barcelona Council, the group defined the ESM thus: 'The European social model is based on good economic

performance, a high level of social protection and education and social dialogue.' It was recognized that 'since the creation of the European Communities, social policy has always been lagging behind economic policy' and it was added that 'it is probably one of the major achievements of the Lisbon Strategy to try to put them on an equal footing'. This seems an optimistic judgement both because the constitutional structure of the EU privileges the economic and because the social content of the post-Lisbon epoch is still to be demonstrated.[3] The group endorsed the view that 'the social model functions as a productive factor':

> Three key compromises can be detected within the social model: between the state and the market; between labour and capital, requiring concerted action and a role for nationwide agreements; and between the welfare state and individual responsibility.
>
> In the 1960s, the conditions were excellent, with strong economic growth and low inflation. There is also a high level of training of the labour force. As a consequence, there was confidence in public affairs as well as in individual rights. Law and collective bargaining fulfilled a key role, the latter one through a truly credible commitment between employers' and workers' representatives. The strength of the European Social Model was determined by the way in which competitiveness, solidarity and mutual trust interacted.
>
> However, since the 1970s this model has become less effective. This is due to the fact that the appropriate conditions are not met anymore. The balance between economic efficiency and social progress has to be adapted to take account of changing economic environment and social context. European Commission, 2004b, (pp. 27–8)

Three challenges to the ESM were specified: enlargement, population ageing and globalization. These were said to necessitate a certain modification of the Lisbon agenda in the following ways:

- To put more emphasis on the employment possibilities of the service sector as a whole, rather than on the potential of the ICTs;
- To address demographic issues by longer working lifetimes (the target of five more years was adopted by the Barcelona Council in 2002), immigration and natalist measures ('to allow European couples to have the number of children they desire') centring on improved child-care facilities, parental leave and so on;
- Certain reforms to the Stability and Growth Pact, so that the constraints involved relate more to long-term conditions and less to short-run fluctuations in budgetary positions.

As regards social protection, the group called for this to be financed increasingly out of social income as a whole, rather than labour income;

it called for strengthened social dialogue at all levels; and it asserted that since globalization threatens certain groups in the developed world, "social inclusion must be developed as a policy in itself".

Of specific relevance to financial issues is the position that the group adopted on pensions. As a general framework, it suggested a new intergenerational pact which would address both pension problems and those of young people (insecurity, adverse distributional developments). This proposal was subsequently adopted, at least in principle, by the Commission, although it is still unclear what the content of such a pact would be. Besides the risks traditionally covered by European social protection regimes, the report identified new risks, resulting from globalization, and necessitating 'new securities' which include lifelong learning and 'capital ownership'. Although the latter point was not fully developed, it relates in part to funded market pension schemes. The report argues that the expansion of such schemes is necessary to preserve European ownership of European enterprises:

> Recent developments have proved the great vulnerability of companies whose capital is owned by Anglo-Saxon pension funds or hedge funds. If the EU wants to keep control of the economic centres of decision of its companies, it has to develop European pension funds as well as capital ownership by the workers themselves, which has already developed recently in many Member States in a very rapid and successful way. (European Commission, 2004b, p. 29)

This tied the social agenda very closely to financial integration and its consequences. The rapid growth of institutional investors became a way of limiting external ownership and at the same time of providing a new, asset-based, security for workers. The linkage calls for at least two comments. On the one hand, the transition from 'insider' to 'outsider' investment systems, together with privatizations financed by stock market flotations, has been so far the basis for a new heightened penetration of US pension funds into the ownership of European companies, for instance in France. On the other, if a 'new security' is to be based on the individual possession of financial assets, what needs to be said about the distribution of such assets among the insecure?

After this report, the Commission itself published a brief review of the Social Agenda in February 2005. For the most part this dealt with employment issues, and the expansion of employment was still seen as the main weapon against 'exclusion'. The issue of poverty was handled in a more cursory fashion – there was to be a 'European year of combating poverty and exclusion' in 2010. An attempt would be made to focus such EU-level instruments as did exist (above all the European Social Fund) on the priorities of the agenda, but in general the Union could only

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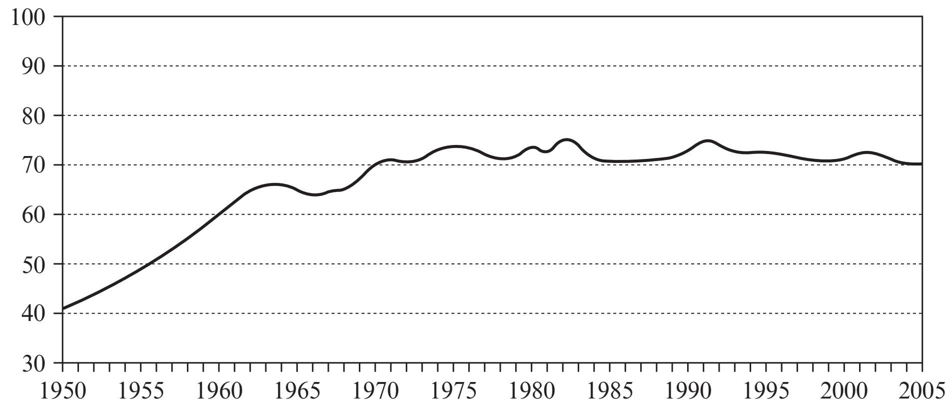
deploy the Open Method of Coordination (OMC) in the field of social policy, that is, it could only encourage, not determine, certain lines of policy because member states retained control in this field. Here, the aim was to stimulate improvements in the minimum income programmes of the member states, which was certainly the only logical approach within the existing constitutional and budgetary constraints, but it is extremely difficult to assess progress in counteracting poverty because few data are available since the launch of the Lisbon agenda. The Commission (2005b) noted that, 'at the start of the decade, the number of citizens of the enlarged EU who were at risk of poverty and persistent poverty was very high: 15% and 9% respectively'. (These data seem to refer to the 15 member states at the time – such data as are available suggest that the corresponding levels in many new member states are rather higher.) The document did make the judgement that 'many people are still in considerable difficulties and are obtaining neither employment nor the national minimum income protection'. In view of this, 'from 2005, the Commission will begin consultations on the reasons why the existing schemes are not effective enough'.

It should be noted in this context that, while the employment component of the Social Agenda was closely linked to the Lisbon growth objectives, this was not as true of the anti-poverty component since the measure of poverty applied is relative, some 60 per cent of median income. (This use of the median is perhaps significant – it means that measured poverty rates are not sensitive to widening inequalities in the upper half of the income distribution, such as might follow from higher rewards for highly qualified workers or for successful entrepreneurs.) The Commission vehemently denied that the goal of poverty eradication had been ditched, but, as yet, it is impossible to see what effect that goal has had on social outcomes.

5.5 THE KOK REPORT

The High Level Group chaired by Wim Kok (2004) was clearly responding to what was, by the time of its convocation, something of a crisis in the Lisbon agenda.

After a recapitulation of the original Lisbon programme, the High Level Group acknowledged that it had been framed in the climate of 'irrational exuberance' which had characterized stock markets around the time of its formulation: 'The Lisbon strategy is sometimes criticised for being a creature of the heady optimism of the late 1990s about the then trendy knowledge economy, neglecting the importance of the traditional



Source: Commission services, 2004–25: forecasts

Figure 5.5 European productivity relative to the US

industrial strengths of the European economy......... this is a fair criticism' (Kok, 2004, p. 9 with the omission of a quite unnecessary qualifying clause).

But things had gone wrong. Like most other commentators, the Group emphasised the failure to meet growth and employment targets, but they also mentioned failure to meet environmental objectives. To some extent these problems resulted from contingencies – the US downturn and so on – but the main factor had been 'a lack of commitment and political will', compounded by 'incoherence and inconsistency, both between participants and between policies' (Kok, 2004, p. 39–40). Neither the OMC nor the Community Method has been working properly.

Were European macroeconomic policies in any way responsible for the failure of Lisbon? The Kok report asserted several times the need for 'a wider macroeconomic framework as supportive as possible of growth, demand and employment' and in this sense endorsed the planned revisions to the Stability and Growth Pact (SGP). The perhaps Aesopian reference to macroeconomic issues repeated that the problem was that insufficient surpluses were built up in periods of high economic activity; however, it is difficult to see which period could have been meant because the 1990s were not a period of boom but were in fact dominated by the struggle to meet the Maastricht criteria.

Lisbon, however, remained indispensable because of the deep and manifold challenges faced by the EU and the ESM. The Group insisted that 'The Lisbon strategy is not an attempt to become a copy-cat of the US – far from it; Lisbon is about achieving Europe's vision of what it wants to be.' However, the US remained the key external reference and

provided the metric of success and failure, for example in terms of labour productivity (Figure 5.5).

Although, as with most recent assessments of Lisbon, the original agenda was seen as too complicated, the Group insisted that its revision should maintain the scope of the original version, including its social and environmental dimensions. Thus five priority areas were specified:

- Innovation and the knowledge society
- The internal market (including financial markets)
- The right climate for business (including risk capital)
- An inclusive labour market
- Sustainable development

It will be shown below that in practice the revised agenda was rather narrower than this but it can be noted already that the Group, although they listed the 'eradication of poverty' (together with the application of the OMC to social protection) as a component of the original agenda, did not address in their recommendations this most striking and ambitious goal of the Lisbon enterprise. This silence might be taken to imply that the goal was seen as unrealistic or the social agenda as too crowded. The Group repeated, very reasonably, that higher levels of employment would work to reduce poverty; their main recommendation on 'inclusion' was to reinforce the European Employment Strategy. But apart from labour market policy the only proposals in the 'social' sphere concerned 'life-long learning' and 'active ageing' – policies aimed, respectively, at improving employment outcomes and at containing pension costs.

On financial services, the Kok Group repeated that 'dynamic and highly competitive financial markets . . . are an essential driver of growth in all other sectors of the economy and must be a cornerstone of efforts to boost the EU's economic performance.' (Kok, 2004, p. 26). This led to an endorsement of the FSAP, of its extension to integrate clearing and settlement systems and of a further drive for integration in the field of retail finance. The report was, of course, a stimulus to policy discussion rather than an academic treatise but the expression 'essential driver of growth' might require both some qualification and some evidential support.

On risk capital, the Group repeated the standard analysis that there is 'insufficient mobilisation of capital' to sustain entrepreneurial activity, but added that 'investors in Europe should be more encouraged to commit to long-term involvement in start-ups'. This view marked a certain distance from the US model where it is, on the contrary, not long-term

commitment but the prospect of early exit via an IPO which is often seen as an indispensable incentive.

The Group went on to endorse the general process of financial integration, but again with a slight change in emphasis:

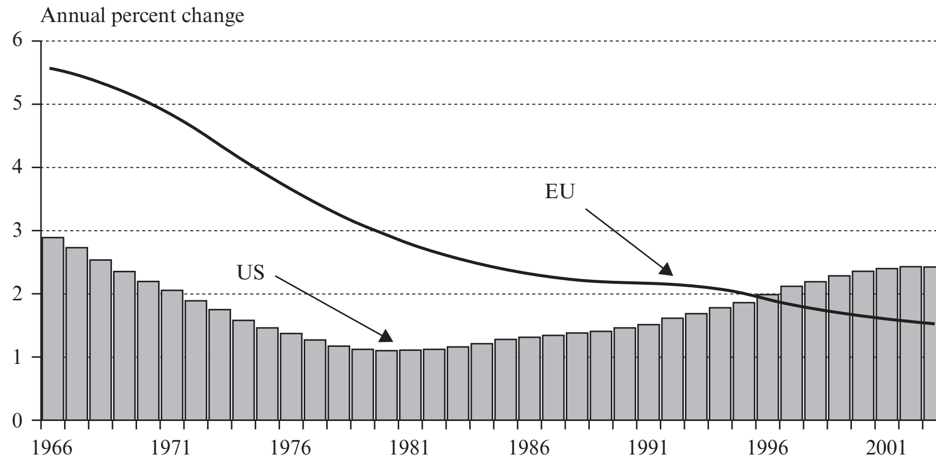
> Equity markets and funds remain fragmented and below their critical size. As a consequence, the risk run by funds and private investors is unnecessarily increased as exit strategies are blocked. This in turn leads to lower investments and to Europe missing out on many opportunities. Therefore, the whole chain of creating worthwhile opportunities and assuring investment in them needs to be reinforced, linking funds, companies, industry and universities. (Kok, 2004, p. 30)

The suggestion here seems to be that financial integration would lead to more liquid markets and, because this would permit dealing on a larger scale, to bigger institutional investors better able to diversify risks and rebalance portfolios. Thus we see the benefits of the FSAP and the RCAP defined, in a very realistic way, in terms of scale benefits rather than in terms of more intense competition or enhanced allocative efficiency. (Note that the reference to 'exit' in the second quotation sits somewhat uneasily with the 'long-term involvement' of the previous one.) But the new stress on the innovation 'chain' as a whole and on communications among all the actors seemed to reduce the usual emphasis on finance and financial markets.

In a further shift, one subsequently endorsed by Commission President Barroso, the public sector and public finance appeared as key supporters of start-ups and innovations: 'Financial and public institutions offering different financing instruments supporting a specific policy objective, such as privileged loans, grants or subsidies, could cooperate better to make it easier for companies to locate the appropriate funding and to make use of the opportunities offered.' (Kok, 2004, p 30). (If, *per impossible*, these public participations gave rise to ownership rights, this would represent a somewhat surprising ideological departure; see Holland (1972) on 'the state as entrepreneur'.

Overall, the Kok Group went farther than other commentators in the attempt to rescue the Lisbon agenda as a strategy combining employment and growth objectives with ambitious ecological and social targets. They endorsed the intention 'to embed Europe's commitment to social cohesion and the environment in the core of the growth and jobs generation process so they are part of Europe's competitive advantage' (Kok, 2004, p. 16).

But their analysis went along with a general drift towards seeing growth and employment as the means to these other ends: these are the 'key priorities'.



Source: Kok (2004, p. 16)

Figure 5.6 Productivity per hour in the Us and the EU

5.6 THE PRODUCTIVITY GAP

What is the exact nature of the emerging productivity gap between the EU and the US? The aggregate data often referred to in the Lisbon literature are illustrated in Figure 5.6, from the Kok report.

A study by O'Mahoney and van Ark (2003) permits an accurate disaggregation of the productivity gap. In country terms, three quarters of the productivity slowdown in the EU can be attributed to two countries: Germany and Italy, 'with Germany about twice as important as Italy'. Thus what is often presented as a Europe-wide problem is in fact dominated by events in this single member state, which might therefore be accorded a priority position in analysis.

In terms of sectors, the study used three interrelated classifications: in terms of technology, labour force skills and innovation. Results are summarized as follows:

— *US productivity growth acceleration, EU unchanged or declining.* Industries that are ICT producing manufacturers or intensive users of ICT, employ graduates or lower intermediate skilled labour, and where innovations arise through specialized suppliers, supplier based innovation and are provided through demands of clients.
— *EU productivity growth relatively high, little or no US acceleration.* Industries that are ICT-producing services, employ highly skilled craftsmen (higher intermediate skilled labour) and/or where innovations are largely process changes arising from in-house R&D.

— *Relatively low and declining productivity growth in both the US and EU.* Industries that neither produce nor intensively use ICT and employ mostly unskilled labour (pp. 12–13).

Of course, a sectoral analysis of the productivity gap is not the same thing as a sectoral explanation. There may be, and most probably are, economy-wide factors in the EU or in the US which have played a part in the differential performance of various sectors. But the phenomenon under study does seem to relate to a very specific aspect of technological development and technology diffusion over a relatively short period of time. The time period may even be too short to justify strong policy conclusions, but to the extent that it does we are confronted essentially with an *investment* problem and responses might be sought in a close analysis of the determinants of ICT investment.[4]

Connections between these investment issues and the broad themes of European employment policy are complex. There are certainly education and training issues, but the pertinence of 'flexibility' in the sense of atypical contracts is questionable. A recent sectoral study of productivity growth and employment factors finds no connection whatsoever – the high-performance sectors tend to employ full-time, prime-age male workers on permanent contracts and could therefore be said to be as far away from the 'flexible' labour market as it is possible to go (Anderson et al., 2006).

In any case, the productivity gap, as the core phenomenon behind much of Lisbon's economic prescriptions, does not seem to admit of a detailed analysis which would support the key themes that were adopted. In general, the drastic slowdown of the US economy in 2008 also calls into question the supposed structural superiority of the American model, while the massive disturbances in financial relations at the same time must qualify, in particular, the enthusiasm for US financial practices which inspired the Lisbon agenda.

5.7 BRITAIN AND THE INCLUSION INDICATORS

A simple point should be made about the various indicators of social exclusion developed in the context of Lisbon. This is that the UK (often accompanied by Ireland) displays particularly bad performance across virtually all the measures available (see Table 5.1).

The general picture is that Britain (and Ireland) exhibit inequalities and levels of social disadvantage similar to those of Spain and Portugal, in spite of significantly higher levels of income, and that these two countries

Table 5.1 Social indicators for Britain and other EU countries

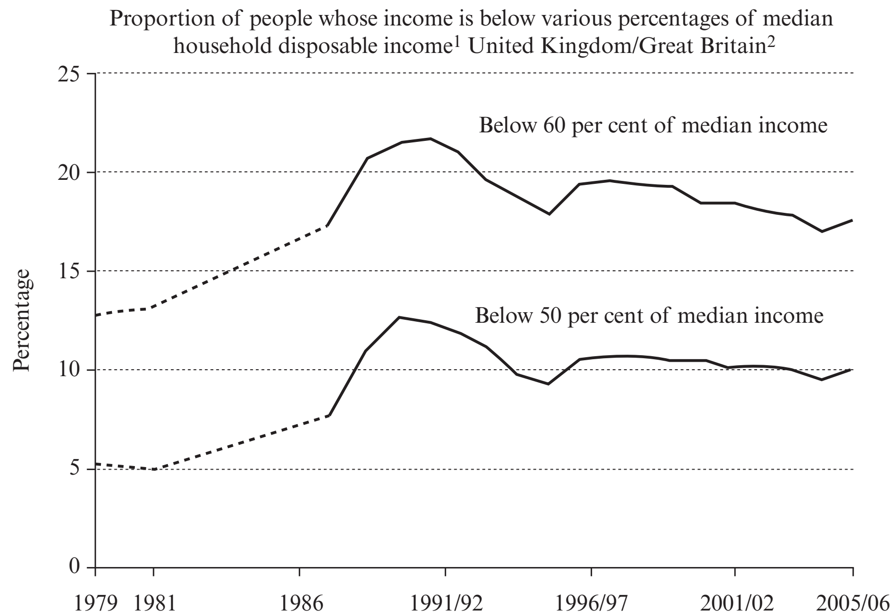
Indicator	EU-15 Average	United Kingdom	Notes
Percentage of population at risk of poverty 2001	15	17	UK level exceeded by Ireland, Spain, Italy, Greece, Portugal
Percentage of children at risk of poverty 2001	19	24	UK level exceeded by Ireland, Italy, Spain, Portugal
Percentage of 65+ population at risk of poverty 2001	19	24	Higher figures only in Ireland, Portugal, Spain, Belgium
Income quintile ratio S_{80}/S_{20} 2001	4.4	4.9	Exceeded by Greece, Spain, Portugal
Gini coefficient 2001	n.a.	31.0	Exceeded by Portugal, Spain, Greece
Percentage of children in jobless households 2003	9.8	17.0	UK highest in EU-15
Long-term unemployment rate 2002	3.0	1.1	UK bettered only by Sweden, Austria, Netherlands, Luxembourg, Denmark
Early school leavers not in education or training (%) 2003	18.1	16.7	Figures higher only in Portugal, Spain, Italy

Source: European Commission (2003c)

therefore represent somewhat retrograde social systems among those of Northern Europe. This pattern occurs in spite of relatively low unemployment rates, which might be thought to be a counteracting influence.

In most discussions of financial reforms, on the other hand, Britain (with Ireland, which was historically a subordinated region of the British economy) is seen as a pioneer – approaching much more closely the US structures and practices which provide the model for the financial integration programmes than do other member states. This is hardly a coincidence – it is the actual functioning of the market mechanisms celebrated as the economic dimension of Lisbon which generates the ‘exclusions’, that is to say, the inequalities which are recorded in the Lisbon indicators.

It must be added that the New Labour government in Britain made strenuous efforts to square this circle, essentially by major programmes of tax credits aimed at children and low-paid workers. It is perhaps a little



Notes:
1 Contemporary household disposable income before deduction of housing OCED equivalisation scale.
2 Data for 1994/95 for Great Britain only.

Source: Office for National Statistics (UK), *Social Trends*, 2008

Figure 5.7: Poverty indicators for Britain

early to judge the success or otherwise of these programmes, but recent data suggest that, together with rising employment, they may have helped to stabilize the percentage of the population falling below the usual EU poverty threshold (60 per cent of median income) (see Figure 5.7).

However, to the extent that wealth becomes a factor of increasing importance in social and economic outcomes, the trend in Britain seems to be adverse (see Table 5.2).

Notice the continued deterioration under New Labour. As wealth inequalities are translated into socio-economic inequalities of all kinds the New Labour tax credit programmes may be running hard to stand still.

5.8 THE MOVE TO A NARROWER AGENDA

Commission President José Manuel Barroso (2005) offered a condensed account of the New Lisbon agenda. Firstly, the general failures of the

Table 5.2 Wealth inequalities in Britain

	Distribution of wealth in UK (%)				
	1975	1986	1991	1996	2001
Most wealthy 1%	21	18	17	20	23
Most wealthy 25%	71	73	71	74	75
Most wealthy 50%	92	90	92	93	95

Source: Office for National Statistics, *Social Trends*, 2003[168]

first five years were acknowledged in a reasonably frank way. As the Kok report indicated, Europe had, if anything, moved further away from becoming 'the most competitive and dynamic knowledge-based economy in the world' in that it now confronted not only a continuing gap vis-à-vis the US but also the dramatic transformations in India and China. The main problem, however, was in implementation:

> While many of the fundamental conditions are in place for a European renaissance, there has simply not been enough delivery at European and national level. This is not just a question of difficult economic conditions since Lisbon was launched, it also results from a policy agenda which has become overloaded, failing co-ordination and sometimes conflicting priorities (Barroso, 2005, p. 5).

Yet the programme remained valid. 'We need a dynamic economy to fuel our wider social and environmental ambitions.' Failure to resurrect the strategy would involve 'the costs of non-Europe' which 'have been substantiated through a large volume of academic evidence.' (It was added immediately, and very correctly, that 'one can argue with the figures.') (Barroso, 2005, p.6).

The rebirth of Lisbon was sought through a sharper focus on central objectives, essentially on jobs and growth, and the strategy was given an alternative name, 'Partnership for Growth and Jobs' .Political obstacles were to be overcome by mobilizing 'support for change'. 'Everyone . . . and at every level must be involved in delivering these reforms'. (Barroso, 2005, p.7). Procedures and reporting had to be streamlined. One measure that was taken was to simplify the policy guidelines issued by the Commission. These now cover several years, and the economic policy and employment policy guidelines have been compressed into a single document, although the latter move may only serve to further subordinate employment standards to economic imperatives.

Thus, the core economic and employment objectives were given complete

priority. For example, completion of the internal market again moved centre stage. The ambition of the revised social agenda, to use the Open Method of Coordination to promote minimum income systems, although not repudiated, was absent from this document; the 'modernization' of social protection seemed only to signify improved employment incentives and pension schemes which encourage a longer working life. In this way, broader social (and environmental) objectives were in practice subordinated to the traditional economic programmes of the EU, with the reassurance that economic success would permit these wider objectives to be reached. One might question both the assumptions on which this reassurance rested: firstly, the assumption that the proposed economic reforms would indeed lead to more growth and employment; and secondly, the assumption that economic policies of the kind envisaged would be compatible with the values and outcomes required for the European Social Model.

In fact, economic performance in the EU improved a little after the midpoint of the Lisbon strategy in 2005, but it is by no means clear that this was due to the Lisbon measures. The report prepared by Iain Begg (2007) for the European Parliament, although generally sympathetic to the Lisbon agenda in its revised form, finds no link between the Lisbon measures and the limited economic upturn and warns of a serious imbalance among the EU economies, with German employment recovering via increased exports which put pressure on its neighbours.

On the specific issue of finance, however, the long reconsideration of Lisbon does seem to have led to a certain demotion. This can be seen in two fields. The optimism of Lisbon (and of the early FSAP) that the emergence of big European institutional investors would provide a solution to pension problems seems to have been silently abandoned. The key measure now is to extend working life with, as supporting policies, the promotion of both immigration and fertility. This shift has at least the merit of making declared policies somewhat more logical. The 'modernization' of pension systems is still called for, but, to the extent that the ambiguities of EU language can be penetrated, this term seems increasingly to refer to parametric changes to existing systems rather than to a rapid privatization of provision (see Chapters 9 and 13). Of course, it remains the case that serious reductions in public provision would in themselves drive people towards market-based pensions, but the latter are no longer painted in such rosy hues as in the past.

Secondly, there was a similar switch in emphasis as regards risk capital. The Lisbon target of much higher R&D spending (3 per cent of GDP) was repeated, but rather less was said about the organizational forms of risk capital. Instead we have a somewhat ironic reorientation as regards *state aid policy*. At the Stockholm Council, this was still anathema: '*State aid* in

the European Union still accounts for more than 1% of GDP. This must be further reduced and the system made more transparent" (European Commission 2000c – presumably the figure given excludes agriculture). Now it became clear that state aid was to have a new and more positive role in support of R&D and innovation, especially in the SMEs. The Barroso document asserted that, 'starting later this year, Member States, regional and other public actors will have more scope to support research and innovation, particularly by the EU's small and medium-sized businesses' (2005, p.9). Revisions to the code of conduct governing macroeconomic policy seem to support this new approach in that they suggest a slight relaxation of budgetary rules to encourage this type of expenditure. Like the implicit move in pension policy, this shift on R&D cannot be faulted on logical grounds, but it testifies to a certain disappointment with the promise of financial reform as such to dynamize the EU economy.

NOTES

1. The term 'social cohesion' suggests an absence of conflict, which may not be compatible with, for example, a strong movement for a fairer distribution of income or wealth. The other term in standard use in the EU, 'social exclusion', is also problematic. Originally, it had a precise meaning in the context of Bismarckian social protection systems based on labour market participation. Someone without an adequate record of such participation could find themselves excluded from the social protection regime. In other contexts, the term seems to be a euphemism for 'disadvantage' or 'poverty'.
2. Subsequent development of the 'flexicurity' theme permits a more precise interpretation of its meaning to the European Commission. On the one hand the 'security' referred to is *employment,* not *job* security. This is a dubious switch because someone who loses their job and then finds another often suffers substantial reductions in pay and conditions. On the other hand, the broad recognition of problems with the standard 'flexibility' agenda, that is with the multiplication of 'atypical' employment contracts – such as part-time and temporary contracts, 'zero hours' contracts, the use of agency labour, putative 'self-employment' is now used to justify not enhanced protections for the workers concerned but rather a general weakening of standard labour contracts. This kind of reasoning is also being used to support a decisive turn in EU employment policy towards deregulation. For the new official position see the Green Paper on 'Modernising' European Labour Law (European Commission, 2006c). For a critique, see Keune and Jepsen (2007).
3. Most commentators are of the view that this imbalance persists. For example, see Scharpf (1999).
4. It is interesting that O'Mahony and van Ark suggest (2003, p. 11) that the European slowdown is partly related to "moderation in wage growth. . ...during the second half of the 1990s" which may have discouraged the rapid substitution of capital equipment for labour. On this issue see also Kleinknecht (1998).
5. Because of problems in data collection, this table has been dropped from subsequent editions of *Social Trends.*

Chapter 16

Financial markets and social security

The references cited in the text can be found in a list of all references from items 14–18 on page 326.

9. Financial markets and social security

John Grahl

9.1 INTRODUCTION

The increasing salience of financial markets and the rapid growth in many countries of institutional investors channelling household savings onto these markets have been pointed out in earlier chapters. These developments form the background to a political project to transfer responsibility for important welfare functions from the state to the market. The two most important examples are probably health care and retirement pensions. In both cases, throughout Europe, provision today is very largely a public function. But there is a strong drive to limit or reduce public responsibility both for health care and for pensions, and to make households, using private insurance companies and privately managed pension funds, take over a large part of the responsibility. The argument for this kind of change is one aspect of a general assault on public services and social security which tries to call many public goods and social services into question and to privatize broad areas of the public sector.

The present chapter concentrates on the pensions issue. It makes a critical assessment of the moves towards market-based provision in the European Union and of the arguments on which these moves are based. It is suggested that these arguments fail in three key respects: firstly, they are conceptually incoherent in that they do not address the resource issues involved; secondly, they fail to recognize the efficiency of public provision and the inefficiency of most private provision in the field of pensions; thirdly, they promote changes which must aggravate social inequalities and divert resources away from those pensioners most in need.

9.2 THE CASE FOR MARKET PENSIONS

A very significant document in the present debate was a report from the World Bank (1994), which has been very influential in policy debates. The

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argument was that ageing populations would make the present reliance of most Western countries on public 'pay-as-you-go' (PAYGO) systems unsustainable. The ratio of inactive pensioners to the employed population whose contributions provided their pensions was going to deteriorate. The recommended solution was to move responsibility away from the state towards the market: funded pensions, based on the marketable assets accumulated by households through the institutional investors, would compensate for the predicted inadequacy of public provision in the future.

The entire argument rests on a massive *petitio principii*: that the accumulation of marketable financial claims will produce resources which cannot be mobilized through existing public PAYGO pension schemes. As has been frequently pointed out, a financial claim (on the state, on an enterprise or, usually via a financial intermediary, on households) and a public pension entitlement are two logically equivalent devices for transferring current output to the holder of the claim: neither of them as such generates the output in question.

The proponents of pension privatisation thus have to suggest that, in some way, the accumulation of claims in private pension funds will promote the availability of real resources from which tomorrow's more numerous pensions can be paid. Two arguments are made to support such a suggestion, both equally specious.

Firstly, it is argued that the current savings made today by people contributing to funded pensions will raise the rate of investment and thus render the economy more productive in the future. In fact it is impossible to establish any positive relationship between the role of private funded pensions and the level of savings in an economy. Two countries which depend to a very great extent on market-based pensions, Britain and the US, have notoriously low, sometimes negative, rates of household savings (together with serious problems of indebtedness for many households) while in Germany, for example, where pensions are still largely provided through a public PAYGO scheme, household savings are very high – indeed in recent years perhaps too high in that private consumption expenditures have been so low as to restrict employment in the domestic economy.

Of course, the management of savings and investment is a key concern of macroeconomic policy and it may at times be important to stimulate household savings (indeed it would be desirable to do so in Britain to limit the importation of consumer goods and to contain problems of over-indebtedness for low-income consumers). However, there is no evidence whatsoever that the promotion of market-based pensions acts as such a stimulus. In fact, the tax breaks used to encourage people to take out such

schemes, although they are very expensive and a serious burden on public budgets, seem to have the principal effect of merely diverting the savings stream of high-income households from one channel to another.

The second argument from 'demographic crisis' to the need for market-based pensions simply depends on the notion that there are clear limits to public spending on pensions. It is not clear what these limits would be: no evidence exists that higher social security contributions to cover higher numbers of pensioners would be a disincentive either to employment or to savings. From the point of view of the neoliberal project there is, or should be, a maximum level of public spending which it is imperative not to transgress. In reality it is normal, when the proportion of older people in the population rises, to increase the proportion of GDP which goes to older people.[1]

9.3 DEMOGRAPHIC CRISIS AND MORAL PANIC

It has been pointed out that an increase in the proportion of older people in the population raises a question of resources, not a question of financial techniques. But this resource question has been grossly exaggerated. Between the present and 2050, the time horizon in many studies of population ageing, there is enormous scope firstly for a big reduction in unemployment, which would substantially improve the balance between contributions and payments in public systems, and for economic development, which would provide additional income out of which the increased needs of an older population could be met.

According to EU data, on present policies public pension expenditure will increase by more than 5 per cent of GDP between now and 2050 in the following countries: Belgium (5.1 per cent) the Czech Republic (5.6 per cent), Cyprus (12.1 per cent), Luxembourg (7.4 per cent), Hungary (9.9 per cent), the Netherlands (7.6 per cent), Portugal (9.7 per cent), Spain (7.1 per cent), and Slovenia (8.3 per cent) (see Table 9.1).

In the cases of Cyprus and Spain, actual levels of expenditure are well below the EU average and most of what will be taking place is simply a movement towards European norms. Luxembourg has such a small and wealthy population that there cannot be any reason for concern. In the Netherlands, the public sector provides a universal flat rate pension at some 70 per cent of the minimum wage (a pension based on years of residence rather than employment). This is a very successful strategy against poverty in old age and there is a political will to maintain the scheme even though its costs will rise with demographic change. On the other hand, the Netherlands already has bigger private pension funds than any country in

Table 9.1 Predicted pension expenditure as a percentage of GDP

Country	Public pensions, gross as % of GDP								Change 2004–30	Change 2030–50	Change 2004–50
	2004	2010	2015	2020	2025	2030	2040	2050			
BE	10.4	10.4	11.0	12.1	13.4	14.7	15.7	15.5	4.3	0.8	5.1
CZ	8.5	8.2	8.2	8.4	8.9	9.6	12.2	14.0	1.1	4.5	5.6
DK	9.5	10.1	10.8	11.3	12.0	12.8	13.5	12.8	3.3	0.0	3.3
DE	11.4	10.5	10.5	11.0	11.6	12.3	12.8	13.1	0.9	0.8	1.7
EE	6.7	6.8	6.0	5.4	5.1	4.7	4.4	4.2	−1.9	−0.5	−2.5
GR											
ES	8.6	8.9	8.8	9.3	10.4	11.8	15.2	15.7	3.3	3.9	7.1
FR	12.8	12.9	13.2	13.7	14.0	14.3	15.0	14.8	1.5	0.5	2.0
IE	4.7	5.2	5.9	6.5	7.2	7.9	9.3	11.1	3.1	3.2	6.4
IT	14.2	14.0	13.8	14.0	14.4	15.0	15.9	14.7	0.8	−0.4	0.4
CY	6.9	8.0	8.8	9.9	10.8	12.2	15.0	19.8	5.3	7.6	12.9
LV	6.8	4.9	4.6	4.9	5.3	5.6	5.9	5.6	−1.2	−0.1	−1.2
LT	6.7	6.6	6.6	7.0	7.6	7.9	8.2	8.6	1.2	0.7	1.8
LU	10.0	9.8	10.9	11.9	13.7	15.0	17.0	17.4	5.0	2.4	7.4
HU	10.4	11.1	11.6	12.5	13.0	13.5	16.0	17.1	3.1	3.7	6.7
MT	7.7	7.6	8.3	9.0	9.7	10.7	11.7	11.2	2.9	0.6	3.5
AT	13.4	12.8	12.7	12.8	13.5	14.0	13.47	12.2	0.6	−1.7	−1.2
PL	13.9	11.3	9.8	9.7	9.5	9.2	8.6	8.0	−4.7	−1.2	−5.9
PT	11.1	11.9	12.6	14.1	15.0	16.0	18.8	20.8	4.9	4.8	9.7
SI	11.0	11.1	11.6	12.3	13.3	14.4	16.8	18.3	3.4	3.9	7.3
SK	7.2	6.7	6.6	7.0	7.3	7.7	8.2	9.0	0.5	1.3	1.8
FI	10.7	11.2	12.0	12.9	13.5	14.0	13.8	13.7	3.3	−0.3	3.1
SE	10.6	10.1	10.3	10.4	10.7	11.1	11.6	11.2	0.4	0.2	0.6
UK	6.6	6.6	6.7	6.9	7.3	7.9	8.4	8.6	1.3	0.7	2.0
EU-15[1]	10.6	10.4	10.5	10.8	11.4	12.1	12.9	12.9	1.5	0.8	2.3
EU-10.9	9.8	9.2	9.5	9.7	9.8	10.6	11.1	−1.0	1.3	0.3	
EU-12[1]	11.5	11.3	11.4	11.8	12.5	13.2	14.2	14.1	1.6	0.9	2.6
EU-25[1]	10.6	10.3	10.4	10.7	11.3	11.9	12.8	12.8	1.3	0.8	2.2

Note: [1] Excluding Greece.

Source: European Commission (2006b)

Europe except Switzerland (in 2001, pension fund assets amounted to 105 per cent of GDP in the Netherlands as against 66 per cent in the UK and 63 per cent in the US, according to OECD 2005b, p. 24) and so it is difficult to see what a further development of market-based funded pensions could contribute. Portugal does seem to be one case where ageing will give rise to tight constraints. The Portuguese situation is marked by very high degrees of inequality both among pensioners and for the population as a whole; increased spending per head of the older population will be necessary to relieve poverty.

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In general, however, it is clear that there is no emergency. Relatively small increases in public spending on pensions as a fraction of GDP are required, on average from 11.0 per cent to 14.6 per cent over more than forty years; there is no reason, apart from neoliberal ideology, why these increases cannot be made.

9.4 ADMINISTRATION COSTS

There are big economies of scale in pension provision, whether or not this provision involves funding.[2] Governmental schemes, involving the whole employed population and not allowing individuals to opt out, tend to have the lowest costs per euro of pension finally delivered. Occupational schemes, organized on a sectoral basis or by very large employers, have significantly higher costs; schemes sold by institutional investors directly to individuals have the highest costs, and these costs are the higher, the wider is the choice of schemes open to the individual.

From the point of view of an individual customer, the costs of a funded occupational pension scheme can be divided into: accumulation costs (the difference between the returns on the securities underlying the scheme and the returns credited to the individual's account); alteration costs (which must often be met when the individual's circumstances change – for example, a change of employer); and annuitization costs which occur when the individual retires and has to turn the funds accumulated in their account into a regular payment (Herbertsson and Orszag, 2001).

The alteration costs are often very high, representing a distribution away from contributors who change their occupation or employer towards those in more stable circumstances. Although this has been an embarrassing problem for the advocates of 'flexible' labour markets, their preferred solution, to replace occupational by 'personal' pensions chosen by the individual, fails because of the very high marketing costs of the latter. From the point of view of the institutional investor as pension provider, costs can be divided into: acquisition costs (costs of acquiring new business, essentially marketing costs); administration costs (costs of administering individual accounts); and asset management costs as such (portfolio purchase and alteration). It is the first two of these which dominate the supplier's costs, with 'acquisition' or marketing costs being particularly onerous for 'personal' schemes.

A typical personal pension in the UK absorbed 40 per cent of the individual's contributions (Murthi et al, 1999, cited by Herbertsson and Orszag, 2001).[3] It is for this reason that most of the personal pensions marketed in the UK in the 1980s were later declared to have been mis-sold and

the institutional investors who were responsible were made to compensate their customers.

9.5 WEALTH INEQUALITIES

There are three broad principles according to which pension income can be distributed. There can be, firstly, distribution according to *citizenship* or, in practice, *residence*. This is the most egalitarian approach, and the most developed example is perhaps the basic component of the public pension in Denmark. Although at present only relatively limited schemes, of course in the public sector, function in this way, there are strong arguments for a move in this direction to reduce inequalities and simplify the working of social security systems.

The second distributional principle, which has been predominant in continental European countries up to the present, is *earnings-related*. Pensions calculated in this way depend on wages while in work (and often on years of employment). These systems aim to maintain the broad pattern of wage distribution among the employed population into retirement. They are obviously considerably less egalitarian than flat-rate pensions and may tend to perpetuate the injustices of working life into the years of retirement, in particular as regards women's pensions. For this reason earnings-related systems can be modified in favour of lower earners or to take child care and care of the elderly into account as well as employment records. Most such systems work on a public sector PAYGO basis, which facilitates this redistributional objective, but many pre-funded occupational schemes also correspond essentially to the 'earnings-related' principle, especially where they are 'defined benefit' schemes, that is where they guarantee a certain pension in function of years of contribution; the guarantee is usually expressed as a fraction of earnings in employment.

The third possible principle characterizes 'personal' pensions but also, to an increasing extent, other private-sector pensions, such as the defined contribution schemes operated by many employers. This is simply to pay pensions in function of the accumulation achieved by the individual, that is, in accordance with their *wealth*. This is a radically inegalitarian approach since, in all countries, the distribution of wealth is extremely unequal, much more so than the distribution of earnings. One's ability to acquire wealth depends on how much wealth one already has and on the amount of savings one can devote to further accumulation – those with high incomes can save many times more than those with average incomes while, for the lowest income groups, saving may be practically impossible

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Table 9.2 Distribution of wealth in selected countries (c. 2000)

	Share of wealth of richest 1%	Share of wealth of richest 10%	Percentage of households with zero/ negative net worth
Canada	15%	53%	20%
Finland	13%	45%	15%
Germany	14%	54%	19%
Italy	11%	42%	3%
Sweden	18%	58%	27%
UK	10%	45%	11%
US	29%	67%	17%

Source: (Sierminska et al., 2006) Luxembourg Wealth Study

and no wealth at all can be accumulated. This is certainly the case today as regards market-based pensions.

All studies of wealth distribution testify to massive inequalities. For example, a very recent study (Sierminska et al., 2006) attempts to produce comparable measures for seven countries (see Table 9.2).

The data in Table 9.2 specifically exclude pension entitlements, but this only reinforces the point. Even social-democratic Sweden is characterized by extreme inequality in the distribution of wealth. In Europe, especially in Scandinavia, these inequalities are mitigated by pension entitlements based on residence, on earnings and, for those without resources, on need. To the extent, however, that market-based pensions displace public PAYGO schemes while collective provision gives way to purely individual responsibility, pensions will become a simple corollary of personal wealth – inadequate except for a privileged minority.[4]

9.6 RISK AND THE MOVE TO DEFINED CONTRIBUTION

The social security systems which were built up over the twentieth century are not only effective systems for the redistribution of income. Quite apart from their redistributive aspects they are extremely efficient systems for insurance against risk. Many of the risks which can be routinely covered by public social security systems are either impossible or very expensive to insure via financial markets (Barr, 2001). This is true, for example, for

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such risks as unemployment, chronic sickness or the need for intensive care in old age. Information problems, non-diversifiable risks, externalities and other difficulties frequently obstruct market-based approaches to many of the risks which confront people in their everyday lives.[5]

Market-based pensions, pre-funded from the accumulation of securities, are subject to two main risks. Firstly, there is the danger that the pension provider – whether an employer sponsoring a pension scheme for their workers, or an institutional investor selling pension schemes to individuals – might become insolvent: there have been numerous recent cases in Britain and the US. It is interesting that the response of the authorities has been to intervene and to regulate, in Britain for example by compelling providers to contribute to a state-run system to refinance insolvent pension schemes.

The second risk is that the assets accumulated in the fund will prove inadequate to pay the pensions required, either because the net return on the investments is too low, or because very low interest rates make it costly to turn an accumulated pension account into a regular ('annuitized') pension. In principle this risk can be insured against on the market – insurance companies in particular may offer long-term savings plans with a guaranteed pay-out. These tend, however, to be very expensive so that most individuals buying pension products opt for 'defined contribution' rather than 'defined benefit' schemes, meaning that it is the contributions rather than the final pension pay-out which is fixed.

Until recently, however, private pensions with a somewhat more collective character – those organized on a sectoral basis or by large employers – tended to be on a defined benefit basis, where members of the scheme were guaranteed a certain pension, usually in function of their earnings at work. Thus the risk that pension funds' assets would not cover liabilities was assumed by the sponsor of the fund, whether an employer or an institutional investor. This corresponded to a situation where occupational pensions were essentially perceived as deferred wages – as arising from the employment contract (often subject to collective bargaining).

In recent years there has been a wholesale flight from 'defined benefit' pension provision. Particularly in the US and in Britain, where employer-provided pensions were of great significance, employers began to close defined benefit pension schemes and replace them with defined contribution schemes. The employees concerned usually lost out in two ways: firstly, they had henceforth to carry all the risks of the security markets in which their pension funds were invested; secondly, they usually faced a straightforward decline in provision since employers cut back their payments into the new funds.

This was essentially equivalent to a cut in wages – the rewards offered

to employees were reduced. Clearly these moves by employers were made possible by a decline in the strength of organized labour. At the same time, however, the widespread refusal by employers to accept pension fund risks demonstrated how important the risks were that could not simply be diversified away across security markets; to the extent that diversification can eliminate risk any sizeable pension portfolio can do so. But, after diversification, systemic risk (that affecting all securities) remains, and it is clear that this risk was substantial. To cope with systemic risk is a public function since only governments are in a position to defend pension entitlements in the face of a generalized decline in investment returns.

9.7 EU PENSION POLICY AND THE OCCUPATIONAL PENSION DIRECTIVE

Although EU leaders were clearly dazzled by the rapid rise of equity prices (especially for high-tech stocks) when the Lisbon agenda was being defined in 2000, it has not been possible for them to promote pre-funded pensions, based on the security markets and delivered by the institutional investors, as a plausible response to pension problems in the EU. The difficulties with such an approach were too great: even if a switch to pre-funded pensions were brought about, no resources would thereby become available to meet future pension needs; the costs of market-based pensions might well be prohibitive, especially for low-income groups; reliance on such pensions would clearly have extremely adverse distributional consequences, incompatible with the European Social Models; and the risks involved for those with limited resources were obviously excessive.

Nevertheless some significant moves have been made in that direction. In Germany the Schröder government introduced a market-based, funded element into the state system, but this remains predominantly a PAYGO scheme. A very small funded element has recently been introduced into the Swedish scheme. In Britain, where many pensions are very inadequate, a new funded scheme, based on employers' and employees' contributions is planned. Originally this was to be operated by a new central agency but pressure from the institutional investors prevented this. However, the most important reform in Britain was the recent decision to strengthen the basic state pension by linking it to the growth of incomes, not just the rise in prices.

In practice, the main reforms taking place are *parametric* changes within public PAYGO systems rather than moves away from these systems. The key parameters here are: the age at which pensions become payable (or the number of years of labour market participation required for eligibility); the

contribution rates levied on employers and employees; the level of pension subsidy from general taxation (or the level of pension surplus appropriated by the government); and the generosity or otherwise of pension provision. It is very important that the parametric changes which are used do in fact improve the position of the disadvantaged pensioners. This is not in general the case for increases in the age at which pensions become payable except perhaps in some southern European countries where the age of retirement has been very low for specific occupational groups. This is firstly because the life expectancy of the poor is often much lower than that of the rich and so even this apparently technical adjustment may aggravate social injustice. Secondly, the activity rates of older workers, especially the lower paid and more disadvantaged ones, are very low and if their pensions are delayed many of them will be unemployed or compelled to remain in very poor jobs. An important 'parametric' resource which is insufficiently used would be to reduce the tax breaks given to high-income groups with private pension schemes.

Thus, although many EU leaders might well have desired a thoroughgoing market approach, they realized that this was impractical. They did try to develop a European pensions market in the Directive on Occupational Pensions which was adopted in 2003. However, it was never very likely that this market would grow rapidly to any significant scale. At the same time therefore the European Commission developed a somewhat different approach, which might be regarded as a surrogate form of prefunding. The main emphasis today is less on replacing public by private provision, but rather more on 'strengthening' the public finances so that higher rates of public expenditure in the future can be accommodated without a big increase in tax revenues. To this end, member state governments are urged to run budget surpluses, so that it will be easier to run deficits to cover the future peak in age-related spending. The Commission (2006b) now writes:

> The Stockholm European Council outlined a three-pronged strategy to tackle the budgetary implications of ageing populations:
> – Member States should reduce public debt levels at a faster pace;
> – Member States should undertake comprehensive labour market reforms, including tax and benefit systems, in order to achieve higher employment rates, in particular among older workers and women;
> – Member States should undertake appropriate reforms of pension systems in order to contain pressures on public finances, to place pension systems on a sound financial footing and ensure a fair intergenerational balance.

This approach has at least the merit of recognizing that pension provision is and must remain essentially a public responsibility. It has, however, several demerits.

Firstly, public finance objectives are laid down with no consideration of their macroeconomic consequences. Any large or rapid tightening of budgetary policy is likely to have a negative effect on employment and thus undermine the attempt to increase the ratio of the active to the inactive population. Secondly, the dogmatic repetition of the demand for 'comprehensive labour market reforms' ignores the tendency of these 'flexibility' measures to increase inequalities. As has been suggested throughout the present discussion, the real problem of pensions in Europe is basically one of inequality rather than demographics: pensioners in general are not a disadvantaged group, but there are very many poor pensioners. Measures designed to increase employment by imposing lower wages and economic insecurity on the most vulnerable sections of the workforce will make this situation worse. Thirdly, to the extent that there is a demographic problem, it is quite logical to finance the associated expenditures in part by government deficits and thus avoid a sharp fluctuation in the total tax burden. Only if a problem continuing over a very long period were anticipated would it be necessary to make a fundamental shift in the budgetary stance, and even then, it would be desirable to make the shift gradually.

9.8 PENSIONS IN THE NEW MEMBER STATES

In many of the new member states of the EU, previously within the Soviet sphere, there have been rapid and dramatic changes in the pension system in recent years. In the Baltic states, in Hungary, Poland and the Slovak Republic very similar market-oriented reforms have been implemented. These involve adding to the existing public PAYGO systems, a second *mandatory* scheme, which is to be fully funded and to operate on a defined contribution basis.[6] The population which is compulsorily insured in this way usually consists of all members of the workforce below a certain age; since older workers have no hope of accumulating significant entitlements they are not required to make contributions.

So far, there are numerous restrictions on the institutions which manage the funds collected by these schemes – their fund management has not yet been opened up to external penetration although this is certainly in the logic of the Occupational Pension Directive. The fact that these new member states retain, for the time being, their own currencies makes it possible for their governments to restrict investment in foreign assets to 30 per cent of the total value of the funds. Initially at least, these pension funds have invested very heavily in the bonds issued by their own governments – which calls their rationale into question: if the assets accumulated

are merely claims on the government why not simply record claims (also on the government) within a PAYGO system? The administrative costs of the second option would be much lower.[7] It is far too soon to evaluate the performance of these new funded schemes, which will not mature and start to pay out significant numbers of pensions for several decades. However, it is possible to point to characteristics of these societies which lead to specific problems for their pension systems.

The structures inherited from the state socialist era, although far from adequate, scored rather high in terms of both coverage and distribution: EU indicators for income equality among pensioners, for replacement ratios and for poverty 'risks' among pensioners have rather favourable values in these countries. These data, however, must be interpreted in light of the low levels of income of the population and the drastic disruption of economic and social life during the 1990s.[8]

Financial problems for social security systems in these countries are very immediate. Although the population is certainly ageing in some of them, the real constraint on their social security systems arises from low employment rates, especially among workers aged over 55 (see Table 9.3). These low rates, in turn, reflect the massive process of deindustrialisation which followed the collapse of the centrally planned economy and the virtual impossibility of reintegrating all those who lost their jobs at that time.

In these circumstances, the move to 'funded' provision, a long time into the future, reflects less a response to long-run demographic problems than an inability to respond to current pressures with systems which historically depended on high levels of employment.

The nearly uniform imposition of radical, market-oriented change by

Table 9.3 Employment rate in selected new member states (ex-soviet bloc)

Employment rate (%) 55–64 years	
Czech Republic	43
Estonia	52
Hungary	31
Latvia	48
Lithuania	47
Poland	26
Slovak Republic	27
EU25	**41**

Source: European Commission (2006b), Technical Annexe p. 33

most of these countries perhaps indicates weaknesses in civil society. The representation of domestic interest groups is weak; the influence of foreign agencies and their 'experts' is more powerful and direct than it would be in Western Europe.

The Czech Republic represents an interesting contrast to the other post-Soviet economies. Its institutional development has clearly been more influenced than that of Poland, for example, by social-democratic experience in Western Europe, and its pension system has been redesigned more along Western European lines than according to the blueprints of the neoliberal advisors whose handiwork is seen across most of the other new member states. Currently the Czech Republic has one of the most effective pension systems in the EU: over 65s at risk of poverty number only 4 per cent; the incomes of over 65s are 83 per cent of those of younger people; and the distribution of pensioner incomes is both more equal than among the Czech population at large and more equal than in most other EU countries. This is not a cheap system – it requires contributions of 28 per cent of payroll – and this has been made possible by an overall economic performance somewhat better than that in other new member states.

9.9 A QUESTIONABLE 'MODERNIZATION'

Many statements of the EU's Lisbon Agenda call for a modernization of the European Social Model. It is impossible to object to modernization in the abstract, but in concrete terms one central meaning of the modernization is usually a shift from public to market-based pension provision. This would not in reality be a modernization of the European social models but an abandonment of one of their defining goals, the security of the European populations in their old age.

It is noteworthy that in the member state where reliance on market provision has gone furthest, the UK, the functioning of the pension system is, by the EU's own reckoning, very weak (see Chapter 10). It is irresponsible, given such results, to promote pension strategies which, in effect, take the UK as a model.

Change in the direction which is advocated by many European leaderships would do nothing to provide more resources for the retired; it would aggravate social inequalities; and it would undermine the economic security of European populations. To the extent that such policies are motivated by a desire to expand the role of security markets in contemporary economic life, they display a confusion of ends and means and a misunderstanding of the role that market finance can play in economic development.

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NOTES

1. The dimensions of the 'ageing' problem are frequently expressed in terms of a 'dependency ratio', that is the ratio of the retired to the employed population. The underlying notion here is some kind of labour theory of value according to which the entire social product would accrue to employees. In fact the share of wages in GDP has been falling for two decades in most EU countries and is now around 60 per cent, with around 40 representing various forms of property income. Obviously this last is in potential an important source of revenue for governments. It must also be recognized that the economically non-active population includes children as well as retired people. The ratio of the active to the non-active population as a whole is much more stable than the ratio of the active population to the retired.
2. It is also true, of course, that PAYGO schemes are cheaper to administer than pre-funded ones, because they do not have to bear the costs of asset management.
3. The Labour administration elected in 1997 attempted to reduce these costs by promoting 'cheap and cheerful' standardized pension schemes, known as 'stakeholder' pensions. They have been successful neither with the public, to whom they offer minimal benefits, nor with the institutional investors, who cannot make much profit out of them.
4. No argument will be made against the accumulation of market-based pensions by the wealthy, as a *supplement* to public schemes. And the role of market-based savings schemes will tend to expand as societies become richer. However, it is neither necessary nor just to subsidize such accumulation out of public funds.
5. Shiller (2003) argues that innovation and technical change in securities markets may make them able to handle more of the risks of ordinary life. But it is significant that many of his examples of successful innovation in covering risks relate in fact to public systems of social insurance, not to the financial markets.
6. The Lithuanian funded scheme is in principle voluntary, but once someone has joined it they cannot leave.
7. No custody costs, very few regulatory or legal costs, no transactions costs, and so on.
8. In Poland, the incomes of people above 65 years are higher (113 per cent) than those of younger people – this is a unique situation in Europe but it relates to widespread poverty among the younger population.

Chapter 17

Finance and the household

The references cited in the text can be found in a list of all references from items 14–18 on page 326.

10. Finance and the household

John Grahl

10.1 INTRODUCTION

Most discussion of regulation in the financial sector identifies two broad motives: stability and consumer protection.[1] The issue of financial stability is dealt with in Chapter 7 above and again in chapter 14; thus the present chapter concerns only consumer protection.[2] It should be noted, however, that sometimes the actual regulatory measures which might be adopted on grounds of stability coincide with those taken to protect the consumer of financial services; for example, measures to maintain confidence in the banking system can serve both purposes.

Information Asymmetries

Much of the mainstream literature on regulation runs in terms of information asymmetries between the suppliers and the users of financial services. The basic notion is that retail consumers, whether individuals, households or small businesses, have much less information about the efficiency, quality and honesty of specific financial service providers than do the providers themselves. If then consumers are unable to discriminate between good and bad services, they may simply distrust all suppliers rather than choosing the best. This limits the market for the service in question; indeed it may, in the limit, prevent any transactions at all. Honest and efficient suppliers are penalized by the activities of dishonest and inefficient ones.

Among the factors leading to information asymmetries is the fact that households may transact much less frequently than the financial companies with which they are dealing – for example, someone may only ever need to arrange one or two mortgages – and this means they are bound to lack the detailed knowledge which will be available to a financial company specialized in the provision of mortgages. The same may well apply to a pension or a long-term savings plan.[3]

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Market Power

Market power may be a further motive for consumer protection measures. Some financial sectors are highly concentrated and this can lead to the exploitation of consumers. And effective market power may result also from information problems when consumers are unaware of the full range of suppliers of a particular product.[4]

Social Inequalities

Both information asymmetries and market power can result in market failure. In terms of mainstream economic analysis they may justify regulation or other forms of intervention to increase the efficiency of the market economy.

However, these narrowly economic motives are not in practice the only reasons for regulation to protect consumers – broad considerations of social justice and equality are also at work. Banks, insurance companies and other financial institutions are often among the richest and most powerful structures in contemporary society and those who own and control them among the richest and most powerful individuals. Limits on the ability of these institutions to profit at the expense of ordinary people and, especially, of the most vulnerable, are therefore seen as necessary in terms of social justice and the legitimacy of the economic system.

Market Regulation versus Public Provision

The view taken throughout this book is that many household needs are better met through public than through market provision. This is, for example, the case for most health insurance. It is also true for most pension needs – the public sector can provide pensions at lower cost, with greater security and in a much fairer way than can the private sector (see Chapter 9). For example, actual pensions outcomes are much less satisfactory in Britain, where there has recently been a substantial move away from state provision, than in France or Germany where the state continues to play a larger role.[5] Thus the arguments below for stronger regulation of market finance are not meant to imply that even well regulated financial markets are superior to state provision – on the contrary.

However, even where the state retains a major role in such fields as pension provision, the market demand for financial services is likely to grow as a result of rising levels of income and the increasing complexity of economic relations. And where private sector provision is extensive it is

important that it works as well as possible, even though more public provision might be desirable.

10.2 METHODS OF CONSUMER PROTECTION

As for financial regulation in general, consumer protection systems exhibit a great deal of diversity across Europe, as a consequence of differences in needs and in types of provision. In recent years, however, regulatory systems have tended to converge to a certain extent. One trend has been a move to cross-sectoral regulatory institutions and away from sector-specific institutions; this might be seen as a response to the increased ability of financial companies to enter different sectors – as when British banks became big players in the mortgage market. A second trend has been a move to more formal rules and procedures; this can be related to the increased openness of some financial activities to competitive entry so that the population of enterprises supplying a given service might be less stable and less susceptible to informal controls.

Both trends can be seen as moving towards the US model of a dominant single regulator in the financial sphere – the Securities Exchange Commission (SEC). In fact, there has been some pressure from the US to converge on this model, at least as far as security markets were concerned, in order to avoid a competitive disadvantage for US security markets (Lütz, 2002). However that may be, unitary regulators have been introduced in Germany, for example, by bringing banking, insurance and security trading regulators under one roof (Fröhlich and Huffschmid, 2004, chapter II, section 1.1), and in Britain where legislation in 2000 replaced a series of sectoral regulators by the unitary Financial Services Authority.

In retail sectors, regulatory change has tended to involve more precise rules governing the description and marketing of financial products (as with the introduction of statutory 'cooling-off periods' during which a customer might cancel a financial agreement without penalty) and the treatment of customer complaints, with a widespread use of ombudsmen to reduce the cost of disputes. But this kind of formalization has tended to focus on procedures rather than on the substantive nature of the financial services which are being sold to the public. The prevalent view has been that substantive restrictions are an obstacle to competition and innovation and a number of such restrictions have been removed – most importantly restrictions on the portfolios of institutional investors such as limits to their placements in certain assets or abroad. Thus stricter control over procedures has accompanied some substantive liberalization

and deregulation. Once again, US practice has often been influential – for example in relaxing specific controls over many of the portfolios managed by institutional investors and substituting some version of the 'prudent man' approach used in the US which simply requires that portfolio decisions are reasonable given the interests of the consumer.

10.3 THE FAILURE OF INTEGRATION IN THE RETAIL SPHERE

The Commission itself has had to acknowledge that the Financial Services Action Plan has not yet brought about much integration in retail finance. Retail markets for banking services, institutional investment, consumption and housing credit and so on are characterized by considerable national variations; branch networks, representing huge investments, are still very important in some of these markets and constitute barriers to the entry of suppliers from other countries. The local knowledge which domestic suppliers possess about customers, about their requirements and preferences and about the risks in extending credit to households and small businesses may be very important and may also represent obstacles to market penetration by foreign financial enterprises.

Thus a Commission report in 2004 finds the highest level of integration among financial institutions themselves, considerable integration in the provision of financial services to non-financial companies, but very little in the retail sphere: some convergence in prices is claimed and the emergence of some new transnational infrastructures (mostly, one expects, in the provision of payment services) but virtually no cross-border establishments by providers of retail services (Frangakis, 2005).

These obstacles to direct market entry mean that financial companies wishing to penetrate retail markets in other European countries may often seek to do so by mergers and acquisitions, by purchasing existing companies. Here again, however, less integration is observed than might have been expected – there are in fact fewer cross-border mergers in retail finance than in most other sectors of the economy, a fact which the Commission deplores and which it brought to the attention of the ECOFIN council in 2004.[6]

A final factor depressing international markets for retail finance may be the recent crises on the stock market and in the banking system and the associated corporate and financial scandals. Many retail investors were inveigled into schemes promising big returns from international placements and may now feel inclined to distrust similar adventures.

However, there may also be some long-run tendencies towards greater

integration: the introduction of the euro must itself facilitate cross-border transactions, and the growing use of the Internet may give rise to new forms of service provision which are less tied to specific countries or localities (for this reason the Commission takes a great deal of interest in e-commerce). There are also, at least in principle, benefits from further international portfolio diversification[7] which can be expected to improve the risk/return characteristics of the investment products offered to households provided that external investors are not systematically disadvantaged by their lack of knowledge or of influence.[8]

The point here is that these are long-run tendencies which may lead to greater integration if countervailing forces do not prove to be stronger. The voluntarism of the EU, which sees integration as the outcome of legislative and administrative commitment has, as so often in the past, clearly shown its limits in the field of retail finance.

10.4 INTEGRATION OF MORTGAGE MARKETS

In 2007, the European Commission's Directorate-General for the Internal Market, which has been responsible for some of the most extreme free market projects launched by the EU, started to push for a full integration of European mortgage markets (European Commission, 2007b). This is a particularly fatuous proposal. It is based on the usual one-sided and exaggerated estimate of the benefits of integration. In fact, since the financial corporations which make home loans already have full access to wholesale credit markets in each other's countries, there is no great need to integrate the retail side of the market. The Commission claims that integration would widen the range of mortgage products available to consumers but such widening might well work to the disadvantage of consumers because it could make for spurious product differentiation and render price comparisons more difficult.

At the same time, integration of mortgage markets would require a convergence of regulatory systems and in practice this would mean a levelling down of standards. Regulation in housing markets, developed over generations in response to the specific social priorities of different member states, would be crudely levelled downwards to permit the interpenetration of markets by the biggest corporate players.

As usual with the D-G for the Internal Market, a simplistic view of US practices inspires ill-thought-out proposals for Europe. Until recently, American mortgage markets were strongly influenced by big quasi-official institutions ('Freddie Mac' and 'Fannie Mae') which allocated mortgage credit with a concern for stability in housing finance and with the social

objective of facilitating access to property ownership for middle-income groups. Naturally no suggestion of similar strong institutions to influence European markets comes from the Commission. Rather, the Commission admires the recent deregulation of US housing finance and proposes to imitate it.

But this deregulated mortgage market, with an unrestricted secondary market in mortgages and mortgage-backed securities was a major factor in the 'sub-prime' financial crisis which has led to the disruption of banking and credit markets around the world. In the housing sector itself, the specific consequences of the crisis include drastic declines in house prices, a collapse of house-building and the subjection of thousands of low-income households to the distress of repossession. In the UK, which has one of the most deregulated mortgage markets, many of the same phenomena can be seen.

The Commission had rapidly to change its tune on these stability issues. In the expert report which was used to prepare the way for the launch of the mortgage market integration drive (European Commission, 2006d, p. 9) it was argued that a strong secondary market in mortgages would necessarily contribute to stability by spreading risk. By the end of 2007 it had to be acknowledged, in the *White Paper* itself, that things were not as simple and that the secondary market in mortgages could involve problems in monitoring debtors. The *White Paper* recognizes that the fact that

> many of the rules which restrict the offering of certain products on a cross-border basis have been designed to protect consumers and/or preserve financial stability. The problems which occurred recently on the US sub-prime market serve as useful reminders of the importance of not taking undue risks with these crucial public policy objectives (European Commission, 2007b, p. 4).

In practice, however, close and detailed regulation of secondary markets would block the move to market integration since it would deter many financial corporations from moving into other member states.

10.5 THE FIN-USE CRITIQUE

It is a sign of the distortion of political processes in the EU that it was only when the FSAP was virtually finished that any systematic attempt was made to consult with the retail users of financial services (households and small businesses) as to the validity of the strategy. One aspect of this belated integration of consumers was the creation of FIN-NET. This

establishes communications among the various member state systems for dealing with customer complaints and if possible resolving disputes between providers and consumers without court action.[9] The objective is to encourage cross-border transactions by making it easier for dissatisfied customers to complain and to seek compensation. The premise of the system is what is usually called 'home country control', that is, each financial institution is regulated in the country in which it is based and this regulation is recognized as valid in each member state in which it operates.

The second aspect of consultation with consumers, the establishment of FIN-USE, a forum of experts representing user interests called exactly this premise into question. What is needed, claimed these experts is 'user home country control', that is a general requirement of a financial institution operating in another country to meet all the regulatory requirements of that country (FIN-USE Forum, 2004). These requirements are not arbitrary but reflect specific user needs, rooted in history, culture and social norms. Such a view leads the users to come close to seeing the FSAP as a whole as a case of regulatory capture, as a series of policies whose essence is to promote the interests of the powerful suppliers of financial services. The four reports on which FIN-USE was asked to comment are seen in virtually these terms, as representing compromises between suppliers and regulators to the detriment of users:

> It is a common feature of the four reports that they fail to discuss the possibility that the creation of pan-European markets in financial services could have negative effects on some users. Yet it is well-known that economic integration has winners and losers even if the overall impact is positive. FIN-USE is concerned that no thought seems to be given to compensating the 'losers' (p. 4).

> FIN-USE is of the opinion that these [national] laws, developed over many years and reflective of the diverse cultures that make up the EU, should not be lightly dismissed. Instead, an empirical case must be made for why the potential benefits of a bigger market outweigh the costs of doing away with existing consumer protection laws (p. 5).

From this position a comprehensive critique of the FSAP is developed. This may leave intact the case for integrating wholesale markets where powerful and knowledgeable actors confront each other, but it completely undermines, on both social and economic grounds, the basic thrust of the FSAP towards regime competition, self-regulation of finance by the financial companies themselves, and the removal of strict rules in the interests of market integration. The box (10.1) of counter-examples offered by FIN-USE is worth reproducing as a whole.

BOX 10.1 BENEFITS OF STRICT PROTECTION LAWS

In order to prevent the sale of 'false' or unnecessary insurance – sometimes combined or 'packed' with legitimate insurance products – consumer protection legislation and case law often guarantees that insurance must provide coverage of risks that the target group actually faces. These same laws specify 'cooling off' periods (i.e., periods during which the purchase of insurance products can be cancelled without penalty) and set maxima for the length of time that buyers must pay insurance premiums.

- In payment systems, some countries have created a right to a basic bank account for all citizens (including over-indebted individuals and those with very low income). In addition, some countries have placed restrictions on the ability of service providers to terminate payment services. These laws presumably reflect a societal belief that access to financial services should not depend only on the ability of suppliers to profit from service provision.
- In securities markets, an increasing body of national law concerns the allocation of risk in particular investment vehicles. The idea is that adequate advice, informed by the individual financial situation of the investor, must be provided.
- Laws against excessive pricing (including, for example, usorious interest rates, excessive fees for unwanted services and excessive penalties for exiting long-term contracts), predatory lending, fraudulent investments have a long history especially on the continent.
- Laws that protect the elderly against fraudulent investment products.

Source: FIN-USE Forum (2004)

10.6 SYSTEM-WIDE PROBLEMS

One point made strongly by FIN-USE is that the massive failures of the US financial system from the dotcom bubble and consequent stock market collapse through such corporate scandals as Worldcom and Enron and

the revelation of widespread fraud and malpractice by institutional investors, financial advisers and security dealers, have not elicited any adequate response from the Commission. It has imitated the US government in calling for more effective auditing and financial reporting by enterprises but has not called into question either the overall working of the financial system or the direction of change towards a wider role for security markets.

However, there is a lot of evidence to indicate that financial problems today are indeed system-wide, and cannot be reduced to the misconduct of individuals or to localized malfunctions. The security-based financial system can be viewed as a series of links, connecting the households which are the ultimate suppliers of financial resources with the corporations which are major users of these resources. Households, often through the activities of advisers or other agents, supply savings to insurance companies and other institutional investors who, in turn, place these funds on secondary financial markets. A host of agents – analysts, credit ratings agencies, stock traders and fund managers, clearance and settlement agencies – are involved in their so doing. Through the interconnection of secondary and primary markets, the valuations established on the secondary markets control the allocation of capital among the corporations in general. A continuous flow of accurate information to the security markets is one necessary condition for these valuations to be meaningful and another host of agents, inside and outside the corporations, are involved in acquiring and transmitting this information – such as financial managers, auditors and accountants. The distributed profits of the corporations then return via the institutional investors to repay and reward the households as providers of funds. The structures of corporate governance, such as boards of directors and management incentive systems, have, as at least one of their functions, the alignment of corporate behaviour with investor interests.

Now, every link in these complex chains has been called into question by the recent development of financial systems. The institutional investors have sold inappropriate savings products to households, often using unscrupulous sales forces whose commissions push up the costs of the products and lower the returns to customers. The same institutional investors have often carried out transactions on security markets which are contrary to the interests of their customers – firstly by failing to make the best possible assessments of the securities they are trading and then by incurring excessive transactions costs which have benefited a range of security market professionals – in both cases to the detriment of their customers. The corporations which were supposed to function in the interests of investors have rather been guided by the priorities of their top

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managements who have creamed off an ever-growing share of company revenues. The professionals – outside directors, accountants, auditors and the rest – who were supposed to control management have failed to do so and have instead been induced by easy money to give free rein to excessive managerial rewards and to the deception of investors.

These considerations apply in general not just to households as investors but also to the other main interactions between households and the financial system, where households are borrowers or users of the payments infrastructure. According to free market doctrines the interests of the households should predominate; in reality their interests are often subordinated to those of the enterprises which supply financial services.

The main response to the scandals and crises of recent years, both by the US authorities and the European Commission, has been to call for more *transparency*, for fuller and more accurate flows of information. In general, this proposal is justified, although a move to very frequent reporting periods may not be an advantage if it encourages a preoccupation with short-run variations in company performance.

More fundamental flaws in the financial structure have to be acknowledged. Firstly, there are many grounds to question the power and autonomy of the modern corporation. Those who promote the drive to enhance the economic role of security markets take it for granted that the markets in which an enterprise functions, together with minimal legal safeguards, constitute an adequate system of social control. Many corporations themselves are starting to recognize the implausibility of such claims, as the increasing discussion of 'corporate social responsibility' makes clear. But the rhetorical tribute paid to social responsibility does not alter the profound gaps in the social control of large businesses, endowed with legal personality; when the maximization of investor returns becomes the only legitimate objective for corporate leaderships then they are sanctioned to disregard or circumvent every social constraint without being effectively subordinated even to the interests of shareholders.

In fact, it has been realized since the 1930s that the emergence of giant corporations brings about a separation of ownership and control which compromises the position of outside investors. (The classic thesis of Berle and Means, the separation of ownership and control, has recently been re-examined and updated by several writers; see in particular, Aglietta and Rebérioux, 2005). Some wish to see in the growth of institutional investors a strong countervailing force to that of corporate leaderships, but the actual functioning of these financial institutions is, perhaps necessarily, centred on the security markets and on the construction and maintenance of portfolios rather than on the monitoring and control of individual corporations. Although pension funds, investment trusts and insurance

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companies will certainly press for transparency from the corporations in which they invest, they are not in a position to exercise close and continuous supervision of the corporations – indeed they would be reluctant to develop close relations with any specific company because this would compromise their ability to trade the securities concerned.

The problematic role of the corporation, then, is one deep factor determining the malfunctions of the financial system. A second is the intrinsic susceptibility of security markets to cumulative waves of rising or falling prices, related to imitative behaviour among the traders active on these markets. Once again, the fact that, today, institutional investors play a very big role on these markets does not change the basic nature of the difficulty – indeed, the competition among institutional investors may promote imitative behaviour as each of them tries to avoid being left behind by the portfolio shifts of the others. These speculative swings on security markets cannot be eliminated simply by improving information flows if the division of the market into individual actors with separate interests is maintained. It is the emergence of certain common views of future developments which can limit these waves of pessimism and optimism, but such shared opinions emerge from a discursive process with a political and social content – which has to be regarded as a public good.[10]

Thus, the problems of retail finance should not be seen as limited failures of a financial structure which is fundamentally sound; rather, these problems result from basic weaknesses in the corporation as an institution and in the functioning of the securities markets.

10.7 THE BRITISH CASE

To present the problems of retail finance in a more concrete manner, it is useful to examine some of the many failures in the British system. Britain is a lot closer to the market-dominated financial structures which are found in the US than are other European countries. The British case can therefore be taken to represent the kind of financial system which the EU's financial integration strategy is trying to bring about by its promotion of the role of security markets. There is a lot of evidence that the British system serves the interests of households very badly.

Households as Savers

This negative view of the British system has been reinforced by a number of authoritative reports into various aspects of retail finance. The Myners (2001) review of institutional investment, although very much written

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from the point of view of the financial sector itself, identified serious 'distortions' in the activities of pension funds, including a tendency to 'herd' in their investment decisions. The critical relationship between fund managers and the brokers who dealt on their behalf in the stock market was opaque, so that there was a tendency for transactions costs to be excessive. The review identified even more serious failings with the individual savings products sold by insurance companies (in Britain, most of these are what is known as 'with profits' schemes). The fierce competition in this sector was all about marketing the products and had little or no impact on the net returns received by savers.

The Sandler report (2002) examined the products of the insurance companies in more detail and also considered the functioning of investment companies. The role of so-called 'Independent Financial Advisers' was looked at in more detail. These enterprises are not in any true sense independent – they derive their income not in the form of fees from those they advise but as commissions from the institutional investors whose products they sell. Governments have repeatedly retreated from radical reform of the IFAs because the necessary reform – to eliminate the IFAs' interest in distorting consumer choice by forbidding them to accept commissions, or at least to make this interest clear to the consumer by strict disclosure requirements – would put much of the parasitic IFA structure out of business. Sandler comments that 'the focus of competition for providers is on winning distribution rather than on providing simple, good value products to the end consumer.' The latest attempt at reform, in 2005, changed the rules governing the range of products to be distributed but again shied away from tackling the deep conflict of interest which prevents IFAs giving impartial advice.

British commentators often refer to a 'savings gap', meaning by this that many households are not acquiring sufficient assets for a decent retirement. There are various measures of the 'gap'; Sandler refers to an estimate that personal savings are 20 per cent below the required level. In fact the whole notion of a savings gap is tendentious because it rules out reinforced public provision as the best way to improve pensions and because it neglects the fact that many pensioners are very well off so that the distribution of income among pensioners is just as important an issue as the total amount of income going to pensions. Nevertheless, those who accept the notion of a gap just because they wish to exclude redistribution and public provision face the difficulty that public distrust of the financial sector is such as to discourage many people from increasing their savings. It was this perspective which informed the enquiry of the Treasury Select Committee (2004) of the House of Commons. The Select Committee endorses and strengthens the Sandler critique of commission-driven sales in the retail financial sector. It emphasizes that the information failures in

the sector include a failure to give consumers an accurate account of the risks of many products. The overall judgement is harsh:

> Presently, many areas of the long-term savings industry are struggling to offer returns that can realistically be expected to be much better than those available from a good deposit account, especially when allowance is made for the risks involved in most forms of long-term savings. This suggests that one of the main priorities for the long-term savings industry is to work out how it can deliver competitive returns to the saver. This is likely to require both the development of lower cost distribution mechanisms and a much greater emphasis on investment performance and asset allocation.
>
> Nevertheless
>
> the industry currently fails to engage in serious dialogue on a regular basis with consumer bodies and other interested parties on issues such as pension reform, access for the less affluent or, indeed, general consumer confidence. This may well partly explain why the industry in recent years has seemed to limp from crisis to crisis (p. 69).

Households as Borrowers

British households as investors, then, are not well served. In many ways their treatment as borrowers, as users of finance, is even more alarming. Long-term borrowing for house purchase does not in itself raise particular difficulties, although the provision of mortgages in Britain was for a long time linked to the sale of certain savings products ('endowments') which were subject to all the problems referred to above. Mortgage endowments were eventually treated as a case of mass 'mis-selling', and the financial sector is still involved in the slow and often reluctant compensation of some of the victims.

However, it is the provision of shorter-term credit, to support consumption expenditures, where the most serious problems arise. Two illustrations can be given. Banks and other providers of unsecured loans often try to sell to the borrower at the same time an insurance policy known as 'payment protection insurance'. These policies are supplied to banks and other lenders by insurance companies and then sold on, at the same time as a loan is agreed, to households at horrific mark-ups. Further, they are often sold to people to whom they are valueless – for example, the self-employed who are not covered against unemployment. Even when the policy is of some value, it clearly benefits the lender as well as, or even more than, the borrower because it greatly reduces the chances of default; it is in particular less sophisticated customers, and those most in need of credit, who are persuaded to purchase these over-priced and deceptive products. Although the FSA (2005) has been trying to limit the scale of abuse, lenders make enormous sums from payment protection which is

said to account for 10 per cent of the profits of major commercial banks. A report from the Office of Fair Trading (2006) recently concludes that, in the market for payment protection, some £5.5billion annually, 'consumer detriment appears to be a significant fraction of the total market value'. The matter has been referred to the Competition Commission (2008), whose first report begins by estimating 'that the 12 largest distributors of PPI made profits in excess of the cost of capital of £1.4 billion in 2006, on their combined Gross Written Premium (GWP) of £3.5 billion.' This is attributed to inadequate competition, although it is as much a question of simple dishonesty as of market power.

In a similar way, other malfunctions in the provision of credit to households affect above all those on inadequate incomes or facing economic insecurity. Many British households are in debt difficulties, as is signalled by the rapidly rising number of personal bankruptcies. 'Some 8% of individuals have monthly repayments on unsecured borrowing in excess of 25% of their income.' Yet financial corporations market all forms of consumer credit in the most ferocious way. 'County court judgements against personal debtors in the first half of 2005 rose by 15% to 290,643.' Between September and November of 2005, credit card issuers sent over 100 million unsolicited offers of credit cards to British households (Credit Action, 2006).

As in much of the financial sector, competition is focused on marketing and product discrimination rather than price, so that competition does not effectively reduce the cost of credit to households. The Treasury Select Committee, which issued a damning report on credit cards in 2003, noted certain improvements in industry practice in 2005, but added: 'The industry as a whole has further to go if the goal is to be achieved of ensuring that customers can understand clearly what they are being charged for in their use of their credit cards and, for some, avoid arriving almost unknowingly at a point where they have built up dangerous levels of personal debts.' (Treasury Select Committee, 2005).

The poorest and most vulnerable individuals tend not to deal with established banks or financial corporations but become the prey of loan sharks and 'doorstep' lenders. Here, three-digit interest rates are the rule rather than the exception: the Housing Corporation (2005) reports that

> financially excluded families with no access to affordable credit will have to borrow money from doorstep lenders at rates of up to 600%. For those forced to turn to illegal loan sharks, the prospects are even worse. In July 2005, a loan shark in Birmingham was convicted having charged interest rates of up to 8,000%.

There are no adequate systems or structures in Britain to protect the poor from this ruthless exploitation.

Households and the Payments System

In an economy which makes less and less use of cash, individuals without access to the payments system face immense difficulties in their daily lives. For most of the population, the necessary transactions services are provided in the form of current accounts with commercial banks. Households in general are not well served by the banks. The Cruikshank (2000) report, commissioned by the then British Chancellor of the Exchequer, Gordon Brown, told what is now a familiar story of overpriced products and poor services. One can take as typical the judgement on money transmission:

> Money transmission services are supplied in the UK through a series of unregulated networks, mostly controlled by the same few large banks who in turn dominate the markets for services to SMEs and personal customers. This market structure results in the creation of artificial barriers to entry, high costs to retailers for accepting credit and debit cards, charges for cash withdrawals up to six times their cost, and a cumbersome and inflexible payment system that is only slowly adapting to the demands of e-commerce.'

All other aspects of Bank services are criticized in similar term – the commercial banks meanwhile make profits which dwarf those of most other enterprises.

Once again the worst difficulties are faced by the weakest and most vulnerable. In some other European countries, notably France, individuals have the right to a basic bank account which permits them to receive wages or social security benefits, to make a certain number of electronic payments free of charge and also to make a certain number of free cash withdrawals each month. In Britain, however, reluctance to constrain the activities of the financial corporations means that no such right has been established. The Treasury (HM Treasury, 2004) report on the issue begins by recognizing that

> One in twelve households in the UK lacks access to a bank account of any kind. For them the costs of transactions as simple as cashing cheques or paying bills are high, and services such as hiring videos and contract mobile telephones are unavailable. Whilst lacking a bank account has costs in itself, the implications of financial exclusion can be much broader. Families can be locked in a cycle of poverty and exclusion, or turn to high cost credit or even illegal lenders, resulting in greater financial strain and unmanageable debt.

In Britain the term, 'exclusion' is used too much, a weasel word for poverty. People with decent jobs, homes and incomes will often be able to include themselves in social life. Nevertheless, in the context of payments services it is valid to speak of exclusion, in a concrete sense.

The critique of British retail finance is of general significance because the whole thrust of the EU's financial strategy is towards exactly this kind of system: British finance is characterized by powerful financial corporations, by huge security markets, by the prevalence of 'arm's-length', market-based corporate finance over the socially embedded investors often found in continental Europe. The regulatory constraints on British financial companies are minimal in order to give as much scope as possible to market forces. It is just such a system, on a Europe-wide basis, that is aimed at by the FSAP and the Lisbon agenda in general, while EU competition rules for the service sector threaten to undermine existing structures of social control and intervention at member state level. But the most elementary examination of the retail finance in Britain, drawing on documents from the most orthodox establishment sources can show that the financial model which is aimed at by the EU may have a very negative impact on the welfare of the households which make use of it.

10.8 DISMANTLING SOCIAL CONTROL

At the retail, as at the wholesale level, financial services are increasingly important and an essential aspect of contemporary economic life. Many retail services work well for many people much of the time. But when they fail to do so, as happens sometimes for most consumers and very frequently for the poorest and most vulnerable, the results are distressing and in complete conflict with the values of the European social models.

In this sphere as in others, the European social models require effective systems of social control. Yet the main tendency in recent decades has been to dismantle such systems. This process has many aspects, only some of which have been discussed here.

- Established barriers between particular sectors of retail finance have been removed in order to stimulate competition; in any case, technological change was making it difficult to maintain these barriers.
- Public sector provision has been reduced, both to control public spending and as part of the broad privatization drive. Particularly important here has been a general reduction, across Europe, in the provision of financial services through post offices. These services were often used most by low-income groups. There have been threats also to the public sector banks (Sparkassen) in Germany, whose position has been challenged as contrary to European competition rules.

- Along with the reduction in public provision there has also been a move away from non-profit provision – the role of cooperative and mutual financial institutions has been reduced, again often in order to enforce competition rules. There is evidence, however, that the transformation of mutuals into profit-making corporations, for example in the case of British building societies, has worked against the interests of consumers.
- There has been a switch in regulation away from the substantive control of financial services and products to a focus on procedures – on information disclosure, for example, or marketing practices. It has been argued, to justify this switch, that substantive controls block innovation. In practice, however, many innovations are spurious – a question of marketing rather than genuinely new services and the abolition of controls on pricing and quality standards may have damaged consumers –especially low-income consumers.
- Growing international trade in retail financial services and the increasing use of the Internet to sell and deliver financial services, although both trends are slower than is sometimes thought, raise a whole series of new problems for effective social control.

In principle, the EU is very well placed to act as a vector of renewed social control, through its transnational reach and its ability to promulgate and police high minimum standards in service provision. There are some signs that EU institutions are becoming more aware of these responsibilities.[11] But to discharge them in an adequate way will require a shift away from the current insistence on market-led integration as the overriding priority of EU policy in retail finance.

NOTES

1. See Goodhart et al. (1998) chapter 1, 'The rationale for regulation'.
2. The term 'consumer protection' is used here to emphasise that the household, whether it is saving, borrowing or using other financial services, stands in a relation to the company providing the service which is analogous to that of a retail customer to a corporation providing consumer goods or services. Much of what follows, however, also applies to small businesses as users of financial services since the imbalances in power and information between small businesses and financial corporations can be as great as for households. The term 'investor protection' is also often used in the literature when the service involves the use of household savings.
3. Thus, detailed protection regulation is usually thought to be less necessary in wholesale financial markets where all participants can be assumed to be experts and to have a good understanding of the product and services which are traded. But note that even in wholesale markets, investors are not always as informed as they should be.
4. For example, many British people were unaware that they were entitled to use certain

pension savings to buy an annuity from any supplier and simply bought it from the company providing the pension savings plan. Regulation was used to try to ensure that companies made customers aware of the 'market option'.

5. If the poverty threshold is set at 50 per cent of median income, then the percentage of old (over 65 years) people in poverty is as follows: France, 7.8; Germany, 9.8; Sweden, 7.7; United Kingdom, 20.9, United States, 24.7 (Wu, 2005).
6. See European Commission (2005c), annex I, section IV). The Commission seemed to suspect that member state competition regimes were being used as protective devices to block cross-border mergers, although it offered no evidence of this. Some conceivable types of integration do not take place because there is little or no need for them but it is always difficult for the Commission, usually so committed to market principles, to understand this elementary aspect of market economics.
7. Davis and Steil (2001, p. 33) give the following figures for the percentage of pension fund portfolios held in foreign assets: United Kingdom, 18; United States, 11; Germany, 7; Japan, 18; Canada, 15; France, 5; Italy, 0. There would appear to be considerable scope for more diversification to take advantage of the variation in the macroeconomic cycle across countries as well as of differences in economic structure and thus in exposure to economic risks.
8. Such disadvantages, however, have certainly marked many of the first steps towards the internationalization of asset management: when it becomes difficult to find a domestic purchaser for a dubious asset then attempts are made to find a sufficiently naive foreigner. The external adventures of Britain's Midland Bank and Abbey National, the huge foreign losses of the Credit Lyonnais, the problems met by Deutsche Bank in its drive for global supremacy all supply chastening illustrations.
9. It is rather difficult to assess the value of the FIN-NET system. It is reported that some 400 consumer complaints were dealt with in its first year of operation (2002) but no full evaluation seems as yet to be available.
10. Both the sub-prime crisis and the preceding dotcom bubble and collapse were conditioned by the attempt of wealth-holders – individuals but also and especially banks and other financial corporations – to obtain rates of retur*m* which simply could not be delivered on a continuing basis by the economy. Establishing more realistic conventions regarding the yield on investments is a key condition for more efficient financial markets, but such conventions cannot be produced by market processes themselves.
11. Besides the FIN-USE network, referred to above, one can mention the recent study, by the European Economic and Social Committee (2007), of the social consequences of recent financial developments, although there were clearly divisions within the committee on the need for stronger measures of social control. However, recent developments in EU policy have been rather negative in this respect. The influence of financial service users on policy formulation seems to have been attenuated.

Chapter 18

The impact of financial change on European employment relations

The references cited in the text can be found in a list of all references from items 14–18 on page 326.

11. The impact of financial change on European employment relations

John Grahl

11.1 ECONOMIC AND IDEOLOGICAL FACTORS AND STANDARDS

In attempting to assess the impact of financial change on employment relations in Europe, it is necessary to recognize that this change has more than one dimension: clearly there are both economic and ideological aspects to the new salience of security markets and shareholders. Also of great importance is the issue of standards of practice where economic and ideological forces are combined.

Finance and Corporate Behaviour

The direct economic aspects are related to the constraints and opportunities in the financial environment of an enterprise. From the late 1950s, many mainstream economists thought that financial mechanisms would have little or no impact on corporate behaviour or corporate strategies. This was the implication of the Miller–Modigliani theorem which states that the value of an investment (and by extension, of an enterprise as an assembly of investment projects) is unaffected by the way in which it is financed.[1] Were this the case, changes in the system of corporate finance would have no economic impact on employment relations.

However, the Miller–Modigliani theorem depends on the absence of asymmetric information. Information may be incomplete without being asymmetric so that investments involve risks but, by assumption, both the suppliers and users of finance assess these risks in the same way. When this assumption is not made, that is, when it is recognized that the enterprise as a user of funds will probably have more information than the suppliers of finance, the result no longer holds. Financial institutions and financial practices can now affect the value of potential investments, and thus corporate behaviour, by their impact on the information flows from the enterprise to its creditors and investors.[2] The theme of asymmetric information

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permeates finance theory today and supports the view that changing structures of corporate finance might well alter corporate strategies, including approaches to employment relations.

The Shareholder Ideology

But ideological aspects must also be recognised. The increased scale and importance of equity markets, in particular, is not simply an economic development: the notion of *shareholder value* provides one view of the meaning and purpose of the modern corporation, a view that has been widely propagated in recent years. It is not, however, the only such view – at the same time a different, even to some extent opposed, corporate ideology has developed, that of 'corporate social responsibility'. Both types of thinking can be related to the separation of ownership from managerial control in the giant modern enterprise: shareholder value denies the separation by suggesting that the proprietors (the 'principals') are still essentially in control through the management (their 'agents'); on the other hand, corporate social responsibility acknowledges that managerial autonomy is a reality but claims that it is exercised in socially legitimate ways.

Codes of Practice

However, it is also necessary to see the ways in which financial change *combines economic pressures with the development of norms of conduct*. Both equity and bond markets today depend on the standardization of the financial claims which are traded on them and this standardization of securities implies the imposition of common standards of practice among the firms which issue these securities. This is true immediately of the essential flows of information from a corporation back to the markets on which it is financed, that is the requirements on reporting corporate performance and on the accounting conventions to be used when doing so. But the standards of practice linked to these markets go beyond information flows in this narrow sense to embrace corporate governance as a whole: the way decision making in the firm is organized and the forms of accountability which are established. One aspect of the increased salience of security markets and dispersed ownership of equity is that formal codes of governance tend to become more important; when there are a only a few large investors closely tied to the company, it is less important to codify procedures in this way because the allocation of responsibilities can be directly apprehended by those involved.

Thus a comparative study of European corporate governance codes finds that they have proliferated in recent years, the majority (25 out of 35)

having been issued since 1997, and that there are strong trends towards convergence in the practices and structures which are recommended in individual countries and, increasingly, on an international basis.[3] Even though the legal position of shareholders is very different across member states, this convergence of norms signals the increased weight of the capital markets in corporate life because it establishes benchmarks of practice which make it easier to relate company performance to the measures of risk and return used by dispersed investors.

11.2 SHAREHOLDERS AND CORPORATE STRATEGIES

Managerial Predation

In reality, shareholders have generally failed to impose their priorities on corporate managements. Brenner (2003b) documents this for the central case of a market-based financial system, the US. In 1992, the Chief Executive Officers of US corporations owned about 2 per cent of their outstanding equity; by 2002 this had become 12 per cent, perhaps the biggest expropriation of wealth in human history, and essentially at the shareholders' expense.

A necessary condition of this vast failure of market-based control was consistent and dramatic overvaluation of companies on the equity markets. Michael Jensen, one of the leading academic advocates of shareholder value, now accepts that things went badly wrong and points to overvaluation as one of the key factors.[4]

However, in the aftermath of the world-wide stock market crash of 2000 and 2001 and with institutional investors attempting to rehabilitate themselves among their customers, equity markets may regain some of their disciplinary role. Just as important is the wide range of issues over which corporate leaderships themselves endorse a shareholder orientation of their strategies, a process of internalization of norms which, in Europe, has tended to run ahead of actual changes in financial constraints although these also have been accelerating.

Thus in his survey of changes in European corporate organization, Streeck (2001) observes that:

> In recent years, European large firms have come under pressure to extend similar attention to shareholders, especially minority shareholders, as Anglo-American firms; this is reflected in the debate on 'shareholder value' . . . as well as in ongoing changes in European regimes of corporate governance. Anglo-American arm's-length financial relations mediated through a

> developed capital market are increasingly beginning to invade and replace traditional European systems of *national insider finance*. In the process, the behaviour of Continental-European companies is changing as they find themselves forced to address many of the issues emphasized by the standard corporate governance literature: e.g., how to ensure that minority shareholders are given reliable information; how to prevent 'insider trading' at the expense of outsiders; and how to hold management accountable to the interests of minority investors.

(It is pointed out that this reorientation does not stem from immediate financial pressures as most large European corporations could rely upon internally generated funds to meet most of their investment needs.)[5]

What strategies would a shareholder orientation suggest? As far as employment relations are concerned the general answer is straightforward: a relegation of the interests of labour, in so far as these are in conflict with profitability. In the abstract, there might be issues on which shareholders and employees could find common ground as against corporate managements; both groups might have an interest in making management more accountable, in limiting managerial predation and in extracting more information about the activities and plans of the management.[6] However, in practice, decision-making power in the company usually remains with senior management, and strategies continue to reflect the interests of these elites. Shareholder interests, as interpreted by the managerial leadership, seem likely to sharpen antagonisms between employees and employers in so far as they imply pressure for higher profits.

If we look at how more specific aspects of corporate strategy might, under shareholder pressure, impact on employees then there are several examples, all of which seem to be adverse to employee interests. Firstly, there might be pressure to curtail investment and to distribute a higher fraction of profits to shareholders; the retention of earnings inside the firm and the adoption of investment projects aimed at growth more than profitability are classical sources of friction between management and dispersed shareholders; employees would normally favour more investment at the price of lower dividends.

A related example concerns company structure. On grounds of transparency dispersed shareholders dislike conglomerate companies; they prefer to control risks by diversifying their portfolios rather than by diversification of activities at the level of the individual enterprise. This preference may become more marked as institutional investors come to the fore because they, unlike all but the wealthiest individual investors, can carry out effective portfolio diversification and therefore have little interest in reducing the risks carried by single companies for a given expected rate of return.[7] This investor preference, however, directly increases the job

insecurity of the employees by reducing the scope for redeployment within the firm.

On similar grounds, shareholders might press for the outsourcing of any activities which are not central to the production and sales strategies of the corporation. In this case, the transparency of company performance may not be the only motive: investors may also wish to dispose of assets which have lower rates of return than the targets they try to set for the enterprise.

Associated with such targets are various performance metrics, such as 'economic value added' which are intended to correspond to the shareholders' interests. These differ from each other in some respects but tend to have in common that they focus on profitability while seeking to limit managerial discretion in reporting performance. They tend therefore to emphasize cash flows as an indicator of the resources which might become available to shareholders. The result may be a general pressure to reduce expenses which could impact adversely on working conditions. From the point of view of shareholder value, the very notion of 'retained earnings' is suspect. Everything, in this perspective, belongs to the shareholders and must be distributed to them unless retention serves their interests.

Mergers and Restructuring

A key aspect of the shareholder value movement is its approach to company restructuring, mergers and so on. On the one hand, mergers often present an opportunity for the extraction of large amounts of cash from the corporate sector; on the other, they are typically seen, from a shareholder point of view, as a means of bringing inefficient or spendthrift managements to account. The productive logic of many mergers, however, is unclear while employee interests tend to be relegated to the extent that financial motives are determinant. Clearly there may be occasions when a merger or takeover rescues jobs in an enterprise which would otherwise fail. However, the reverse is even more frequent – the restructuring is the occasion for job-shedding and wage-cutting.

Even when European elites were rushing to embrace virtually every aspect of the US shareholder model, there remained considerable reticence on the question of takeovers. The Commission officials responsible for the internal market had no doubts – their aim was to facilitate hostile takeovers by outlawing most of the measures by which an incumbent management might fight off an unwelcome bid. From their point of view the interests of the (dispersed) shareholders of the target firm should be paramount. The Takeover Directive was seen as central to financial integration: the key consideration was that shares issued anywhere in Europe should have the

same characteristics, including the same possibility of being purchased in the course of a takeover.

However, in July 2001 the European Parliament, in a dramatic tied vote, rejected the Commission's proposals for a Takeover Directive. A very diluted version was passed by the EP in December 2003, but this did not establish the 'level playing field' desired by the Commission because the legal framework for (especially hostile) takeover bids remained very different in different member states. The outcome was not particularly logical in that no clear or agreed view emerged as to the reasons which would justify blocking a takeover; in that sense, the compromise Directive reflected the uneasy conscience of the EP. However, the extreme view of the Commission, that the only thing that mattered was the right of the holders of shares to dispose of them as they pleased, was certainly rejected and behind this rejection lay a concern for the social implications of restructuring.[8]

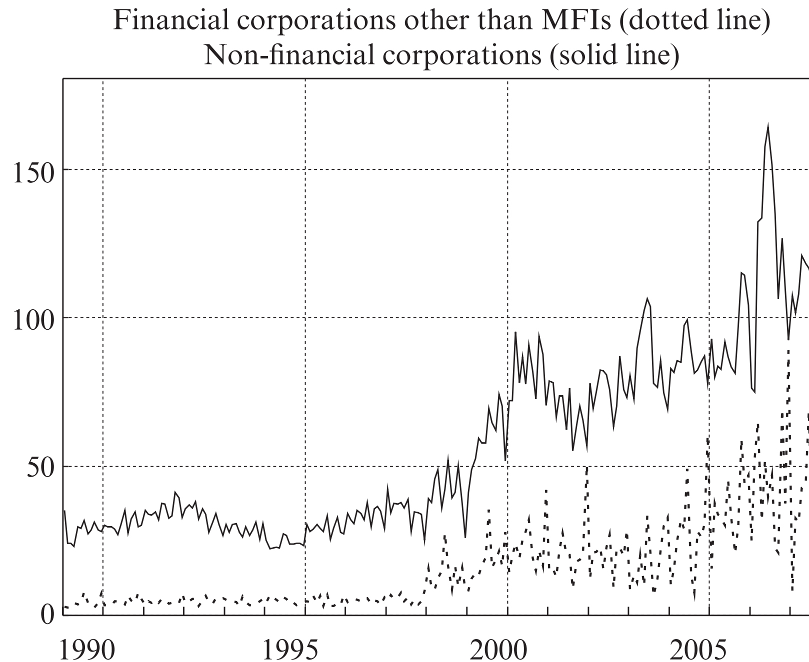
Incentives and Inequalities

Finally, it can be pointed out that the shareholder value drive is associated with sharply unequal rewards within the corporation. The activities of both management and employees are interpreted in a 'principal–agent' framework according to which the principals (the shareholders) have the problem of constraining their agents (corporate managements in the first instance) to subordinate their own interests to those on whose behalf they are supposed to be working. The solution proposed was to reward corporate leaderships in function of the returns they generated for shareholders in dividend payouts or rising share prices. In practice this led simply to an enormous inflation of rewards for corporate leaders, with no corresponding benefits to the so-called principals.[9]

At the same time, the focus on shareholder interests means that there will be an attempt to compress the incomes of those employees whose performance is most easily monitored or who are most easily subjected to market disciplines.[10] The outcome is a widening of income inequalities within the corporation. In contrast, where corporate strategy relates to a coalition of stakeholder interests, these inequalities will be smaller.

Corporate Bonds

It should be added that, in quantitative terms, the bond market is much more important in corporate finance in Europe than is the equity market. Further, there are clear signs of a recent increase in its importance. Banks and other financial institutions have always made considerable use of the



Note: Gross Issues, all maturities, all currencies (by sector of the issuer; EUR billions; transactions during the month; nominal values) January 1990 to January 2006.

Source: ECB securities issues statistics

Figure 11.1 Debt securities issued by euro area residents

bond market, but now non-financial corporations appear to be doing so. The big expansion of these issues around the turn of the century was linked to the auction of third generation mobile phone frequencies, and the subsequent decline in issues suggested that the corporate bond market might return to the levels of the mid-1990s. This does not appear to be the case, however, and the new, much higher level of activity seems to have been established (Figure 11.1).

However, the greater prominence of bond markets does not have the same implications for the corporation as an increased dependence on equity markets. Bondholders resemble shareholders in that they both require 'transparency' and a full flow of information to the security markets. But there the resemblance ends. To the holders of bonds and other fixed-income securities, the value of their holdings depends on the extent to which risk can be reduced. For this reason they prefer corporate issuers to possess wide margins of safety, in terms of both revenues and assets. The first of these reduces the probability of default on debt service,

the second reduces the probability of loss following default. In both cases shareholder interests are opposed to those of the bondholders because the former are seeking to reduce asset holdings and direct all revenue flows not needed for profitable investments back to themselves. Thus the switch of many large European corporations away from bank loans and towards the bond market does not seem likely to have major implications for corporate strategy.

11.3 THE SHAREHOLDER DRIVE IN GERMANY

The impact of the shareholder movement in Germany is of particular interest because Germany is often seen as the most important example of a form of financial organization which puts much less emphasis on security markets than does the US, since the typical large corporation has tended to rely for equity capital on a small number of 'inside' investors with close links to and expert knowledge of its activities. To the extent that the wider public has contributed to corporate finance, it has been indirectly, through the banks, which have been by far the biggest suppliers of credit to the corporate sector.

The German financial system was, until recently, regarded as particularly efficient in view of the rapid development and strong competitiveness of the German economy over several decades. However, like other features of the German system, it has been called into question in the context of the slow growth and high unemployment rates seen in Germany since the early 1990s.

It is important to recognize that employment relations in Germany are also under enormous pressure for reasons other than financial change. Since the 1980s neoliberal projects have sought to lower labour standards, to encourage more inequalities in the distribution of income and to compress both direct labour costs and the social wage. The specific rationale for this project has sometimes changed; what began as, above all, a strategy against inflation is continued as a strategy to promote low-cost service employment and to respond to the supposed challenges of globalization. Most recently a series of reforms to the social security system has drastically reduced indemnities for the long-run unemployed and tightened up eligibility criteria with a view to promoting low-paid and part-time employment as well as self-employment by the unemployed.

Thus the shareholder value drive takes its place among an array of forces working to destabilize German employment relations and to intensify both administrative and market constraints on workers. Nevertheless, it may be possible to link certain developments more closely to financial change.

Recent Changes in Financial Structures in Germany

Compared with other continental economies, in particular that of France, patterns of corporate finance were relatively stable in Germany until very recently. Ownership of the larger enterprises was highly concentrated and often involved either a single dominant investor or a small group with effective control. There was an extensive network of cross-holdings among the larger enterprises, with the big banks in particular holding substantial stakes in industrial companies. This structure, sometimes known as *Deutschland AG* or 'Germany Incorporated', was seen as the support for close linkages among the biggest firms. The general public held relatively few shares and participated in the finance of industry indirectly, through the banks. The stock market was relatively undeveloped in terms of both the number of firms listed on it and its overall capitalization. Foreign ownership was very limited except for a few foreign, mostly American, companies which had established a presence in Germany.

This situation now seems to be changing fast, especially as concerns the very biggest firms. The structure of industrial cross-holdings is now considerably attenuated, as is the role of the banks as a shareholder in other companies. The German Monopoly Commission reports that whereas in 1996 the six biggest private sector banks held stakes in 75 of the largest 100 companies, by 2004 this had been reduced to 30. Over the same period the total number of cross-holdings among the 100 largest companies fell from 51 to 28 and the number of enterprises (including the banks) possessing such stakes from 39 to 17 (Deutscher Bundestag, 2006). These developments have been analysed by Streeck and Höpner (2003) as the dissolution of *Deutschland AG*, in a process which is redefining German corporate interests and transforming corporate practice.

There is only a slow decline in the role of bank finance in the German economy. However, financial change in Germany is reflected less by quantitative change in the financial activities of the banks as in a change in their role. The banks themselves are increasingly active in fund management and now tend to regard their shareholdings in other German companies as essentially portfolios of securities rather than as the support for industrial collaborations.

Stock market data are hard to interpret because the stock market crash of 2001–2002 was particularly severe in Germany. Capitalization fell from $1432 billion at the end of 1999 to $686 billion at the end of 2002. Since then, however, it has grown at an accelerating rate to reach $2105 billion 2007. The number of companies quoted on the Deutsche Börse on the other hand has not recovered its peak of 983 in 2001 but has grown fast from a low of 764 in 2005 to reach 866 in 2007.[11]

Table 11.1 Distribution of German financial system liabilities (in per cent), by type of financial institution

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Banking Sector	76.9	77.1	76.0	75.4	75.4	74.8	72.9	72.1	69.9	70.4	71.3	72.9
Insurance sector	18.2	18.0	18.3	18.6	18.3	18.1	18.8	18.6	18.9	18.2	17.8	16.9
Other financial services	4.9	4.9	5.7	6.0	6.2	7.0	8.3	9.3	11.2	11.4	10.8	10.2

Source: Vitols (2003).

These changes appear to be less rapid among smaller companies, where cross-holdings remain common and foreign ownership is growing less rapidly.

The stock market crash of 2001–2002 and in particular the failure of the Neue Markt, a secondary stock market specializing in innovative companies and start-ups, may also have delayed the pace of change in German finance. However, there has been a shared determination among business and political elites in Germany to reorient the corporate sector towards market-based finance. A most important step in this direction was a tax reform by the Schröder government which allowed banks and other companies to sell off their accumulated holdings of shares free of capital gains tax.

Shareholder Orientation in Germany

Although these changes in financial practice are often very recent, the orientation of German companies has shifted rapidly. For example, Lane (2003) writes that

> the German system of corporate governance . . . is in the process of converging towards the Anglo-American system and . . . this has fundamentally affected the way strategic decisions are made in firms. Large, internationally oriented companies are particularly affected. But the notion of shareholder value and its many behavioural effects are gradually spreading also to other parts of the economy. Consequently, the distinctive logic, which had underpinned the German variety of capitalism during most of the post-war period, is eroding. This transformation is affecting also labour and industrial relations in negative ways.

Lane sees the sources of this reorientation not only in international capital markets (potential access to which may affect corporate behaviour

even though actual financial practice is relatively stable) but also in the pressures of product market competition and

> new cultural and/or ideological orientations. . .the reference is to the concept of shareholder value and associated motivations, cognitions and scenarios for action. These have been widely propagated by consultancy firms which often are of Anglo-American origin. They also have been absorbed through participation in new programmes of management education, particularly the MBA, and, last, during extended spells of direct exposure to Anglo-American business environments when managing German subsidiaries in these two countries. The management practice of measuring performance through application of precise financial indicators, fundamental to the concept of shareholder value, has become widely adopted by and legitimate among higher German managers.

This transformation in corporate behaviour, then, involves both specific changes in company ownership and corporate finance and a more general reorientation towards the global economy. Factors at work include the increasing autonomy of large enterprises in all countries with respect to national regulatory regimes and their increasing use of financial market conditions as a reference point. But ideological influences have also been important.

11.4 CAPITAL MARKETS AND SHAREHOLDER POWER

For a balanced assessment of contemporary financial change it is necessary to distinguish the expanding role of internationalized security markets from the ideology of shareholder value. The first of these is an essentially economic development which adapts financial relations to the internationalization of production and exchange. Until now, in fact, it is more obvious in European bond markets than equity markets, although the internationalisation of debt markets makes the internationalization of equity markets feasible, because the pricing of equities relates them to the return on a very low-risk security such as a government bond.

The problems arising from these developments are discussed throughout this book. They include the intrinsic instability of deregulated equity markets, the tendency of *all* markets not subject to effective social control to generate inequalities and the weight of established interests (those of powerful financial actors in Europe and, especially, the US) in the design and construction of the new international market regimes.

In principle, these problems of regulation and control are best addressed at a European level. However, at present EU leaderships remain wedded

to simple market-based integration, divorced from any social project and threatening to undermine existing forms of social control in member states, without building European structures to replace them.[12] In these circumstances, it can be important to defend social objectives at member state level, even if this retards the development of certain international economic relations.

However, it should be remembered that there is nothing sacred about the financial *status quo ante* in Europe. It is true that the 'inside' investors who control the big corporations have been constrained, in different ways in different countries and regions, to recognize the validity of other interests, including those of the employees. However, these groups still constituted privileged elites which sought to defend their own concentrated economic power. Indeed, it is often established industrial elites who are leading the drive towards an internationalized economic and financial system, partly at least because these developments can free them from the social compromises of the past.[13]

In the German case, for example, the structure of interlocking ownership and control which characterized large-scale industry in Germany (and, as has been seen, continues to do so) was not seen as desirable by the trade unions because it meant that, in any conflict, they were confronted not by separate employers but by a closely integrated grouping mobilized to defend the collective interests of big capital. Thus the social advances made within the 'stakeholder model' of German capitalism should not be identified with that model itself which is open to many objections.

On the other hand, the ideology of 'shareholder value' cannot be validated by the new salience of equity markets at an international level, even though some financial developments lent a certain plausibility to some of the claims which it makes. This ideology seeks to deny that large corporations today represent concentrations of unaccountable power, by claiming that the interests of shareholders remain predominant, actually or potentially, in corporate decision making.

The empirical falsification of the shareholder story (most obvious in the predation of corporate leaderships and related scandals) has been referred to above. The logical weaknesses of the shareholder value position have been well expressed by Aglietta and Rebérioux (2005). Dispersed shareholders have, in reality, traded in the possibility of corporate control against the *liquidity* of their holdings. Their own interests mean that they value the ability to exit from their investment more highly than a decisive voice in corporate strategy. Indeed, were a shareholder to develop a privileged, 'insider', position in a corporation, the very knowledge so acquired would become an obstacle to dealing in the shares concerned as it would give rise to an information asymmetry with other investors.

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Contrary to a fashionable view, the recent rise of the institutional investors does nothing to mitigate the divorce of ownership and control. Essentially, it intensifies it because the institutions are even more focused on portfolio liquidity and market trading than are individual investors (for a survey, see Grahl and Lysandrou, 2006). These investors will certainly exercise significant influence on aspects of corporate governance which might affect their ability to trade equity. But they have no ambition to control the companies concerned and will avoid any relationship to a corporation which might give them the status of insiders because this would inhibit their trading.[14]

11.5 SHAREHOLDERS AND CAPITAL MARKETS

It may be necessary to distinguish more clearly than is often done between the following trends. On the one hand is the broad rise of security markets, including equity markets, to become much more important aspects of the corporate environment than in the past. This is true especially, but by no means only, in countries such as Germany where they were previously of very limited importance. On the other hand are the specific claims and ambitions which are articulated in terms of shareholder interests. The first shift seems to be systemic and irreversible, a function of the changing global economy and the new financial linkages which sustain it. The second only coincides with the first in some respects, that is in terms of those shareholder interests which can be met through market pressure on the issuing enterprise, while the nostalgic view, which would restore shareholders to the status of sovereign proprietors, will eventually fade because of its irrealism (Aglietta and Rebérioux, 2005). But even though the shareholder doctrine may prove to be a simplistic and idealized account of the new role of financial markets, this will not free large corporations from the much tighter constraints which capital markets exercise today.

NOTES

1. According to the theorem, the balance between equity and debt in the finance of an investment makes no difference to its value because it is always open to the creditors and shareholders to reallocate risks among themselves if they see an advantage in so doing. Miller and Modigliani give as an analogy a dairy farm: the value of its milk is not affected by whether it is sold as whole milk or separated into cream and skim.
2. One example of this kind of reasoning is the argument that the dominance of a few large ‘inside’ investors in German corporations has made it easier to transmit information to them and thus to finance corporate expansion. On the other hand, it is sometimes

suggested that it is more difficult to finance business start-ups in Germany than in the US because of the absence of a venture capital system.

3. 'Notwithstanding legal differences among EU Member States, the trends toward convergence in corporate governance practices in EU Member States appear to be both more numerous and more powerful than any trends toward differentiation. In this regard, the codes – together with market pressures – appear to serve as a converging force, by focusing attention and discussion on governance issues, articulating best practice recommendations and encouraging companies to adopt them.' (Weil, Gotshal and Manges, LLP, 2002, p. 3).
4. See Jensen (2004): 'When a firm's equity becomes substantially overvalued it sets in motion a set of organizational forces that are extremely difficult to manage, forces that almost inevitably lead to destruction of part or all of the core value of the firm.' He adds that 'equity-based compensation cannot solve the problem because it makes the problem worse, not better.' See also Jensen and Murphy (2004). Jensen now often appeals to ethical forces ('integrity') as the basis for a solution to problems of corporate control but it is hard to see how a world of corporate rivalry, enormous individual enrichment and a focus on profit maximization could be consistent with high ethical standards.
5. Note, however, that the statistics of equity issues need to be handled with care. The fact that *net* issues of equity are low over the economy as a whole does not mean that the equity market is unimportant to individual corporations. If some companies are retiring equity (often in the context of mergers and acquisitions) while others are issuing new shares then the stock market can be an important financial constraint on the companies concerned even though the corporate sector in aggregate is not drawing new funds from the household sector. Over the period January 1999 to January 2006, net issues of shares by non-financial corporations in the eurozone amounted to € 367.5 billion; gross issues over the same period were € 623.9 billion. It is the latter figure which indicates the importance of the stock market to the finance of individual corporations.
6. On this question see Jackson (2005) and Rehder (2003), both of whom argue, correctly, that of the three groups, managers, employees and shareholders, any two might combine against the third (note as well that only under certain conditions will these groups themselves be able to aggregate the interests of the individuals who compose them). Jackson calls these possibilities 'class coalitions' (workers against managers and shareholders); 'insider–outsider coalitions' (workers and managers against shareholders); and 'transparency coalitions' (workers and shareholders against management). Insider–outsider or 'productivist coalitions' – have often been observed and are particularly probable at division-level in multi-divisional companies when divisions are competing for investment. But alliances between shareholders and employees are *oppositional* in nature – they cannot make corporate decisions but must aim to constrain the decisions taken by senior management.
7. Most of the *customers* of the institutional investors are extremely risk-averse, but would still tend to endorse the diversification strategies of the latter, to the extent that they are effective.
8. See also Chapter 4 above. The position of the Commission no longer corresponded to the situation in the US, usually taken as the model for financial reform. Although the US Supreme Court had in 1982 struck down state legislation to restrict hostile takeovers, concern over the consequences of a wave of very ruthless takeovers in the 1980s led it to change its position and, in 1987, to endorse a restrictive statute in Indiana. 'State legislators were not concerned that stock ownership was changing hands, rather, it was the aftermath that was disturbing. In many cases, the goal of acquirers was not to simply control the stock, but to control the assets. In these instances, bidders would acquire controlling interest in a target company and then *profit* from the large-scale liquidation of assets or the corporate restructurings that resulted in plant closings, layoffs, or out-of-state relocations. Takeovers motivated by such objectives were believed to threaten jobs, tax revenues, existing interdependent business relationships, community

stability, and corporate contributions to socially responsible causes. . . . As of March 1992, over 40 states had passed or strengthened statutes regulating hostile takeovers.' Mallette and Spagnola (1994).

9. Thus in the largest 350 US corporations, the shareholder drive carried CEO compensation from 50 times the average wage of employees in 1982 to 525 times the average wage in 2000. The collapse of the stock market bubble brought this down to a mere 281 times average wages in 2002 (the mean CEO compensation standing then at $7,400,000 (Erturk et al., 2005).
10. Thus the same era which saw the explosion of CEO rewards in the US was also marked by a slow decline in real wages for most workers.
11. Data from the World Federation of Exchanges.
12. The most obvious recent example of this approach is the notorious Bolkestein Directive, which sought directly to undermine and even to suppress a wide range of regulatory measures at member state level. See Dräger and Wagenknecht (2005).
13. The Swedish economy is a good example of this process. Swedish corporations are the most multinational in Europe, at least in part because of their desire to free themselves from the constraints imposed upon their activities in Sweden itself.
14. Today it is usually a legal requirement that trades must not be made on privileged information; but it is also an economic necessity. Institutional investors are able to trade with each other on a routine basis only because they can plausibly claim *not* to be trading on private information.

Appendix A

References for items 14 - 18

This is the reference list from Grahl (ed) *Global Finance and Social Europe*, and it includes all the references for items 14 - 18 as well as some others on the same theme which might be of interest.

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