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The need for capital regulation in Europe

Finance and the real economy are literally inextricably linked, and yet it is vital to distinguish between them in order for politicians to keep globalisation under control. Finance has proved to be a powerful aid to growth. Yet, among all economic activities, it is one of those most exposed to 'market flaws': there is a considerable information asymmetry between professionals and ordinary economic agents; there are significant externalities – i.e. the impact on third parties not involved in transactions, such as the effect of a bank failure on depositors and on the entire economy – and an immediate risk of 'moral hazard' arises when a reckless banker is saved from legitimate bankruptcy by Central Bank intervention; economies of scale, network economies and product differentiation generate non-competitive structures such as monopolies, oligopolies and monopolistic competition, which are sources of 'market power' and hence excessive profits; and lastly, the quality of physical infrastructures is crucial in globalised finance to prevent breakdowns in payment systems. Thus the financial sector, by its very nature, requires robust regulation by public authorities. But these authorities still operate on a national scale, while the supply of finance is global and so tends to elude them. This mismatch between market and politics, coupled with other factors – the information technology revolution and the unceasing creation of new financial products – is now putting finance on a course that is fraught with major risks to the efficiency, economic stability and social cohesion of our societies. Let us take a look at these three elements: efficiency, stability and equity.

First of all, from the point of view of efficiency in resource allocation, it is accepted that efficient financial markets lower the cost of capital for investors and raise income from savings for households, thereby stimulating growth. Now that the markets in goods and services are globalised, consistency dictates that finance should likewise go global. But globalised finance is strengthening its hold over the real economy, with adverse effects. For instance, current demands for double-digit returns on investments in publicly listed companies are encouraging those companies to maximise short-term gain at the expense of more stable, long-term growth strategies. In addition, finance is a driving-force behind unearned income linked to market power as well as innovation, and the former no doubt plays as much of a part as the latter in the spectacular gains of stock markets around the world.

Next, from the point of view of economic stability, Alan Greenspan (Greenspan, 2007) marvels in his memoirs at the resilience shown by the world economy: it has absorbed economic shocks and financial crises for the past two decades without world growth being affected to any great extent. But these crises have resulted in high costs for vulnerable economies in the South and are now exposing susceptible social groups to interest rate fluctuations – examples being subprime mortgage borrowers in the United States and excessive credit card debt in the United Kingdom. Besides, there is no guarantee that a deeper, more severe crisis will not emerge at the heart of the system some day and mushroom into a worldwide recession. Thus finance could trigger a major international economic crisis, both through the brutal fallout from the structural imbalances that it has spawned – witness the USA's gigantic foreign trade deficit ([1]) – and through the liquidity and solvency crises that it might experience, as is the case with subprime mortgages in the United States at present.

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[1] Martin Wolf refers in the *Financial Times* of 22 November 2007 to the 'great unwinding' that could lead, if not to a recession, then in any event to a long period of growth below US potential, if exports do not take over from domestic demand. It is worth noting that China presents the symmetrical risk: domestic demand that is not growing at the pace of the relative decline in exports.

Finally, in terms of income distribution and equity, the financial industry appears nowadays to be one of the most profitable sectors of the international economy: people living on unearned income and finance professionals are receiving abnormally high returns and capital gains at the expense of other groups and sectors ([2]). What is more, such earnings can readily evade taxation. Financialisation of the economy is now emerging as one of the main factors that exacerbate inequality, along with technical progress and deregulation. So is it justifiable to describe global finance as destabilising and predatory? Yes, undoubtedly!

1. The arrival of financial capitalism

Capitalism has always been financial, ever since its beginnings in Western Europe at the end of the Middle Ages: the market capitalism of the Renaissance and the Great Discoveries was at the same time financial; the industrial capitalism born in England at the end of the 17th century was likewise financial. But nowadays global capitalism is first and foremost financial before being industrial and market-led. There is even shareholder capitalism, described by Jean Peyrelevade (Peyrelevade, 2005) as 'all-out' capitalism. Although the financial industry represents only the tip of the iceberg of the world economy, it has a profound influence owing to its growing hold over the real economy. Jean Peyrelevade provides some telling figures on the concentration of economic power in private hands: 'it appears that ten to twelve million individuals (two thousandths of the world population) control half of the market capitalisation on earth, and probably an only slightly smaller proportion of humanity's commercial assets' (Peyrelevade, 2005: 40-41) ([3]). As a result, governments'

2 *Le Monde* reported on 1 July 2007 that in Mittal's takeover bid for Arcelor, both parties' merchant banking fees amounted to between €230 and 300 million, or 0.10 to 0.15% of the transaction cost.

3 The author estimated that, in late 2003, market capitalisation stood at $31,000 billion, or 86% of world GDP ($36,000 billion) while total world capital amounted to three times this sum. The total number of shareholders was 300 million, according to him, or 5% of the world population, half of them in the USA. Since on average stock-market portfolios represent only a fraction of individual shareholders' assets, shareholders 'possess a considerable proportion -

regulation of their economies is nowadays subject to the imperative of competitiveness, as required by the markets, whereas overall regulation, which is still very partial and very uneven, is aimed primarily at responding to demands for deregulation and the free movement of capital. Despite efforts to achieve harmonisation, binding multilateral rules and regulations which promote social, environmental or cultural values as opposed to commercial logic are still few and far between.

Three questions spring to mind, given this snapshot of present-day financial capitalism. How was such a system able to acquire legitimacy? Is it effective? Is it sustainable? One initial vague, but fair, answer would simply be to take a look at growth: as long as the system can rely on persistently satisfactory growth performance in the dominant countries – United States, Europe, China and other emerging economies – in other words, enabling the middle classes to aspire to stability or improvements in their circumstances, it will be difficult to form a political consensus around introducing more regulation at national level, still less so at multilateral level, to counter the drift into inequality and environmental destruction.

The current state of affairs is quite simply untenable, so much so that we could of course wait for the wake-up call inherent in the system to sound: the short-termism of the markets will reveal its limitations compared with more long-term and more stable corporate growth strategies; once mounting inequality begins to affect the middle classes it will prompt corrective action, since their political clout will make such action unavoidable; environmental protection has now become a vital issue. But the risk of breakdown looms too large nowadays to postpone reforms which would 'send the market back to bed' and recreate space for politics.

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undoubtedly more than three quarters - of humanity's market capital, defined as assets of all types (real estate, houses, apartments, securities, liquid assets, works of art) owned and traded by private individuals'. These figures are corroborated in a study by the UN University (UNU-Wider). According to the *Financial Times* of 6 December 2006, 'the richest 2 per cent of adults own more than 50 per cent of global assets, while the poorest half only holds 1% of the wealth'.

The European Union (EU) is an appropriate setting in which to deal effectively with all the dimensions of financial capital and negotiate, or even impose, Europe's preferences on the rest of the world.

However, the continent of Europe is deeply divided on these matters. Internal divisions exist within each country, although a thorough, substantive debate about viable alternatives could minimise these splits if it were broached seriously. Even more intractable divisions exist between Member States, which bring their own collective preferences and choices of economic specialisation to bear, for example the City in the case of the United Kingdom and the scramble for foreign direct investment in the new Member States. But embarking on a substantive debate about a European response means first of all tracing back the underlying causes of the triumphant arrival of financial capitalism and, in particular, the mechanisms which enabled it to take hold and place itself beyond the reach of politicians. Three sets of explanations account for this transformation: financial markets taking over from international and national regulatory bodies, giving increased power to financial globalisation; shareholder power taking over from bank intermediation; and the burgeoning of the finance industry.

1.1 Global financial markets are taking over from the IMF and the World Bank

Despite the part it played in the success of the post-World War II boom, the regulation of international financial flows was abandoned and, less than ten years after the United Kingdom suspended controls over inward capital movements (1979), regulation gave way to a new international monetary and financial landscape characterised by the free movement of capital, floating exchange rates at the whim of markets, the deregulation and disintermediation of finance in the major financial centres, as well as a proliferation of offshore sites – under-regulated and under-taxed spaces through which the bulk of international financial flows now pass. How can this be?

An explanation has to exist, since this upheaval in the world economy could not have been accomplished without major political decisions by governments. Several authors, including Robert Gilpin (Gilpin, 1987) and Eric Helleiner (Helleiner, 1994), have drawn attention to the differential response of public opinion to two developments: firstly, trade liberalisation within the GATT and the WTO, which traditionally arouses strong resistance even though it has proved very gradual and rule-bound; secondly, the liberalisation of capital movements and financial markets in the 1980s, which went relatively unnoticed by NGOs and politicians. Whereas trade liberalisation poses many very real problems concerning the distribution of profits and welfare costs, its contribution to growth and well-being is indisputable in three respects: a better international division of labour, economies of scale and economies of competition. On the other hand, it is not going too far to see the financialisation of the world economy as a successful attempt to appropriate its main benefits on the part of shareholders in publicly listed companies and a minority of operators – bankers, institutional investors, business lawyers and other professionals – whose share in the distribution of added value has increased significantly over the past twenty years at the expense of labour and the profits of most SMEs ([4]).

Some authors maintain, moreover, that the high distribution cost of financial liberalisation is what has made the liberalisation of trade and investment an unpopular cause, even though it has been much more decisive than financial liberalisation for long-term world growth and for North-South convergence. By understanding how this development occurred, we can shed some useful light on the current balance of power in global economic governance. The formal point of departure is without doubt the collapse of the fixed exchange-rate system instituted by the Bretton Woods Agreement when, on 15 August 1971, President Nixon decided that the dollar would no longer be convertible into gold, causing it to be devalued and subsequently to float freely. In doing so, the United States were learning lessons from ten years of monetary inflation fuelled by expenditure on the Vietnam War and social programmes intended to make US public opinion forget about it. The USA gave up the position of

4 The majority of SMEs are modest firms which are both 'price-takers' and 'environment-takers' without market power, but start-ups and sophisticated service companies, especially in finance, play a part in the expansion of profits.

benevolent overlord, constructed at the start of the Cold War, thereby compelling its allies to share the economic burden of leadership of the free world. Europe was then able to gauge the economic cost associated with strategic protection by the USA.

However, the real beginnings of financialisation date back to the early 1960s, when merchant banks and the US and UK central banks colluded to make the City of London the forum for an early experiment in deregulated finance: this was the Eurodollar market, partly funded by contributions from Communist countries. Financialisation was in fact spurred on by an alliance, tinged with rivalry, between New York and London aimed at generating activity and profitability in these two financial centres that had been constrained by thirty years of oversight by national treasuries. The Reagan and Thatcher administrations which dominated the 1980s hastened a long-prepared move by triggering the Big Bang of the '3 Ds' – disintermediation, deregulation and despecialisation – in the new international context created by the abolition of exchange controls and the floating of currencies. The recycling of petrodollars generated by the two oil shocks of 1973 and 1979 served as a test-bed for a return to the large-scale financing of budget and foreign deficits by the markets, causing some Southern countries to incur excessive debts in the process. These economies were caught between a rock and a hard place in the early 1980s by the fall in raw materials prices and the raising of interest rates by the US Fed.

The Bretton Woods international financial institutions, the IMF and the World Bank, were then utilised to protect rash creditors – Western merchant banks and governments – against possible default by debtor countries. Through the conditions attached to their loans, they forced indebted countries to implement neoliberal-type reforms ill-suited to their needs and means but advantageous for their private and public creditors. This was the rule of the Washington Consensus, which held sway for twenty years in Latin America, Africa and certain Asian countries. It helped spread financial liberalisation to countries too vulnerable to withstand the pressure of short-term speculative capital, as was shown – at their expense – by the financial crisis which hit East Asian countries in

1997 and 1998. Thus global finance emerged both as the unilateral choice of advanced countries and an imposition made upon developing countries.

It is impossible to over-emphasise the role played by London in the global financial revolution and the way in which the alliance/rivalry dialectic between New York and London made its mark on the key worldwide trends of financial deregulation and disintermediation. For the United Kingdom, confronted in the late 1970s by the demise of part of its manufacturing industry, the City of London became the number-one strategic sector in the newly developing international division of labour. Thus the UK authorities stopped at nothing to secure its pre-eminence in the European single market taking shape at the end of the 1980s: a flexible regulatory environment, free capital movement, a beneficial tax system for non-residents and measures to attract international financiers so as to ensure a lively, robust labour market.

But while London sought first and foremost to return to its 19th century tradition of providing the entire world with financial services, New York was to found its growth more on the domestic market. The dynamism of that market was assured on the one hand by an abundant supply of government funds ([5]) which guaranteed exceptional liquidity for the savings flowing in from Japan and the oil-producing countries to be held in dollars – the international currency – and, on the other, by the soaring demand for risk capital in the embryonic information technology sector ([6]) as well as in privatised and deregulated services and utilities. In the United States, then, finance came to feed on two converging trends driven by a global supply-side strategy where markets and public intervention mutually reinforced each other to stimulate growth through public

[5] In particular US Treasury bonds, or T-bonds, the supply of which burgeoned with the increase in the USA's endemic budget deficit, especially under Ronald Reagan. Reagan was of course a champion of supply-side economics but also an unrepentant practitioner of Keynesian financial policy with his tax cuts for the richest taxpayers – the Laffer curve – and massive spending on the 'Star Wars' policy which brought Brezhnev's Russia to its knees in the 1980s.

[6] See in particular the role of venture capital – an early form of private equity – in funding the start-ups of Silicon Valley in California and Route 128 in New England.

expenditure and productivity gains: government indebtedness and debt relief enjoyed by companies. Companies began to prefer calling on capital markets directly rather than on bank credit to finance their internal and external growth, i.e. through mergers and acquisitions. London, for its part, was to dominate the foreign-exchange market fed by speculative capital thanks to the abolition of controls on international capital movements. But the City also took succour from the wave of privatisation and deregulation which arose in Thatcher's Britain before sweeping through the entire European single market, where cross-border mergers and acquisitions proliferated in anticipation of the elimination of border controls on 31 December 1992. The international status of the City of London was enhanced by its connections with tax havens, expanding fast for twenty years including within the EU, which served as a transit point for a significant proportion of foreign direct investment throughout the world, most notably heading for the emerging economies.

Three forces propelled the global financial industry to power from its two initial homes, New York and London, as it moved eastwards – Tokyo, Hong Kong, Singapore and now Dubai – thanks to the economic emergence of Asia and the boom in energy and raw materials. These three forces were the information technology revolution, growing internationalisation of the real economy (fuelling activity on world financial markets), and the financial revolution, itself characterised by the disintermediation between companies and capital markets and by endless financial innovation, whereby the markets always get ahead of the regulatory authorities and more or less successfully correct their own trials and errors themselves. Thus it is that an integrated global financial market has come into being: national borders and the compartmentalisation of sub-markets – stock exchange, foreign exchange, derivatives – have melted away while choices for savers and investors have expanded.

1.2 From bank to stock exchange: financial intermediation gives way to direct finance

It is worth dwelling for a moment on this transition from indirect funding of companies by banks to direct funding by the market via the stock exchange (even though there are historical differences in this trend between Member States). Financial intermediation remained the principal source of finance for a long while. It is a process whereby financial institutions convert the short-term deposits of households into long-term loans to finance corporate investment projects and mortgage loans for householders on the basis of the differential between the deposit rate and the lending rate. Nowadays, however, processing by banks is giving way to a direct relationship between companies and savers through the stock market. Banks no longer engage mainly in processing work but have become intermediaries, just like the new institutional players in the marketplace (unit trusts, pension funds, hedge funds and investment funds, especially those of the private equity kind). Besides, ever since the return of positive real interest rates in the early 1980s, governments themselves have preferred to use the market to finance the public debt, by offering worthwhile opportunities for people living on unearned income.

Direct finance results in a radical change: savers ([7]) are now organised into powerful coalitions via institutional funds and can bring all their weight to bear on the share-out of added value between wages and profits, as well as in the allocation of profits to dividends or to reinvestment ([8]). Capital gain is the name of the game: the return on savings is no longer limited by interest rate levels, but absorbs corporate gains to a greater extent than in the past. The consequences are two-fold: firstly, the entire balance of corporate governance is shifted because power passes from the manager, who hitherto ensured a balance between all the stakeholders

7 It is worth noting that population ageing in the advanced economies prompts a higher propensity to save and hence an increased demand for financial products, which tends to push up the value of assets. This trend can be expected to turn around once pensions have to be paid out to retired people whose numbers are growing faster than the number of active workers. This is the thesis upheld by Jean Peyrelevade (2005).

8 We would point out that, while profits are growing as a proportion of GDP, the proportion of corporate investment is not growing in most OECD countries: the slogan of the 'Reagan revolution' - whereby today's profit is tomorrow's investment and the next day's jobs - rashly taken up by certain European leaders, including even Helmut Schmidt, has not materialised in practice.

– hareholders, clients, suppliers, workers and regional authorities – to well-organised shareholders who want ‘value’ and who, via the system of stock options, make the manager their exclusive agent. Secondly, the form taken by savers’ financial investments – listed or unlisted shares or bonds – will make it possible to mobilise much more substantial funds to finance much more innovative and hence risky projects. Financial innovation completes the picture in the form of securitisation and derivatives: the former converts lending contracts between banks and borrowers into negotiable securities, and increases their liquidity while discharging the bank of the initial risk; the latter make it possible to subdivide risk into its main components – variations in the interest rate, the exchange rate and the price of raw materials, or the likelihood of a borrower defaulting – and to spread the burden of risk across the entire market structure. Risk is diluted but not eliminated. It is no longer micro-economic but becomes macro-economic. The advantage of the growing securitisation of finance is the liquidity offered to investors, who can combine it with a higher yield than that of a bank deposit. The drawback of securitisation is that it discharges the bank of its primary responsibility to evaluate risk.

This truly Copernican revolution in the world of finance has three major consequences. First of all, it indubitably feeds into a new growth dynamic centred on technological innovation and productivity gains, which are fundamental requirements of societies confronted by population ageing and a dearth of natural resources. Secondly, it alters the share-out of added value in favour of finance, owing to a new balance of power between mobile, close-knit capital on the one hand and, on the other, labour which is land-based and fragmented by the advent of new forms of production ([9]). Thirdly, fundamental uncertainty arises about the

9 This balance of power is likewise modified by a differentiation occurring within the working population itself. A growing income divide is opening up between earners of stable, high salaries who have a preference for money purchase pensions (which promote asset growth) and workers with less job security who are on lower wages and prefer the relative security of a pay-as-you-go pension.

systemic risk now resulting from a combination of macro-economic factors – the structural imbalances of large economies and exchange rates – and financial factors – the sophistication and unfathomability of products. This new, poorly regulated world of finance can lead to formidable financial instability.

1.3 Globalisation of the financial industry

Global finance is organised on two closely connected levels: the regulated market and offshore financial markets, i.e. tax havens. As Nicolas Veron ([10]) sees it, the regulated global market is structured in a multi-polar fashion (New York, London and an ever-competing Asian constellation), with transcontinental stock exchanges, but still dominated by banks. Banks are internationalising, but more along regional than global lines, with the exception of HSBC. Regulation geared to protecting investors has until now been ensured by a duopoly between the United States and the EU, with the latter taking the lead but drawing its inspiration from work done in the US and the UK, especially on accounting standards and operator supervision. China, whose capital account is not liberalised, nevertheless remains an unknown quantity in the evolution of a truly global system, especially regarding the priority attached to investor protection.

The other level, which is less well-known but absolutely central to the system, consists of an amorphous group of offshore financial markets, otherwise known as tax havens. Their quality is very variable and they compete to appropriate a share of the immense added value generated, or rather monopolised, by international finance. Indeed, in globalised finance, flows of capital cross borders instantly and anonymously, evading the regulator and the tax authorities. New technology has made a significant contribution to placing offshore finance, long the preserve of the very wealthy, within reach of the average saver. According to Jeffrey

[10] Nicolas Veron, senior research fellow at Bruegel (www.bruegel.org), has made a crucially important contribution on the issue of financial organisation and standardisation on a European and international scale through his work at Bruegel and his columns in *La Tribune*.

Owens ([11]), head of the tax policy division at the OECD, the financial assets located in offshore markets amount to between 5 and 7,000 billion dollars, or 6 to 7% of all the funds managed around the world; this volume is five times higher than twenty years ago. He reports that the number of offshore financial markets registered as such has doubled and now stands at more than thirty.

If recent financial developments have led to one dangerous and morally unacceptable anomaly, then it is the existence of tax havens; to a much greater extent at any rate than speculation by hedge funds or corporate restructuring initiatives by private equity investment funds. The latter naturally prompt major reservations, and are in need of reform, but they do have genuine merits whereas tax havens are a potential source of destabilisation and serious regulatory and fiscal distortion. These under-regulated and under-taxed financial centres are no longer merely exotic places through which dubious funds pass and where illegal – or even criminal – transactions take place. They lie at the very heart of the most advanced economies and have become an unavoidable point of transit for every large-scale international financial transaction, as well as a home for private financial assets in search of discretion and preferential tax treatment – even a place where large fortunes can avoid income tax. Sometimes they revolve around financial centres such as London, for the network of British tax territories and former colonies; sometimes they themselves are established as financial centres, one example being Luxembourg whose GDP per capita is now one of the highest in the world, along with Bermuda.

This anomaly has in actual fact been institutionalised within the EU where, to a much greater extent than in the United States (where such matters are far more strictly circumscribed), it is heightened by the regulatory and fiscal competition engaged in by our main financial centres. Indeed, several Member States offer extremely advantageous tax arrangements for non-residents, while the new Member States are waging all-out war on the taxation of corporate profits, dragging down the

11 Cited by *The Economist*, Special report on offshore finance, 24 February 2007.

Community average. Certain Member States, notably Luxembourg, Belgium and Austria – and, for that matter, Switzerland – persistently refuse to abolish bank secrecy on non-residents' holdings when it comes to taxing savings. These various legal mechanisms guarantee discretion for financial transactions aimed at either speculative activity, 'fiscal optimisation' or even outright fraud. Their existence considerably complicates the fight against all other forms of organised financial crime, meaning that this fight remains fundamentally ineffectual in respect of human and drug trafficking as well as terrorist activity, because it is no easy matter to distinguish between money laundering that results from tax fraud, organised crime or even terrorism.

A vast group of new players is now active in global finance and has an ever-increasing range of tools available to it. Some, such as banks, insurance companies, unit trusts and pension funds, operate under strict conditions of liquidity, solvency, transparency and supervision. These conditions are defined by the so-called Basle I (1988) and Basle II (2005-2006) Agreements ([12]) in the case of banks, and according to the International Financial Reporting Standards (IFRS) in that of companies; the latter were adopted by the EU in 2002 but are in the process of being extended to all OECD countries. The same applies to the supervision rules for intermediaries drawn up by the most advanced countries belonging to the Financial Stability Forum. However, these operators work in different time-frames – pension funds may choose to tie up capital for a very lengthy period – and sometimes create financial products that pose unknown problems. In order to boost the investment returns offered to their clients they sometimes incorporate high-risk securities, such as the ones backed by the US subprime mortgage loans or the products offered by hedge funds. The damning vice of some instruments, such as derivatives and futures, is their extreme

12 The Basle I and II Agreements (negotiated at the Basle Committee which brings together the central bank governors and supervisory agency presidents of the G10 countries) relate to capital adequacy requirements for banks, i.e. the regulatory capital needed to cover the credit risk.

sophistication: they can escape oversight even by fund managers and regulatory authorities ([13]). As for private equity investment funds, which operate a high capital/debt ratio, they aim to profit from the restructuring of unlisted or temporarily delisted companies; their involvement can sometimes prove positive, sometimes predatory (asset-stripping). Their strategies are impenetrable and the social costs are not taken into account.

Finally, the accumulation of foreign exchange reserves in net exporting countries (China and the oil-producing countries) has led to a proliferation of 'sovereign funds' over which governments exert direct or indirect influence. These funds target investments of various kinds (financial assets, companies, technology, service networks, raw materials or energy sources) using contrasting strategies: portfolio diversification and foreign currency holdings for countries that produce raw materials; industrial strategy and security of supply for China. Provided that their strategies and transactions are transparent, sovereign funds play a positive role on the whole. In particular, they have recently helped to restock the capital of the major Western banks affected by losses owing to transactions on the US subprime market. Here too, portfolio diversification into foreign currency serves to achieve a more balanced distribution between the dollar and the euro.

2. Global finance and inequality

The subject of inequality has long been of little interest to economists, with the exception of pioneers such as Paul Krugman and Thomas Picketty, on the grounds that – according to the neoliberal precept – growth is expected to provide employment and thereby improve the lot of the poor. Even less attention has been paid to this issue at EU level, since income and asset distribution is only peripherally covered by European economic policy: thanks to subsidiarity, it is the preserve of Member States. Europe is now waking up fifteen years too late to the

13 Charles Bean, Chief Economist at the Bank of England admitted his inability to understand the workings of some of these tools. *Le Monde*, 3 October 2007.

problem of a certain return to mounting inequality ([14]). The complexity of the subject is somewhat off-putting: what indicators (social, health, cultural, financial) should be used to gauge inequality? What has caused the upsurge in inequality observed in particular in the United States, the United Kingdom and, more recently, Germany: technical progress, globalisation, the weakening of employees' bargaining power, the instability of family and parental structures, or financialisation? The latter's effects are therefore difficult to ascertain, except through the use of artificial indicators which require very subtle interpretation or through hard facts the real extent of which is open to debate. The fact, for example, that pension funds also manage the often modest savings of some employees cannot be overlooked.

Despite these reservations, it is vital to shine a bright spotlight on what can only be described as the extravagances of the financial industry and, moreover, to subject it to an economic and anthropological appraisal. A moral verdict is also called for. According to European statistics analysed by Michel Husson (Husson, 2007), the standard wage component of added value in the EU went from 63.2% in 1960 to 66.3% in 1982 and 57.7% in 2006, i.e. a drop of 8.6% between the last two dates. It has since settled at the 2006 level. Analysts believe that the excessively low proportion of profits in the 1960s and 1970s made it impossible to sustain sufficient investment in growth. Today, on the other hand, it is the level of consumption that is proving too weak.

However, the respective proportion of wages and profits constitutes only a very rough approximation of income distribution. For instance, disparities within the wages category have spiralled. Michel Husson tells us that, in the United States, the proportion of GDP accounted for by the best-paid percentile of workers rose from 4.4% to 8% between 1980 and

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[14] Only recently have the BEPA (Bureau of European Policy Advisers) and DG Ecfin (see the Commission's website) done any work on this subject, which is still poorly documented statistically at EU level. Data are often partial and outdated, so it is difficult to assess in real time the effects of policies and markets on income inequality, still more on assets even though these represent an increasingly relevant part of social inequality.

2005. In 2005, directors of large French companies earned 300 times the minimum wage on average ([15]), stock options excluded. By contrast, directors of SMEs earned an average of €4,000 in 2004, compared with an average wage of less than €2,000 per month and per household for French employees as a whole. Similar disparities exist within the share of national earnings taken as profits, for example between the profits of listed companies and SMEs. It is also notable above all that a growing share of profits is no longer reinvested but is redistributed to shareholders in the form of dividends or, worryingly, through share purchases by companies themselves, which heightens individual inequality. Most tellingly of all, the (French) National Council for Statistical Information points out that 'measuring wealth remains the black box of inequality in France, especially owing to possible under-reporting and tax optimisation techniques enabling individuals or companies to pay lower taxes' ([16]).

All in all, work done by Paul Krugman and Larry Summers in the United States reveals that most of the past twenty years' growth has been pocketed by 1% of the population. According to Thomas Picketty ([17]), the richest 1% saw their share of GDP increase from 8% in 1980 to 16% in 2004. Robert Reich ([18]) notes that, at the end of George W. Bush's second term of office, the USA has reverted to the earnings distribution of 1926. The New Deal effect of income compression has thus been wiped out during this period, even though it included the Democrat administration of Bill Clinton.

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[15] According to *Le Monde* of 14 December 2006. This is the average pay of directors of CAC 40 companies. In an interview with *Le Monde* ten years ago, Peter Drucker, the US management guru who experienced a wage disparity of 1 to 20 in the post-war period, described the then rate of 1 to 200 as 'socially untenable'.

[16] *Le Monde*, 21 November 2006

[17] Thomas Picketty, quoted by the *Financial Times*, 2 November 2006, 'Anxious middle: why ordinary Americans have missed out on the benefits of growth', by Krishna Guha, Edward Luce and Andrew Ward.

[18] Supercapitalism, Robert Reich.

Therefore it is hardly surprising that, as pointed out by Tim Geithner, chairman of the Fed in New York, the growing gap between rich and poor is undermining political support for trade liberalisation in the United States ([19]). The particular problem of earnings linked to the financialisation of the economy needs to be seen in this context of growing inequality: double-digit returns on investment coveted and often achieved by publicly listed companies or handed to private equity funds; stock options and 'golden parachutes' for directors, and brokerage fees (especially for hedge fund managers and investment bankers). We would merely point out that last year individual end-of-year bonuses in the City of London exceeded £1 million for 3,000 traders and amounted to €13.2 billion in total. In New York ([20]), the 26,000 employees of the merchant bank Goldman Sachs shared a bonus of $16.1 billion.

Three comments are called for here. From an economic point of view, it is senseless to imagine that double-digit yields in economies growing by 2 to 3% per year can be sustained for long without doing serious damage to the share of SMEs and the workforce as a whole in added value. Wage deflation hampers growth. Moreover, the spiralling of pay for managers reveals a serious dysfunction in our economies. Of course, some economists still believe that there is a competitive market for company directors and that their earnings reflect their productivity, but no such correlation has been established through analysis. It appears on the contrary that directors' pay is set in a manner which has nothing to do with the market. What is going on here is more of a Duesenburry-style demonstration effect, or more simply self-aggrandisement.

From an anthropological point of view, most people take a dim view of spiralling inequality. Recent epidemiological studies in the UK ([21]) demonstrate that inequality is becoming intolerable and is leading to an

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[19] *Financial Times*, 'Wages gap undermines support for free trade', by Krishna Guha, 12 January 2007.

[20] *Le Monde*, 23 December 2006.

[21] *The Guardian*, 'Selfish Capitalism' by Oliver James, 3 January 2008.

increase in mental illness, even though it is flourishing in a climate where the materialistic values of capitalism are extolled. Exactly when frustration spills over into anger is an increasingly relevant question. From a moral point of view, it is quite simply unacceptable for a director to make in one year what the average worker in his company would take three centuries of uninterrupted labour to earn. It is up to politicians to determine either a maximum ratio or a procedure for setting socially acceptable rates of pay.

3. Towards a solution

3.1 The difficulties of European regulation

Financialisation driven by market globalisation poses problems for growth, stability and equity which go well beyond the difficulties on which progressive thinkers tend to focus nowadays: jobs, purchasing power, relocation, trade liberalisation, viability of the welfare state, sustainability of pension systems, equal opportunities and social housing. In reality, finance comes upstream of these issues and has a strong, indirect influence upon them ([22]), but its apparent complexity and above all its overall aura have long relegated it to the margins of political debate. Politicians have an almost reverential fear of finance and are afraid of 'causing a flight of capital'; they are as frightened as rabbits and have the memories of elephants. No politician can attain the position of Finance Minister in our countries unless he/she is trusted by the stock exchange and financial circles, which sometimes amounts to making that person 'their' government official, whether on the left or right. One of the left's traditional weaknesses is its lack of interest in financial matters,

[22] Let us take as an example the recent decision of the French government, at the behest of Brussels, to abolish the monopoly of the Banque Postale and the Caisse des dépôts et consignation (a government investment bank) over the popular '*Livret A*' savings scheme. The proceeds from the scheme have hitherto been used mainly to fund the construction of social housing, but if it is opened up to merchant banks they will use it as a loss leader. In this way, an improper interpretation of rules on fair competition at Community level will lead to a reduction in funds for social housing in France.

which condemns it to oscillating between cursing when in opposition and falling into line when in power ([23]). Yet it is here, in financialisation, that the regulation of market capitalism takes place nowadays.

Europe is the most relevant level at which to deal with these matters, but it presents another obstacle: the difficulty of reaching the necessary consensus is even greater owing to the diversity of collective preferences on savings and capital taxation among the 27 Member States ([24]). The EU's normal inclination is to align itself with the countries at the forefront of protecting financial interests: the United Kingdom, Ireland, Luxembourg, Malta, Austria and of course Switzerland which often, by force of circumstances, acts as the '28th' EU Member State. But it is London and Bern that set the trend. The Grand Duchy of Luxembourg, whose vital interests are now at stake owing to its overblown financial services sector, is enjoying the windfall effect but would not stand in the way of tighter European regulatory legislation or of harmonised taxes on unearned income. If significant progress on regulatory and fiscal harmonisation in the financial arena looked likely to affect Luxembourg's economy, Community solidarity would undoubtedly be used to encourage the necessary diversification of its production structures.

A third difficulty has to do with the close scrutiny exercised by the financial media, especially in the US and the UK, over Commission and Parliament initiatives in the field of finance and taxation, beginning with the choice of the Commissioners concerned. The Economist, the Financial

23 Thus there is all the more reason to rejoice at the recent work done by the PES Group in the European Parliament, at the initiative of Pervenche Bérès, chair of the Committee on Economic and Monetary Affairs, attempting to step up pressure on the Commission to make it opt for a more regulatory approach to financial affairs, in keeping with the goal of social cohesion and more independent of US/UK influence.

24 It is no mystery in Brussels that Mr McCreevy, the Irish Commissioner for the internal market and a champion of Anglo-Saxon neoliberalism, managed at the very end of 2007 to persuade the Commission to defer a vitally important proposal aimed at harmonising the basis for company taxation. He did so on the grounds of the forthcoming Irish referendum on the Amending Treaty.

Times and the Wall Street Journal – all incidentally excellent sources of factual information – are capable of ruining the credibility of any Commissioner keen to adopt a controversial stance on such issues, or even of preventing a national politician from joining the European executive body if he/she is regarded as hostile to the interests of international finance as perceived by Anglo-Saxon media gurus. An enormous amount of influence is exerted by these newspapers on Brussels circles in these matters and relayed by the foreign press as well as by the European non-specialist press; so much so that, despite some laudable attempts, no political group in the European Parliament has the capacity today to wage a broad-based campaign in favour of fundamental financial reform tailored to the need for growth and a coherent European model.

The fourth difficulty relates to the method of regulation: voluntary codes (soft law) or binding codes (hard law). In this age of financial experimentation and innovation, the market is constantly exploring the limits of the system, pushing them back in order to boost growth, but more often also so as to corner a larger share of added value for finance. Self-regulation by professionals affords two advantages in this context: firstly, systemic risk cannot be assessed without information that they alone possess – but only to a certain extent in the absence of aggregation; secondly, challenging established positions which generate unearned income means allowing competition free rein, and this requires flexibility that is rarely afforded by coercive rules.

But there are three limits to self-regulation. The first has to do with its ineffectiveness in the face of ‘stowaway behaviour’, the second with the absence of ethical standards, and the third with crisis management. Corporate social responsibility boils down to ‘fair-weather morality’ and very soon finds itself at odds with the harsh reality of business life or becomes confined to a skilful, or even cynical, marketing exercise. The inadequacy of ethical standards is reflected in excessive shareholder power and disregard for the interests of the company’s other partners; the greed of directors who award themselves inordinate salaries and unwarranted wealth enhancement; the quest for market power (the true motivation for numerous mergers and acquisitions); fiscal engineering and impunity for the tax avoidance practices promoted by offshore financial markets. White-collar crime is not sufficiently punished in a business world where efficiency becomes the only rule and individual greed is socially acceptable – or even respectable – behaviour. Only the law can sanction error and abuse and impose a professional ban or severe penal sanctions on managers who engage in insider dealing, price-fixing and tax fraud.

Self-regulation does not survive a crisis. Politicians always have the last word in the event of a crisis. It is they who must act as lender of last resort to ensure the liquidity of the system when confidence is lost, either by depositors (the Northern Rock case) or between banks in the case of a credit crunch. It is they who must wipe out debt when things go wrong, so as to provide minimal protection for ordinary depositors acting in good faith, and to make taxpayers bear the cost. Finally, it is politicians who must devise an economic policy to get out of recession if the financial crisis has gone as far as that.

International cooperation, via the Basle-based Bank for International Settlements (BIS), the IMF and the enlarged G7, is of course inescapable at times of full-blown financial crisis. But no country allows its hands to be tied in advance by ceding sovereignty to a hypothetical supranational authority. Only in emergencies are *ad hoc* solutions devised and compromises negotiated as to cost-sharing and policy-making. The balance of power between countries and, equally, the internal influences at work within individual countries – where the financial industry will continue to loom large in spite of any errors or mistakes made – will determine the speed and nature of responses. If the crisis is serious the role of the public authorities will increase ([25]), but this key point, which alters the balance of the system, will naturally give rise to sharp divergences and tension. Two issues need to be raised here, both revolving around the role of Europe: its present capacity to take back control of finance, and its ability to act at global level in the event of an international financial crisis resulting in worldwide recession.

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[25] A recent editorial in the *Financial Times* went so far as to recommend nationalising the failed bank Northern Rock to stop the subprime crisis spreading to the United Kingdom.

3.2 What financial doctrine should govern internal regulation in the euro zone?

Efficient financial markets must meet several criteria, between which the monetary and regulatory authorities need to seek a satisfactory compromise. First of all, security of transactions and protection of investors' legitimate rights call for a reliable payment infrastructure and proper control over the risks inherent in financial instruments, as well as high levels of professionalism and robust solvency and liquidity ratios on the part of financial intermediaries, especially banks. Secondly, an optimum combination of economies of scale and effective competition between operators, not biased by preferential tax legislation, must work to the advantage of large users as well as individual consumers. Thirdly, proper links with monetary policy are vital in order to boost that policy's efficiency.

What could be a more appropriate level for legislation than the EU? In an interdependent world characterised by market externalities and the knock-on effects and conflicts generated by national policies, international cooperation is of the essence. Governments are no longer equal to the task, with the exception of giants like the United States and China, while for the foreseeable future we shall merely have a constellation of global governances and not a global government – which moreover is both unlikely and undesirable. But Europe, for its part, constitutes an appropriate level in terms of corporate governance, financial organisation, monetary policy (for the euro zone) and capital taxation. However, in order to achieve financial regulation that goes beyond the interests of investors and strikes the appropriate balance with the interests of other economic players, especially workers, we must abandon our blind faith in those experts and practitioners of the profession who nowadays dominate the thinking of the Commission, wholly in thrall to Anglo-Saxon influence. We must open up the finance debate to political movements and social players. In this way it will be possible to base EU financial policy on principles consistent with the need for a healthy, robust economy and a fair distribution of wealth ([26]).

The EU is the ideal size to enact its own law, if it so wishes, to negotiate its enforcement with its main partners – the United States and China – and to impose it on others. The EU should go further and do in the financial sphere what it is already doing in the trade sphere: champion a more efficient and fairer multilateral financial order. The new order would seek to provide the global public goods needed by the international economy to ensure sustainable development: open markets, financial stability, accountancy standards favouring long-term corporate strategies, measures to combat corruption and financial crime, the establishment of multilateral rules on minimum capital taxation, regulation of offshore financial markets and a boycott of uncooperative markets. Since the adoption of the Financial Services Action Plan (FSAP) by the Lisbon European Council (2000), progress has undeniably been made in strengthening basic Community legislation with a view to creating a European market for wholesale transactions, giving retail markets more security (if they cannot be integrated) and updating prudential and supervisory rules. Some important legislation has been adopted by means of codecision, with the Parliament playing a major role in this process. But the main innovation has been the development of the Lamfalussy Method which creates a pragmatic, four-stage procedure combining Community legislation and cooperation among national regulatory authorities. The former lays down a binding framework, while the latter provides the flexibility so dear to City traders which gives London the edge over New York, now that New York is subject to the straitjacket of the Sarbanes-Oxley Act passed in the wake of the Enron and Worldcom scandals.

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[26] The interest newly demonstrated by the European Trade Union Confederation is welcome in this regard - see in particular the speech by John Monks about 'casino capitalism' in late 2006. On this topic see also the own-initiative report of the European Economic and Social Committee, with the contribution by Olivier Derruine (CSC).

But the EU is confronted by structural, doctrinal and interest-based differences which have so far been only partially overcome. One initial difficulty arises from the fact that the internal market in financial services involves all 27 EU countries; financial integration in the euro zone, which has 15 members as from 1 January 2008, is held back by the progress made by all 27. At the same time, unification of the internal market is dominated by rivalry between the City of London and the competing centres of New York, Dubai, Singapore and Hong Kong. London has opted for a structure that is both centralised – the Financial Services Authority – and based on principles allowing for a degree of self-regulation by markets, whereas the United States maintain a rather different dual structure. For the SEC (Stock Exchange Commission) it is rule-based, while for the CFTC (Commodities Futures Trading Commission, Chicago) it relies more on risk assessment. London is not prepared to sacrifice its regulatory autonomy ([27]), which constitutes one of its main comparative advantages in global competition, for the sake of harmonisation or mutual recognition in the EU 27.

The second difficulty is connected with the current gradual transformation of structures into a hierarchy of financial establishments, some of them pan-European, others national or even regional, while the regulators remain national – even though they do cooperate closely with one another through the Lamfalussy procedure. In the case of a transnational trader, supervision is carried out in the country of origin, but if a subsidiary goes bankrupt the cost will fall to taxpayers in the host country. Then there is the question of the lender of last resort: ultimately for euro zone countries this can only be the ECB. One may well ask, as do Dirk Schoenmaker and Sander Oosterloo ([28]), whether the balance that

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27 *The Economist* of 15 September 2007 did not shirk from describing the UK's management as lax, or even lenient, in respect of insider dealing and white-collar crime occasioned by an overly close relationship between regulators and traders within the traditionally British 'old boys' network'.

28 In *Cahier Comte Boël* No.12 (2006) of the European League for Economic Cooperation, on the theme 'Financial supervision in Europe'.

has been struck is stable: 'the policy question is whether home country control of supervision, plus host country responsibility for financial stability is sustainable in an integrating market'.

The third and final difficulty concerns the fact that tax harmonisation is blocked by the unanimous voting rule, while the EU's decision on accounting standards cannot fail to raise eyebrows. Oddly enough, the EU adopted in 2002 the International Financial Reporting Standards drawn up by a committee dominated by US and UK representatives but not adopted by the United States, which preferred its own standards. Although they do have advantages, the IFRS standards raise some tricky questions. In particular, the logic behind them is to maximise shareholder value, and they even rely on the market value of assets, meaning that companies are liable to engage in short-term management rather than taking a long-term strategic approach. One may well wonder whether, in the financial sphere, there are grounds for reverting to a more realistic conception of subsidiarity than the one which prevails today and is really aimed first and foremost at accommodating the City of London. Surely the time has come to assess the merits of a 27-country virtual single market as compared with the reality of a properly integrated 15-country euro zone. We must in fact draw a distinction between the euro zone and the EU, specifically acknowledging two undeniable facts: on the one hand, if a monetary zone is to function well it requires much more in-depth financial integration and economic governance than has so far been admitted ([29]); on the other, it is not for countries having opted to remain outside of the euro zone or not yet in a position to join it to determine

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29 On this subject we would cite Anton Brender and Florence Pisani (2007: 115-116): 'the euro zone is ill-loved. Its institutions, designed at the end of the 1980s, are geared to controlling inflation and public debt… In a world where deflationary forces are rampant, … full employment entails active demand management. Monetary policy cannot play its part without a modern financial system, allowing in particular for ongoing regulation of credit flows to households… yet financial unification has stopped at markets, that of retail banking not being deemed a priority. The consequences of this omission are obvious: since 2000, cuts in the Central Bank's base rate have been passed on in a weak and unequal manner within the zone'.

the degree of integration and governance that is desirable in the euro zone. Whether we like it or not, we are in a two-speed monetary – and hence financial – Europe. We must draw the consequences and agree that all legislation required for integration purposes should be drawn up under the rules on enhanced cooperation. This will necessitate awkward decisions, not only for Dublin and Luxembourg but also for other Member States which are playing a very subtle double game: they are superficially proactive but fundamentally not unhappy to use existing reservations as a pretext for allowing the blockage to continue, out of a desire to protect their own financial interests.

Once freedom of movement for capital has been perfected through the use of a single currency, a high-quality monetary policy and good financial stability dictate that the structures and rules in use on all credit markets must converge, as must financial instruments. Homogeneous market structures are a precondition for effective transmission of the ECB's monetary policy and a rapid, uniform dissemination of the impetus it gives on liquidity and interest rates. National regulations liable to skew decision-making and cause traders to react differently should not be allowed to continue. By the same token, regulatory systems must be the same for all national markets, and there must be a hierarchy of supervision within a common supervisory structure. This is especially true since the wave of restructuring currently underway will soon increase the clout of pan-European banks as compared with national institutions, and since the lender of last resort – where required – will be the ECB. In return, the budgetary cost of bankruptcy by a bank or another financial institution should be mutualised at euro zone level. The euro zone should possess the necessary resources or a means of calling on the necessary contributions in the event of need, with a country by country distribution key agreed in advance.

Europe must establish its own doctrine and its own financial and fiscal legislation, so as to be in a position to interact with the rest of the world in a manner consistent with its goals of economic progress, financial stability and social justice. As long as the EU, and especially the euro zone, is itself the theatre of competition between its financial markets –

concerning not only infrastructure, expertise and the quality of services provided by local operators, but also the relative leniency of regulatory systems and differential tax treatment for savings and corporate profits – it will not be capable of launching an effective attack on the most dangerous and unfair dysfunction of global finance: tax havens. While Europe tolerates them at home, it will have to come to terms with them elsewhere.

The many-headed Hydra and the flight of capital are often evoked in this context: getting the better of it would be impossible, and trying to do so would lead to a haemorrhaging of capital. Such objections derive more from brainwashing than serious analysis. Capital may well transit through tax havens but it does not stop there, because it has to be invested somewhere in the real economy in order to generate profit. So how could it manage without the EU or the United States, the world's top two economies, which offer capital a combination of income and the highest security in the world? Because – let there be no mistake – although the tax take on capital is lower in the USA, tax really is levied there, thanks to very rigorous bilateral treaties with the tax havens housing the assets of rich US citizens, and since prison sentences are handed down to fraudsters. It would not be surreal to envisage setting ourselves as of now the medium-term goal of introducing European taxation on capital – corporate profits and income from financial saving – in order to eliminate tax distortions on these very mobile factors, to re-establish fiscal justice towards labour, and to simplify the lives of traders and savers who invest in more than one Member State. This centralisation of tax would be more effective and fairer than the harmonisation that is being thwarted by the unanimous voting system to be maintained in the Amending Treaty. By reconstituting a new, broader tax base at EU level, taxation levels could be reduced. Moreover, while most of the tax receipts would be redistributed to Member States according to a distribution key of the type used between the various federal states in the USA, a proportion could be paid into the Community budget. It could even serve to establish a compensation fund for euro zone countries, acting as an automatic stabilisation mechanism in the case of divergent cyclical patterns between members of the zone. Given this dual basis of unified financial legislation and fiscal legislation, the EU would be in a position to negotiate terms and conditions with offshore markets, compelling these entities or countries to comply with minimum legal and fiscal criteria. Otherwise, sanctions (a boycott, penalties for traders, taxation of capital entering the EU) would be imposed on recalcitrant countries. Finally, the traceability of capital movements would mean that effective measures could be taken against all forms of international financial crime, including those connected with terrorism.

4. What role should the EU play in global financial governance ?

Can the EU confine its efforts to internal regulation when finance has a global and, in particular, a transatlantic dimension owing to market interpenetration (in spite of regulatory divergences), as the existence of the NYSE-Euronext stock market illustrates ? In '*Fragmented Power; Europe and the Global Economy*' (Sapir, 2007), Benoit Coeuré and Jean Pisani-Ferry pick up on something said by Lorenzo Bini-Smaghi, a member of the ECB Board : 'Powerless Europe : why is the euro area still a political dwarf ?'. They later state (Coeuré and Pisani-Ferry, 2007 : 23) that 'only in financial markets is the EU a significant smaller player, because of its comparatively lower degree of financial development'. The point is that the EU does not have a presence, with powers of expression or negotiation consistent with its responsibilities, in any of the bodies exercising global financial and monetary governance (the Bretton Woods financial institutions, G7-Finance, Financial Stability Forum, FATF, Basle Committees). Remarkably, the changeover to the euro did virtually nothing to alter these shortcomings in the EU's external presence, even though several Member States are represented – if not over-represented – for example on the Boards of the IMF and the World Bank. Although the ECB has quite naturally become a part of the system, within the club of main central banks which meet monthly at the BIS in Basle, it is less self-evident that its arrival (with an indeterminate status) in certain regulatory forums constitutes real progress, owing to confusion over the respective roles of the legislator, the legislative and supervisory authorities and the lender of last resort. Marco Brecht and Luis Correia da Silva (2007 : 223) point out in the same volume that: 'as long as the enforcement power of European institutions in financial services is limited, the EU has externally to rely on Member States'. So the problem is always the same: Europe cannot project itself to the outside world as a global economic power unless it has first achieved internal unity. No amount of institutional tinkering will overcome this fundamental obstacle.

Conclusion

In a context of abundant labour supply around the world, the main variables for adjusting to the structural changes brought about by technological innovation and globalised production are jobs, the status conferred on employees by their contract of employment, and of course wages themselves. Financialisation both feeds into and guarantees this dynamic. Institutional investors are demanding a combination of income and high liquidity for individual investors, which forces companies to seek maximum short-term profit and to redistribute it among shareholders in the form of dividends or share purchases. Financial activity – some innovative, some parasitical and predatory and potentially destabilising – compounds this new relationship between productivity gains and the share-out of added value, making taxation even more favourable to capital due to the debt leverage effect.

This extreme financialisation calls into question three fundamental aspects of the European social compromise. Firstly, growth is doubly affected by the long-term shortfall in investment, especially in innovation, and by wage deflation which slows down consumer demand. Secondly, the growing differentiation between wage levels on the one hand, and between profits (of listed companies and of SMEs) on the other, as well as the disparate share of capital and labour in added value, all result in a concentration of wealth unprecedented since 1945; this reveals untenable inequalities, including for an increasing proportion of the middle classes who are being 'dragged down'. Thirdly, the relative detaxation of capital shifts the tax burden from the wealthiest groups to the middle classes and employees, and reduces the government's capacity to rectify excessive inequality either at causal level (equal opportunities) or in terms of its effects (financial assistance to the least well-off).

Can the principle or methods of financialisation be combated ? Is it advisable ? Is it worth a try ? Only very recently have official bodies and commentators in the economic and financial press, who reflect the views of business circles, begun to ask such questions. Excessive income disparities and the risk of instability have until now been played down, if not denied, but they are coming out into the open at the end of a cycle of wealth accumulation and speculation, now that a crisis is looming. It is becoming possible to agree that the link between profit and growth is no longer as self-evident as it may have been in the 1980s after three decades of wage rises at the expense of investment. Today, a rebalancing of wages and profits may well be advantageous in social and macro-economic terms, but the irresistible micro-economic dynamic of the market stands in its way. The logic of market self-regulation, favoured by the dominant neoclassical school of thought, maintains that there must first be a depression phase which erodes profits and devalues assets, but at the cost of rising unemployment and falling real wages.

Can such a scenario, presaged perhaps by the current deepening of the financial crisis and its recession-inducing impact on the real economy, be averted ? How will governments react, particularly those of EU Member States and even more so of the euro zone ? Will the crisis call into question the opening up of markets around the world ? Will it threaten the unity of the EU, which until now has not had to experience a severe, widespread recession ? Could a new form of New Deal negotiated at European level forestall a sustained deterioration in growth performance which would ultimately create a tense, dangerous, social and political climate within and between Member States ?

What should this new European social pact consist of ? We shall list a few essential components by way of conclusion : a reform of corporate governance geared towards increased participation by stakeholders, first and foremost workers; genuine economic governance of the euro zone with macro-economic and structural dimensions; a monetary policy focused on growth and on preventing financial or property bubbles rather than obsessed by inflation; capital taxation (on savings and companies) set at European level, at least for the euro zone, perhaps with the establishment among Member States of a counter-cyclical solidarity and stabilisation fund; controls on movements of capital involving uncooperative offshore markets; accounting and financial standards and supervisory systems that are compatible not just with the demand for financial stability and investor security but also with long-term corporate strategies; flexicurity contracts that strike a balance between training, income safeguards, employment incentives and protection against insecurity and 'poverty wages' in the formal and informal economy. This agenda could be expanded to include Community-scale industrial policies in the fields of energy, the environment and the defence industries. One might even envisage the creation of European services of general interest, for example in respect of the railways, certain road-rail or interconnected energy infrastructures and even in the education sector – specialist universities – or the cultural sphere. Last of all, there should be incentives for the social economy and the non-market sector, since there is no reason why marketisation should become the yardstick for all economic activity.

In short, if the European Union intends to remain open for trade with the rest of the world, which is a *sine qua non* for its prosperity and security, it must be bold enough to re-engage with the 'European exception', with all the wealth of civilisation inherent in this concept. The Union must continue its pursuit of freedom and justice, an approach it first initiated on our continent in the post-war period and which must not fall victim to globalisation. It is the only approach that can save Europe from the much-dreaded slide into security-consciousness which is currently taking hold. Justice and freedom are in fact the only alternative to the fear now pervading those who derive great benefit from inequality and, conversely, those who are afraid of being sucked into insecurity. If Europe wishes to protect freedom from this formidable coalition of fear, it must devise an alternative to neoliberalism. Capital regulation by the EU is imperative in this regard.

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