Introduction

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FINANCIAL CHANGE IN EUROPE

The financial systems of European countries are undergoing rapid change. The forces involved can be divided into two main groups. On the one hand, the various developments covered by the term globalization, involving increasing interactions across state borders and increasing interdependence among national systems of all kinds, are particularly marked in the sphere of finance – indeed it is clear that liberalized finance is one of the main forces behind the globalization process as a whole. On the other hand, there is a well-defined response by political leaderships in the European Union who have adopted a strategy of deeper financial integration within Europe – the key element of this strategy in recent years has been the Financial Services Action Plan (FSAP).

The increasing importance of financial relations across national borders, indicated both by very large international capital flows and by closely correlated movements in interest rates and share prices across many economies, has made for significant changes in the character of financial systems and in how financial sectors interact with households, governments and corporations.

One of these changes is a widespread expansion of financial sectors, which nearly everywhere account for a larger fraction of economic activity. Another, very important, change is a general decline in the ability of governments to influence financial processes – the removal or attenuation of official constraints on financial transactions has been both a cause and a consequence of the increasing internationalization of finance. Although forms of supranational financial regulation have emerged in response to this decline, these are in an early stage of development and certainly do not re-establish the comprehensive control over finance which existed in many countries up to the 1970s. Thirdly there has been a marked shift in the way finance is provided: although the shift has been very uneven in its timing and across different countries, security markets of all kinds, for company shares and for bonds as well as for complex derivatives based on both of these, have been playing a wider role while bank credit has tended to account for a smaller fraction of total financial provision. (This does not mean that the banks as institutions are less important; in fact large banks are extremely important actors in the new financial landscape and are involved in most aspects of security-based finance.)

The financial integration strategy of the EU has tended to reinforce these changes because that strategy has, in recent years, centred on the development of big financial markets, similar to those found in the United States. The US in fact has been the key model for European policy-makers as they tried to promote a unified, continent-wide, financial system.

The general assessment of this strategy made by the authors of this book is that the European financial integration strategy is a rational response to global developments. To put it baldly, if the Europeans failed to build large, liquid capital markets they would simply drive every investor in and issuer of securities into the North American ones. Such an outcome would have two potential disadvantages for Europe: it might lose influence over the shape of the emerging global financial system; and it might fail to develop strategic advantages in the financial sector itself.

There is extensive literature (for example Hall and Soskice, 2001), which emphasizes the strengths of Europe's inherited financial systems. Typically these written works have given a very big role to relationship banking (bank deposits being the primary way in which retail customers participated in the financial system). Large inside investors have provided much corporate finance, which has therefore depended less on the security markets than in the US. Stable, long-term relations between the users and the providers of funds, often supported by other social relations between them, such as membership of the same regional community, have lowered some of the costs and risks of arranging finance.

On the other hand, the traditional financial systems in Europe were fragmented and under competitive pressure from the globalized systems which developed first in the US. These systems themselves have important strengths arising from their scale and the standardization of many types of financial transaction.

Thus the integration of Europe's financial systems logically implies a change in their nature, both to meet external challenges and to facilitate the development of continent-wide financial relations within Europe itself.

FINANCE AND EUROPEAN SOCIETY

However, these financial transformations may have significant social consequences. This follows from the close connections between financial systems and other, usually national or regional, social structures. The scale and pervasiveness of the financial changes taking place, which imply other transformations in the economic system, also suggest that social consequences need to be investigated.

Four major issues in this context arise from ongoing debates among European social scientists. They are very different in their nature but a consideration of each seems essential for any systematic consideration of the social developments in question.

Economic Stability

The first question arises within the economic sphere itself and concerns the possible instability of the new, more integrated financial system with its stronger orientation towards the security markets. The implications of the emerging system for stability by no means all run in the same direction. On the one hand the increased speed and fluidity of financial relations may allow more scope for disturbances, while denser connections among financial actors may propagate these disturbances on a wider scale. The critical developments in financial systems in 2007 illustrate these dangers in a very clear way. On the other hand security-market finance at least in principle permits a very wide dispersion of risks and a much more complete diversification of portfolios while avoiding the concentration of risks in the banking system. However, recent developments indicate that the apparent securitization of bank assets does not always effectively move the risks involved away from the banks involved.

The social consequences of financial instability are clear – increased insecurity in employment and income for much of the population. In welfare terms it is therefore justified to accept lower average returns on investments if this contributes to greater financial and therefore economic stability. The policy issues which arise concern in the first instance financial supervision and regulation, and in the event of major disturbances, crisis management. But these regulatory questions then connect with institutional ones because they concern the complex assignment of tasks and responsibilities among authorities at national EU and world levels.

Social Protection

A second series of questions concerns the relationship between financial change and the reform of social protection systems. Clearly, in this case, the outcomes do not arise from market processes alone but involve political decisions. Nevertheless, there are close connections between the two spheres of finance and social protection: these are focused on the activities of the institutional investors (Davis and Steil, 2001).

The expansion of these institutional investors, insurance companies and collective investment organizations is a key aspect of current financial change. They channel household savings into the security markets by permitting a much more comprehensive diversification of portfolios than would be possible for most households if they invested directly.

A series of policy questions concerns the ability of institutional investors to take over some of the functions presently carried out by social security systems. The two areas most affected are health care and pension provision – this book focuses on the latter merely in order to keep the discussion manageable. There have already been moves in several countries to give institutional investors a larger role in pension provision, and the EU itself has tended to support this type of change. The main motive is to meet budgetary constraints but there are other goals which include the promotion of financial change itself and the desire to reshape incentives around employment and savings.

There are several potential social problems with this policy direction. One important issue concerns equality. The pay-as-you-go public pension systems which are currently under pressure allocate benefits roughly in line with wages. The institutional schemes which are being substituted for them can hardly avoid allocating benefits in accordance with wealth which, as is well known, is much more unequally distributed than income.

Retail Financial Services

A third set of issues concerns the provision of retail financial services. The relationship between these and wholesale financial transactions among banks, big corporations and security markets which have so far been central to the process of integration is itself an important policy question. The integration of wholesale finance, it was suggested above, is a rational policy response to ongoing developments in the global economy. The logic of integration in the retail market is much less clear. Nor indeed have general initiatives been taken in this field: although a programme to integrate mortgage markets was recently under active discussion at the European Commission, the recent chaos in US mortgage markets has probably put paid to that initiative.

Two rather different questions can be mentioned. There is the emergence of web-based financial services which may lead to more cross-border provision of retail financial services. Problems of regulation and control follow from this, which suggest a greater role for the EU.

However, a second issue concerns the consequences for individuals and households of the general changes in financial systems now taking place. The quality of retail services, their cost and accessibility, the risks of financial exclusion, and the cost of credit to low-income households are all characteristics of retail finance which might be affected by the transformation of wholesale systems. The necessary investigations here concern market processes but also regulatory practices. There is an obvious link to the issue discussed above of the substitution of private for public pension provision; such substitution is useful only if retail financial services are of a high quality.

The strengths and weaknesses of retail finance in the United Kingdom seem to offer useful evidence here. The UK financial system is in general much closer to that in the US than are many other systems within the EU. To some extent it indicates the advantages and disadvantages of the kind of transformations which are taking place elsewhere.

Finance and Employment Relations

Finally, financial change may have very important implications for the nature of European employment relations. This can be indicated briefly by pointing to the well-known contrast between a 'shareholder' and a 'stakeholder' concept of the business enterprise. Clearly this is not a hard and fast distinction – opinions on the matter have developed rapidly.[1]

However, the two concepts or models of the enterprise do still imply a different status for employees within it. The shareholder model makes the leadership of the enterprise into the agents of the legal owners as principals, and commits them to formulate strategies only in the interests of these principals. In a stakeholder conception, on the other hand, managerial strategies are determined by a coalition of interests that include labour.

Of course there are many difficulties in assessing whether corporate behaviour in Europe is actually moving from a stakeholder towards a shareholder model. It is certainly not the case that the increased salience of security markets in corporate finance must lead to such a result. The most closely studied case is probably that of Germany, and here there are disagreements about how far corporate behaviour is changing and what the implications for employees will be.

Nevertheless, there can be no doubt that these questions of employment relations are central to the European social models because they relate to the future nature of the social partnerships and the social dialogues which are, almost by definition, key components of the models.

PLAN OF THE BOOK

This book is based on the work of a European network (FISC) which discussed these issues intensively with a wide range of specialists over a period of three years. The network did not adopt any narrowly specified methodology – given the range of issues and their very different character, it was important to adopt a multi-disciplinary approach and to make use of all studies that helped to clarify the key questions. Nor did the authors attempt to reach unanimous conclusions – at the end of the work there were still some significant divergences among the authors on both theoretical and policy questions.

Nevertheless, the authors, all of whom are active in the Euromemorandum Group,[2] were broadly agreed on two key aspects of the work. In regard to financial processes themselves, they made eclectic use of work in each of the mainstream paradigms: the very abstract efficient markets approach; the asymmetric information approach which makes a major contribution to the understanding of economic institutions; as well as recent critical work within the mainstream, such as behavioural finance and the study of market microstructure. The only question asked was whether a particular study was useful for the research tasks of the network.

However, it is the case that all the members of the group have been influenced by heterodox, essentially neo-Marxist or post-Keynesian theories.[3] These schools of thought most certainly do not reject the insights referred to above but they share a common emphasis on the role of finance in disequilibrated economic systems. As Grahl (2007) points out, both the Marxian and Keynesian traditions call into question the tendency of markets to clear. In doing so they suggest firstly that only effective financial mechanisms permit a market economy to endure and secondly that the key adjustments in such economies are brought about by the pressure of surplus on deficit units rather than by the abstract responses to alterations in relative prices which are invoked in standard theories. Likewise both heterodox traditions, in spite of their differences, tend to regard finance as essentially the mobilization of monetary resources. The mainstream definition of a financial transaction as one which takes place over time is certainly not incorrect but tends to be seen as somewhat abstract.

This orientation does not automatically support any particular conclusions, positive or normative, about financial processes but it does suggest that these processes are extremely important and that changes in the financial sphere may be closely related to those in broader structures of production and exchange.

The second area of broad agreement among the authors concerns social justice. All the schools of thought in which the mainstream discussion of

European financial integration is rooted, have in common the belief that it is essentially market distortions which prevent financial markets from working in the most efficient way possible. In this view, inequalities of income and wealth are irrelevant to financial market efficiency. In contrast to this, the starting point of the authors represented in this volume is that banks and financial markets are chiefly influenced in the conduct of their business by the financing requirements of the wealthy and of the large corporations that have the widest access to and choice in banking and financial markets, and by the balance sheet requirements of the largest banks and financial institutions. The distribution of wealth and income is therefore a key conditioning factor in the functioning of those markets. In so far as an increasing proportion of wealth consists of financial assets, and because many ordinary households are increasingly debilitated by a lack of access to banking and financial services, the effects of financial intermediation on the distribution of wealth and income are a critical aspect of the efficiency of those services. The distributional conditions and consequences of European financial integration are the key links to social justice in the various spheres discussed in the following chapters.

Since these broad agreements were seen as more important than the differences of opinion among the authors, what they present in this book is not a simple collection of papers but rather a systematic and unified account of financial change in Europe and its social consequences. Because of the actual divergences, each chapter is signed by its main author, who assumes responsibility for the views expressed in it, but the sequence of chapters tries to achieve a logical and inclusive structure.

The first two chapters, by Trevor Evans, present a condensed account firstly of financial processes in general and then of international finance as they function in today's economies. These chapters specify, in some detail, the nature of the global financial processes which are developing and the same time explain the economic meaning of the main types of financial market and financial institution discussed throughout the book.

The third and fourth chapters, by Marica Frangakis, put European issues in the foreground: Chapter 3 analyses the pressures for change arising from globalized finance, while Chapter 4 gives a detailed account of the EU's financial integration policies.

The fifth chapter, by John Grahl, relates EU financial policies to the general framework of EU policy summed up in the Lisbon strategy. The sixth, by Grahl and Thorsten Block takes a highly critical look at some of the technical studies of financial integration sponsored by the Commission.

The focus then shifts to the four types of social impact discussed above. Jan Toporowski examines, in Chapter 7, the problems of stability associated with financial integration. The recent turbulence on financial markets clearly demonstrates the importance of the issue of stability, casually dismissed by the European Commission in its drive for financial market integration. In Chapter 8 Photis Lysandrou poses a key question: what are the implications of changing patterns of finance for European corporations?

In Chapters 9, 10 and 11, John Grahl continues the examination of the social impact of financial change, looking first at social security (especially pensions), then retail finance and finally employment relations. It is argued in each case that the EU drive for rapid integration is not accompanied by sufficient concern to prevent adverse social consequences.

The last four chapters, by Jörg Huffschmid and Dominique Plihon, continue the discussion of social impacts, but now with a specific view to making policy recommendations. In Chapter 12, Huffschmid proposes a range of interventions and controls designed to strengthen the position of ordinary citizens, both as employees and as consumers, against the power of the banks and financial corporations. In Chapter 13, he makes a strong case for the preservation and development of public pay-as-you-go pensions. Plihon discusses in Chapter 14 the measures needed to counter the acute financial instability of recent years. In the final chapter he widens the discussion to consider policy responses to the globalization process as a whole.

NOTES

1. See, as an interesting example, the evolving views of Michel Jensen (Jensen and Murphy, 2004), once regarded as a leading champion of the shareholder model
2. The Euromemorandum Group, 'Alternative Economic Policy for Europe', researches EU economic policies and publishes a critical assessment of them every year. See www.memo-europe.uni-bremen.de.
3. Indeed the FISC network included, in Professor Reuten and Dr Toporowski, two very distinguished historians of these schools of thought.