After the crisis: towards a sustainable growth model

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Introduction

As the first decade of the 21st century comes to its term, most countries in Europe and the world still find themselves in the midst of the severest financial and economic crisis in eighty years. Its outcome is still uncertain.

Prior to its collapse in 2008, the prevailing concept of *laissez-faire* financial capitalism had been based on, among other things, the illusion that profits, in particular in the financial sector, could grow at double-digit rates while overall economic growth remained in the low single-digit range. This was reflected, in most countries, in a steady shift in national income from labour to capital. At the same time government policies and structural trends promoted a shift within wage income towards higher-income groups and exerted downward pressure on the terms and conditions of those at the bottom of the labour market.

One of the consequences of these trends was a structural weakness in the growth of demand. Two opposite but complementary growth models emerged, both based on the necessity to address this structural demand-side weakness: either increased household borrowing (e.g. US, UK, Spain), usually on the back of speculative bubbles in asset prices, or export-led growth (Germany, Japan, China) driven by wage moderation relative to productivity trends. Growing global economic imbalances were the result. The crisis has clearly shown that both growth models individually, and their perverse symbiosis, have proven economically unsustainable.

Meanwhile a longer-term crisis was brewing: the ecological unsustainability of the prevailing economic model. This interacted with the economic crisis most obviously in the form of rapidly rising commodity prices during the bubble phase. But the issues – the impossibility of perpetually increasing per capita goods consumption plus growing populations on a planet with finite material resources and tolerance of rising emissions – are more fundamental and remain largely unaddressed, as testified by the failure of the Copenhagen summit at the end of 2009.

The devastating economic and financial crisis has revealed the limitations of financial capitalism and has opened up a window of opportunity to propose and implement the progressive reforms that Europe needs to shift to an equitable and socially and ecologically sustainable growth model. However, as real or imagined signs of recovery are perceived, conservative forces are clearly seeking to re-establish their intellectual hegemony, limit the extent of progressive policy reforms, and return to 'business as usual'. Indeed, with government finances strained and unemployment high, some are seeking to turn the clock back to the discourse of the early 1990s and launching renewed and aggressive attacks on the public sector, welfare states and workers' rights.

It is against this background that the European Trade Union Institute has brought together critical and progressive academics and researchers from Europe and the United States to help launch a debate on setting an agenda for a reformed capitalism 'after the crisis'. This book is the outcome. While a growing number of publications have appeared dealing primarily with analyses of the causes of the crisis, the central aim of this book is to move the agenda from the question 'How could all this have happened?' towards issues of what a new growth model should look like in the aftermath of the crisis. Each contributor to this book was asked to produce a short analysis and policy-oriented proposals in one area relevant to a post-crisis world. In most cases further reading is suggested for those who would like to follow up the issue in question in more detail. The opinions presented here are those of the respective authors, and no attempt has been made by the editors to shoe-horn the contributions into a specific policy agenda. As a result, there are also some overlaps and – we hope productive – contradictions between different texts. However, a number of common themes emerge and this Introduction seeks to tease them out. One thing unites them all, and that is the recognition that the crisis was more than a failure of financial markets: re-regulation of financial markets is necessary, but not sufficient to prevent future damage and to stabilise the overall economy. Rather, a broad agenda of change in a number of policy areas is needed to address the underlying causes in the economic, social and ecological fields. In short, what is needed is a transformation of the existing growth model.

The 39 contributions to this book are divided into four thematic sections. The first deals with financial market re-regulation; the second with labour market and social policies for more equality, social justice and good jobs for all; the third with macroeconomic policy reform and coordination; while the fourth covers institutional complementarities and issues raised by the imperative of ecologically sustainable growth.

Re-regulating the financial sector

According to IMF figures, the total cost of the financial crisis will amount to the astronomic figure of $12 trillion or 20 percent of annual world output. This includes capital injections pumped into banks, the cost of neutralising the so-called 'toxic assets' (paper that is worthless or at least impossible to value) in balance sheets, debt guarantees and vast liquidity support from central banks. As a result of short-term interventions from governments and central banks, countries of the G20 face a combined budget deficit of 10 percent of their GDP in 2009, the biggest since World War II. The starting point of the crisis was undoubtedly the failings in the financial sector. For this reason, section 1, *Re-regulating the financial sector*, takes stock of what went wrong in the world of finance as a point of departure for setting out a wide range of regulatory measures that are deemed essential to clean up the mess and, crucially, to prevent major crises in the future.

All contributions in this section advocate a smaller financial system that serves the interest of the real economy. Since the credit freeze brought the global financial system to the brink of collapse in the aftermath of the failure of Lehman Brothers on 15 September 2008, governments of the G20 have been seeking to move in the direction of a common approach to financial regulation. In his *Principles for financial sector reform*, Sony Kapoor identifies a lack of competition in the banking sector and a regulatory regime that favours big institutions over smaller ones, two factors that serve to encourage speculative and destabilising behaviour. Both he and Paul De Grauwe – in his contribution *The future of banking* – advocate greater simplicity in finance through a functional separation of the banking sector, the second of these two authors referring explicitly to the core principles of the US Glass-Steagall act. Narrow banking should not be regarded as an impediment to growth, but rather as an impediment to the creation of bubble economies, the temporary and artificially high growth rates of which were based on securitisation of credit.

Dean Baker appeals to the regulatory authority and capability of central banks to prevent asset bubbles before they distort the fundamentals of economic growth. Allowing a massive housing bubble to inflate without counteraction was a massive policy error, for which incumbent policymakers should rightly have paid with their jobs. He recommends the introduction of financial transaction taxes to limit the size of primarily speculative transactions. Stefan Schulmeister looks at the financial transaction tax in detail, providing model calculations for different tax rates of generalised financial transaction taxes, and pointing to their mitigating effects on asset price fluctuations and their revenue potential for fiscal consolidation needs after the crisis. In *Making finance serve society*, Helene Schuberth describes the fundamental role of the financial system in intermediation, the allocation and transfer of capital investment to productive use. Shareholder value orientation and financial innovation have shifted the function of risk transformation towards transferring credit risks to society at large. The provision of finance constitutes a public good; therefore the future banking system should be built on a core of public-service, mutual and/or cooperative banking which should not be allowed to engage in investment banking or other features of the shadow banking system.

In many countries, including in the US, governments have put insolvent banks under public receivership, either fully or in part. These banks, in other words, have been nationalised. Yiannis Kitromilides asks whether these moves that most governments, only a few years ago, would have rejected as totally inconceivable must inevitably be temporary in nature – until balance sheets are cleaned up and profitability restored – or whether at least some banks should become a permanent part of the public sector in a mixed economy. In *Reforming finance*, Robert Kuttner lists ten areas of financial reform that are essential to reestablish two basic functions of the banking sector, namely extending credit to households and the business sector, and connecting investors to entrepreneurs, whereas pure trading and speculating should be discouraged to the maximum degree possible. Against the Basel institutions' conventional wisdom of raising capital standards and central banks' blunt fixation on using short-term interest rates, Thomas Palley pleads for *A better way to regulate financial markets* through the introduction of mandatory and variable asset-based reserve requirements for all financial firms. Alongside their stabilising effects on the financial system, these would also increase the efficacy of monetary policy (especially within the euro area, as national requirements could vary) and act as automatic stabilisers at the macroeconomic level.

Building a real economy for equality, social justice and good jobs for all

All contributions in the second section, *Building a real economy for equality, social justice and good jobs for all*, deal with various aspects of the root causes of the financial and economic crisis cited above, notably the growing inequality in most of our societies over the last thirty years and the growth of low-productivity 'bad' jobs. Under the auspices of the neo-liberal consensus, both financialisation and shareholder value orientation grew increasingly dominant, deeply transforming the post-war economic, industrial relations and also regulatory systems. This began in the Anglo-Saxon world in the early 1980s with the Reagan/Thatcher reforms, and later crept into both 'old' and 'new' continental Europe, forging what some have called the 'Brussels Consensus'. In contrast to the pre-crisis model, most contributions in this section echo an approach to shared prosperity, social justice and income distribution, in the tradition of Kalecki and Keynes, which renders growth patterns more stable and sustainable both economically and socially.

Strengthening labour relations and workplace innovations appear as prerequisites for a sustained recovery and future growth in Eileen Applebaum's contribution that focuses on enabling workers and their unions to negotiate wage growth in line with enhanced productivity growth. This requires the dissemination of high-performance working practices that engage workers, a raising of minimum standards, and substantial changes to labour law. Ronald Schettkat, in *Employment after the crisis*, questions the macroeconomic assignment of economic actors in Europe under the neo-liberal regime and, in particular, the deflationary bias of an Economic and Monetary Union based on the theory of a natural rate of unemployment. He calls for a New Deal for Europe such as to ensure that growth remains above its trend rate for an extended period as a means of bringing down unemployment. Sandrine Cazes and Sher Verick point to the role of labour market policies to mitigate the jobs crisis and support a jobs-led recovery, calling on governments to develop stronger labour market institutions and broad-based social security systems that can act as automatic stabilisers during a crisis. Refuting the revised European employment strategy's inconsistent objective of 'making work pay', Bernard Gazier argues for a new norm of sustainable full employment, taking account of and strengthening labour market transitions, while also advocating an end to the gender-biased division of domestic labour. Allan Larsson, in his *Stress-testing Europe's social systems*, proposes a '5P-test', according to which productivity, poverty reduction, pensions, political and social involvement, and public finances, are tested for their crisis resilience. He calls on the new EU Commission to set a European agenda to defend and develop social systems.

Friederike Maier, in her contribution *Re-cession or He-cession*, deconstructs the gender dimensions of the crisis, rejecting the argument that primarily men were hit by the recession. As policy responses to the crisis are not gender-neutral, she draws attention to the need for gender equality in developing economic and labour market policies to overcome the recession. Failing this, the crisis would inevitably serve to deepen gender differences once more. Jill Rubery advocates the adoption of five principles to establish a more equal gender order against the risks of recessionary cutbacks. These principles encompass parental support policies, gender-specific impacts of minimum wage and pension policies, women's rights to economic independence, public sector restructuring, and the need to challenge the power of male elites in the private sector.

Ewart Keep and Ken Mayhew, in *Training and skills during and after the crisis*, examine what to do, and what not to do, when public resources available for education and training become scarce. Although politicians frequently insist on the importance of education and training, it is not a 'silver bullet' in responding to the crisis. Measures to encourage the provision of high-quality apprenticeships, rather than, for example, lengthening compulsory schooling, would represent an appropriate use of public money in many countries. Mario Pianta pleads for a doubling of national and EU resources for *Industrial and innovation policies in Europe*. A new approach to industrial and innovation policies is, he argues, needed to overcome an economic model based on financial rents, and he recommends a focus on information and communication technologies, ecological restructuring and health services, while stressing also that new forms of finance must be tapped, including via the issuing of Eurobonds. The very title of Wiemer Salverda's contribution, *Inequality and the great (wage) moderation*, tells a tale, that of the discrediting of the almost thirty-year-long belief in what Ben Bernanke called the 'great moderation', namely, the idea that market deregulation would bring about increasing employment through lower inflation and declining economic volatility. His call for a better protection of lower wage-earners and incomes by trade unions, and more specifically through an internationalisation of minimum pay, is reiterated in Thorsten Schulten's plea for *A European minimum wage policy* in which a more egalitarian distribution of income would be the result of compressing the wage structure from the lower end, thereby stabilising or even increasing the wage share in national income. This can be achieved by an approach inspired by the open method of coordination: a European minimum wage target at EU level should be set according to which, in every country, the minimum wage – determined either by law or by collective agreement – should be at least 60% of the relevant (national or sectoral) average wage.

Stabilising the macro economy through policy reforms and coordination

The starting point of all the contributions in the third section, *Stabilising the macro economy through policy reforms and coordination*, is that, in the real world, a decentralised market economy is not self-stabilising. This is due only partly to the specific features of the financial sector analysed in the first section, for the causes of instability are indeed more fundamental. In the absence of explicit intervention by government, market economies produce undesirable, even disastrous, outcomes: booms and busts, rising inequalities, economic imbalances. While this may seem self-evident 'after the crisis', it actually runs counter to fundamental tenets of mainstream economics in which simplifying analytical assumptions – such as perfect competition, perfect information, so-called 'rational expectations', the neutrality of money, the separation between the monetary and the real sphere – increasingly became unquestioned (or simply forgotten) working hypotheses on which theoretical work and, subsequently, policy recommendations are based. It was a characteristic feature of the period of dominance of neo-liberalism after 1980 that 'markets knew best', that government failure was pervasive and that even when governments genuinely tried to improve outcomes – rather than serving the interests of politicians and other 'insiders' – they almost always made matters worse. This marked a step back from the more pragmatic economic theorising and policy of the 'Keynesian' period, in which observed relationships at the level of the aggregate economy, rather than theoretical assumptions about supposedly 'rational' behaviour by agents at the micro level (so-called 'microfoundations'), were the starting point for theory and policy.

In different areas, the contributors identify problems arising from a lack of, or from poorly designed, state intervention and call for the introduction of corrective and/or more effective policies. Four of the contributions in this section focus on the current account imbalances that have built up between countries, both globally and within Europe, and are widely seen as having played a key role in the crisis. In a textbook world such imbalances would not arise, as they would be quickly corrected by appropriate changes in exchange rates or, in a monetary union, by competitive pressures on goods markets. The authors show, however, that these equilibrating mechanisms do not work in the real world and propose, accordingly, a range of measures designed to correct imbalances and prevent them from growing to such dangerous proportions in the future. Both Heiner Flassbeck and Pierre Defraigne, while differing in their analysis of the crisis, analyse this issue from a global perspective. They call, amongst other things, for profound changes to global economic governance systems (an increased role for a fundamentally reformed IMF) and for forceful, coordinated action on financial markets, not least foreign exchange markets, insofar as some macroeconomic prices, notably exchange rates, are too important to be left to the vagaries of financial markets. The contributions by Sebastian Dullien and Daniela Schwarzer and by Willi Koll and Volker Hallwirth focus on the intra-European imbalances and propose measures to strengthen the institutional policy monitoring framework at the European level. While Dullien and Schwarzer call for an 'external stability pact' as an extension of the fiscal surveillance process, as a means of monitoring current account imbalances and penalising excessive deficits and, crucially, also surpluses, Koll and Hallwirth recommend *Strengthening the Macroeconomic Dialogue* at European level and supplementing it with national-level parallel dialogues in order to promote wage agreements in line with the needs of non-inflationary, balanced growth within the monetary union.

Since the 1980s the two key policy levers for economic stabilisation – monetary policy and fiscal policy – had been systematically discredited, first by academic economics and subsequently by economic policymakers. According to a consensus that also underpinned the Maastricht economic governance architecture in Europe, monetary policy was to focus exclusively on stabilising inflation, as this was held to be the best (indeed only) way to stabilise the real economy. Fiscal policy – since it could not easily be taken away entirely from governments and parliaments – remained inherently dangerous, in the consensus view, and politicians' hands needed to be firmly tied together to prevent abuse, specifically excessive deficits. The crisis has shattered these beliefs. Swift and aggressive monetary and fiscal policy responses, even if, in Europe, they were far from optimal, were certainly effective in preventing a repeat of the Great Depression. Both monetary and fiscal policy clearly have major and long-lasting effects on the real economy, contrary to the previously dominant teachings of the rational expectations and Ricardian equivalence proponents. What now for these policy areas after the crisis?

Gustav Horn asks *What role for monetary policy?* and responds that a broadening of the mandate of the central bank is needed to incorporate real economic stabilisation and concern for the stability of the financial sector at the macroeconomic level; to this end central banks must have new tools, such as counter-cyclically variable capital requirements. Better fiscal-monetary policy coordination is also vital. Andrew Watt argues that, in order to bring about a needed strengthening of the automatic fiscal stabilisers, use should be made of the European open method of coordination: member states should be induced to hit benchmarks for stronger automatic stabilisers, which because of cross-border spill-overs would be in all countries' best interest. Richard Murphy and Markus Meinzer identify *The tax gap at the core of the current financial crisis and how to close it*. They set out the steps needed to prevent the current huge losses of tax revenue to tax evasion and avoidance due to fiscal competition: notably country-by-country reporting for multinationals and automatic information exchange between tax authorities. Franz Nauschnigg proposes a variable credit growth stabilisation tax that would act as an effective built-in stabiliser, countering bubbles and also helping countries within EMU adjust to a common interest rate. In addition, Eurobonds should be issued to create European-level funds that would aid countries facing constraints on the use of demand-side policies. Together they would create a *Better European financial architecture to prevent crises*.

Given the seriousness of the crisis in the advanced capitalist countries, there is a risk of ignoring the massive problems facing many developing countries. Nuria Molina identifies critical weaknesses in the architecture and the practice of development finance and proposes a series of reforms that are required to *Make finance work for development*. These include a set of binding principles for all development loans that also open up space for alternative policy approaches. Gerald Epstein discusses in detail the use of capital controls as an essential tool, not only for developing countries, in stabilising and managing their economies in the interests of balanced and sustainable growth. Well designed and dynamic capital controls can, he explains, reduce debt, currency mismatches and speculative excesses.

Creating institutional complementarities and making the transition to ecological sustainability

The fourth section, *Creating institutional complementarities and making the transition to ecological sustainability*, covers two key aspects of the broader concept of the sustainability of economic activity. The first is the need to create an overarching and coherent framework of institutions ('institutional complementarities') that embed the narrower, market-driven sphere of production within a broader social framework to ensure the system's social and also material reproduction. Otherwise, unregulated or poorly regulated market mechanisms can destroy the social basis upon which they are dependent for their functioning. The second aspect of sustainability starts out from the recognition that production and consumption must respect the limitations set by the 'categorical imperative' of ensuring that our lifestyles do not compromise the ability of future generations to lead a decent life. Both these elements are hard to grasp within the dominant economic paradigm insofar as this takes as its starting point individual rationality and choice driven by economic incentives, in which prices reflect current 'relative scarcities', and conceives of production as a combination of labour with an in principle unlimited range of physical inputs in which technology is always benign, resulting in an increased quantitative stream of products that people want to buy on the market.

The first five contributions focus on various aspects of coherent institutional frameworks, or 'institutional complementarities'. Bruno Amable starts out from the recognition that *A change of model requires a new balance of power*. He outlines the contours of a new social model based on the interests of the majority of wage-earners, which re-regulates markets, reinforces social protection and defends public services. To this end, a renewed class compromise is required, in order to break down the dominant alliance between finance and high-skilled workers. Dorothee Bohle and Bela Greskovits examine the lessons to be drawn from the crisis for the east central European countries, and Henning Jørgensen does the same for the Nordic countries, in both cases with a focus on institutional complementarities. In the former case the liberal recipes currently being promoted for the new member states are rejected in favour of a longer-term development strategy involving partnership, policy coordination and social dialogue. This requires strong state involvement and adequate fiscal resources which are, hardly coincidentally, the elements identified as underlying the historically good performance of the Nordic countries. The combination of full-employment-oriented macroeconomic policies, flexible markets, strong welfare states and a key role for negotiation between social partners has proved effective in the past and needs to be continually adapted to changing conditions. Similarly Frank Hoffer, at the global level, insists on the need for broad-based complementary policies that go beyond mere repair of the financial sector, drawing on the ILO's Global Jobs Pact. Trade unions, in particular, this author stresses, must do more than merely be co-opted into strategies to 'share the pain'. Sigurt Vitols, meanwhile, setting out a vision for *The sustainable company*, focuses on the company level and proposes a set of measures needed to reorient companies away from short-term stock market performance towards ecological, social and financial sustainability. This requires the development of an appropriate reporting system, the alignment of managerial incentives to these goals and the closer involvement of workers' representatives.

The concluding four contributions in this volume deal more specifically with the issue of ecological sustainability. The challenge is now widely recognised (although climate-change deniers still abound), but what instruments are needed to meet it and, importantly, how is undue sacrifice of other valid social goals (equality, decent jobs, rising living standards) to be avoided?

Iain Begg examines the scope for reforming the EU budget to promote sustainable development. Even given its current limited size, substantial resources could be channelled into a broad carbon mitigation and adaptation programme with a European value added. Begg notes that additional revenues could be generated by a carbon tax, a proposal that is further developed by Jacques Le Cacheux who shows that the EU's lofty ambitions on climate change are not achievable without much more stringent measures, including a coordinated attempt to tax carbon and prevent carbon leakage through a cross-border levy. Jean Gadrey, in his *A job-rich post-growth economy*, considers how our economies could simultaneously address ecological sustainability issues while maintaining high levels of employment: a radical shift in production structures is required in favour of care services and the production and maintenance of (fewer) high quality goods. Such an approach must go hand in hand with measures to reduce inequality and changes in our concept of growth in favour of a more qualitative approach. The publication closes with a contribution by Pierre Jonckheer proposing a Green New Deal and arguing that a broad range of policies will be needed over and above a mere strategy of investing in low-emissions technologies. In addition, regulatory instruments will be required, as will a comprehensive programme to manage the changes required in our labour markets and employment systems. Finally, issues of financing change need to be resolved, notably by diverting public spending towards green investments.

Concluding remarks and acknowledgements

The key purpose of this book is twofold: firstly, to insist on the need for a broad-based reform agenda that is founded on an analysis of the fundamental causes of the crisis, rather than merely tinkering with problematic elements of the financial sector; secondly, to show that there are realistic, progressive alternatives to a return to neo-liberal 'business as usual', and that a new and different growth model, one that is economically, socially and environmentally sustainable, is possible.

Our hope is that the contributions to this book will stimulate further debate among policymakers, academics, and in organised civil society, on the sort of economy and society we would like to live in 'after the crisis' – and that debate will lead to corresponding action! In the European context, it can be seen as a contribution to the on-going debate on the so-called EU 2020 strategy, the successor to the Lisbon Strategy. Common to all the contributions to this volume is the recognition that we need to move far beyond Lisbon, both thematically and in terns of governance processes, if Europe is to meet the demands of its citizens for rising prosperity – in the widest sense of that word – for all.

Producing a book of this nature is a collective endeavour involving a great many people. We would like to thank, first and foremost, the contributors for their response to our call and for providing such stimulating and concise papers. Thanks are due, in addition, to all the many colleagues at the European Trade Union Institute who contributed in different ways to the preparation of this book and the organisation of the *After the crisis* conference held in January 2010. We would particularly like to mention Géraldine Hofmann, Kathleen Llanwarne, Philippe Pochet and Veerle Raes.

Andrew Watt and Andreas Botsch
Brussels, February 2010

Part 1
Re-regulating the financial sector

Principles for financial system reform

Sony Kapoor
Re-Define – Re-thinking Development Finance & Environment

Sony Kapoor is a former investment banker and derivatives trader who now runs Re-Define, an international think tank which advices several governments, international institutions and civil society actors on financial system reform, macroeconomy and development. He has been a strategy adviser to several governments and non-governmental entities, in areas such as debt cancellation, action against tax havens and financial transaction taxes.

The lack of competition in the banking sector and a regulatory regime that favours big institutions over smaller ones are two factors that serve to encourage speculative and destabilising behaviour. The author thus advocates greater simplicity in finance through a functional separation of the banking sector.

In the absence of a set of fundamental principles to guide it, it is more than likely that the reform of the financial system would lose its way and end up not achieving what it is meant to do – create a financial system that supports the real economy and does so without posing a burden on taxpayers. What we recommend below is a minimum set of such principles that financial reforms would need to fulfil.

Competitiveness

The 20%-25% return on equity for banks, 2/20 % hedge fund fee structures and more than $100 billion in annual bonus payouts, all salient features of the pre-crisis financial landscape, are symptoms of too little competition. When the financial sector, a mere facilitator of the real economy, starts accounting for 30%-40% of all corporate profits as it did in the US, this is clear evidence of an oligopoly which is parasitic to the real economy.

Current regulations favour big institutions over small, international banks over domestic banks and complex ones over simpler rivals. This asymmetry, economies of scale and the public subsidy enjoyed by institutions considered 'too big or too complex to fail', has driven the trend towards ever greater consolidation into financial giants with few if any new entrants.

The high rewards available to employees and shareholders in a non-competitive system and the protection against failure for large institutions skew incentives and encourage speculative and destabilizing behaviour. Barriers to entry need to be lowered and financial institutions need to be broken up so their failure no longer poses a threat to the system.

This would deliver a much better deal not only for customers and investors but also for taxpayers since such a system would also be less likely to crash.

Diversity

Soldiers crossing a bridge are asked to break step else the bridge would become unstable and collapse. Likewise, financial stability comes from diversity of behaviour. When everyone wants to buy or sell at the same time, we get asset price bubbles and collapses.

We need the whole range of financial institutions – savings banks, insurance firms, merchant banks, pension funds and development banks doing what they are supposed to do. When banks behave like hedge funds, hedge funds like banks and insurance companies like both we are in serious trouble.

Current regulation allows market prices and institutions' own judgement of risk to influence how much capital they hold. Since this capital is held to guard against market and institutional failures in the first place, there is a big contradiction here. This, together with the use of similar risk management and bonus incentive systems, drives everyone to invest in the same assets at the same time and reduces diversity. It has made the financial system more pro-cyclical, unstable and prone to systemic collapse.

Portfolio theory in finance that advocates that one not place all eggs in a single basket drives every investor to seek new asset classes in which to invest. This worked well as long as access to asset markets, geographic reach and the information available to different investors all differed, since the various buckets of investments were genuinely distinct – i.e. there were many different baskets.

Advances in information technology have meant that nearly everyone has access to the same asset price data more or less at the same time; capital account liberalization has meant that, for all practical purposes, all large and significant financial markets are now open to overseas investors; regulation has driven more and more financial actors to use similar market price incorporating risk-management systems; and the growth of the bonus culture and annual shareholder maximising objectives has made more and more financial actors behave identically in a bid to maximise their income.

The pursuit of diversification against this background has led to an increased degree of uniformity in the financial system which has made it more interconnected and fragile to external and internal shocks with the ongoing financial crisis symptomatic of these changes.

Financial institutions need to be regulated by what they do, not by what they say they do. Capital requirements need to be mandated by regulators, not by markets or own judgement. Diversity can come from different investment horizons, incentive systems, risk appetites or regulatory requirements, and it needs to be actively encouraged.

Simplicity

Because financial regulation lacks broad principles, reactive efforts to 'fine tune' and adjust it have left us with tens of thousands of pages of laws and guidelines which are full of loopholes but act as a barrier to entry nonetheless. Moreover, because these differ across jurisdictions and legal form, financial institutions set up a complex network of hundreds of subsidiaries to game the system. This makes them not only too complex to fail but also, in the case of behemoths such as Citicorp which has more than 2,000 subsidiaries (427 in tax havens), too complex to manage.

What we need is to hardwire simple and blunt regulation such as caps on leverage, country-by-country reporting and prohibitions of off-balance-sheet exposures. This would be more effective if co-ordinated internationally.

There has been a parallel rise in the complexity of financial products driven by the fact that complexity increases profit margins and opportunities for tax and regulatory arbitrage. It does so by increasing information asymmetry between the financial institutions on the one hand and its customers and regulators on the other.

Complexity in legal structures and products also increases opacity and reduces supervisory effectiveness, thus increasing systemic risk. Regulation needs to push for simplicity in legal structures and in financial products.

Fairness

Large banks excel in reducing the tax burden on themselves, as well as on their employees and large customers, through the use of complex products and legal structures often involving tax havens. In good times, they do not pay their fair share of taxes and in bad times the little people like the rest of us who do pay our taxes bail them out. This is not only unfair but, even more importantly, destabilizing since it encourages excessive risk-taking.

Polluters must be made to pay so there is an urgent need to crack down on tax avoidance by banks, bankers and their clients. While that can help reduce future abuse, the costs of ongoing and future bailouts must also be recovered from the financial sector through levying financial transaction taxes. These are easy to collect, hard to avoid, have a very progressive incidence, have the potential to increase stability and can be implemented unilaterally.

Compensation in the financial sector needs to be regulated sharply downwards to make it more symmetric. The best way to do this would be to cap bonuses to 100% (or less) of salary. Current annual bonus structures of multiples of base salary drive short-termism, speculation and irresponsible behaviour because such behaviour can be highly rewarding. The only problem is that eventually the taxpayer has to foot the bill.

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Recipe for reform: accountable regulators and a smaller financial sector

Dean Baker
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Dean Baker is an economist and a co-director of the Center for Economic and Policy Research in Washington, D.C. He is the author of *False Profits: Recovering from the Bubble Economy*, amongst other books. He also has a blog entitled "Beat the Press" on *The American Prospect*, in which he discusses the media's coverage of economic issues. He is frequently cited in economics reporting in major media outlets, including the *New York Times*, *Washington Post*, CNN, CNBC, and National Public Radio.

Allowing a massive housing bubble to inflate without counteraction was a massive policy error. The regulatory authority and capability of central banks to prevent asset bubbles before they distort fundamentals of economic growth should be re-established, while financial transaction taxes would limit the size of primarily speculative transactions.

Most of the debate over reforming the financial system in the wake of the financial crisis has not addressed the fundamental problems that led up to the crisis: an enormous asset bubble and a bloated financial sector. Serious reform should place these items at the top of the agenda.

The asset bubble took the form of a huge over-valuation of housing prices in the United States and many other countries. This over-valuation led to a distorted pattern of growth, with enormous overbuilding of housing and a consumption boom driven by trillions of dollars in housing bubble wealth.

The pattern of growth was more distorted in the United States than many other countries because there are few obstacles to construction and it is relatively easy for homeowners to borrow against the wealth in their homes. During the peak years of the bubble, the residential construction share of US GDP expanded by more than 2 percentage points above its normal level. The savings rate fell to less than zero from a historic level of close to 8.0 percent, implying that housing bubble-driven consumption was more than 4 percentage points of GDP.

When the bubble burst, residential construction and consumption both fell sharply. There is no simple mechanism for replacing a sudden drop in GDP of more than 6 percentage points. The financial crisis accompanying the bursting of the bubble worsened the situation, but the bubble itself virtually guaranteed a severe recession. This fact was entirely foreseeable. It was therefore remarkable negligence on the part of central bankers, most importantly the Federal Reserve Board in the United States, to allow a housing bubble to grow to such enormous proportions.

The lesson from this episode is that central bankers must take very seriously their responsibility to prevent major asset bubbles that distort patterns of economic growth. In this case, deflating the housing bubble before it reached dangerous levels was a far more important priority than any other possible concern of the central bankers.

A commitment to maintaining economic stability required that they take every possible measure to attack the bubble. The first and most important step would have been to use their research capabilities and their platform in public debates to carefully document and present the evidence for the existence of a bubble and the harm that would be caused by its collapse. It is likely that this information alone would have had a substantial impact on the housing bubble, since an explicit and well-documented warning from central bankers that homeowners and lenders would lose money by investing in housing would, in all likelihood, have constituted a substantial deterrent.

Central bankers also should have used their regulatory powers to clamp down on bad lending practices (such as offering low initial ‘teaser’ rates, which subsequently re-set to higher levels) that were inflating the bubble. These practices were quite evident in the United States, where the non-prime segment of the mortgage market exploded in a period in which the labour market was weak and income growth non-existent. Accounts of fraud in mortgage issuance were widespread. Not seeing these practices required an effort at deliberate avoidance on the part of regulators.

The best way to ensure that regulators do not fail to the same extent in the future is to fire the ones whose failure led to the current crisis. This is essential for eliminating the asymmetry of incentives that now exist. It will always be difficult for regulators to take steps to curtail the actions of powerful financial institutions. Therefore they have a strong incentive to ignore lending practices by banks even when they are harmful to the economy. For this reason, regulators must know that the failure to stem dangerous practices by the financial industry also will involve serious risks to their careers. If the failure to regulate effectively does not imply career risks, the predictable result of these asymmetric incentives is that the regulators will defer to the financial industry and ignore dangerous practices in the future.

This raises the second essential financial reform that is needed. The financial industry needs to be downsized. In the United States, the financial sector accounts for more than 30 percent of all corporate profits. The investment banking and commodity trading sectors of the U.S. economy have nearly quadrupled as a share of GDP over the last three decades. Financial services are an intermediate good, something that is produced in order to be able to make the final goods that we want to consume. If any other intermediate goods sector had similarly expanded relative to the economy, for example trucking or warehousing, there would be concern over the enormous inefficiency of these sectors. There should be concern about the incredible waste of resources in the financial sector, the vast majority of which are consumed in highly profitable rent-seeking activity, not greasing the wheels of the real economy.

The bloat in the financial sector is especially pernicious because of the patterns of compensation in the sector. The sector offers its top earners salaries that are out of line with pay in other industries. This undermines pay structures elsewhere in the economy, leading to greater inequality.

The obvious way to limit the size of the financial sector is with a system of modest financial transaction taxes (FTT) similar to the stamp tax on stock transfers in the United Kingdom. A modest tax will have almost no impact on financial transactions that serve the real economy. For example, almost no one is dissuaded from buying stock for long-term investment by the 0.25 percent tax in force in the UK; in fact this tax just raises the transaction cost back up to the levels that existed two decades ago. However, this tax will have a large effect in dissuading short-term speculation. Scaled taxes on options, futures, credit default swaps and other instruments would have a similar effect. Fewer transactions will shrink the industry.

A system of FTT can also raise an enormous amount of revenue. The stamp tax in the UK raises a bit less than 0.3 percent of GDP. A broader set of FTT could raise close to 1.0 percent of GDP. The experience of the UK also demonstrates that such a tax is easily enforceable (it has the lowest administrative cost of any tax). Rewards to employees for reporting non-compliance by their employers would help to stem efforts at evasion of more far-reaching taxes.

The revenue raised through a set of FTTs would help to offset the debt incurred by governments across the world as a result of this crisis. In this sense it would be especially appropriate to have a tax on the sector that was responsible for so much damage to the economy and society.

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The future of banking

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The core principles of the US Glass-Steagall act would bring finance back in line with the real economy. Narrow banking should not be regarded as an impediment to growth, but rather as an impediment to the creation of bubble economies, the temporary and artificially high growth rates of which were based on securitisation of credit.

Should we return to narrow banking? That is, should we restrict commercial banks' activities to traditional consumer and corporate loans held on the banks' balance sheets until maturity, allowing only investment banks to engage in securitisation and other sophisticated investments? In order to answer these questions it is good to go back to the basics of banking.

There are two characteristics of banks that make them very special. First, banks borrow short and lend long. In doing so they create a very special kind of risk, a liquidity risk. This risk is special because it is a "tail risk". It occurs infrequently, but when it does, it has devastating effects. It is difficult, if not impossible to quantify because it occurs as a result of collective movements of distrust and panic. We have no reliable model predicting collective panics.

Second, banks are at the centre of the payments system. This creates a network of borrowing and lending by banks from and to each other. This interbank market has the effect of creating an interconnectedness of risk, i.e. when one bank fails, the other banks are in trouble. When a problem appears in one bank, it is propagated into the whole banking system like an infectious disease. Thus, risks in the banking system are likely to be correlated. This contrasts with what happens in the non-banking sector. For example, when one automobile company goes bankrupt, this is good news for the other automobile companies. The latter can expand their production and increase their profits.

Securitisation, which became popular from the 1980s onwards, was thought to reduce systemic risk because it would spread the risk concentrated in one bank over many more institutions. In fact, it did the opposite; it increased systemic risk. When a bank in the Midwest bundled mortgages into an asset backed security and passed it on to financial institutions in, say, Germany, the interconnectedness and the correlation of risks in the banking system increased. Thus, securitisation amplified the inherent problem of the banking system which is that shocks occurring in one place are quickly transmitted to the rest of the system. As a result, securitisation increased the inherent fragility of the banking system.

How to tackle this problem? There are essentially two ways. In the first one, banks maintain a business model that allows them to securitise their loans in different sophisticated ways, although subject to tighter regulation and supervision than before. This is the approach towards which policymakers gravitate today. It is based on a belief that the risks created by banks can be managed and contained by imposing a series of appropriate capital and liquidity ratios, and, as has been proposed in a number of countries, by subjecting the introduction of new financial products to prior approval.

The problem of this approach is that we do not have a science of interconnected risk, which is the risk created by banks. All we have is a science of independent risks. This is the risk that arises in one place and that can be isolated, because it is not propagated to the rest of the system. This science of independent risks which has been very powerful in developing and pricing derivatives and other sophisticated financial products, is useless as a tool to manage the risks created in the banking system. It is not only useless. It is also dangerous because it will lead to a new complacency. When the new regulatory environment has been put in place it will create the illusion that things are under control, while underneath the time bomb of correlated risks that can be triggered by collective movements of panic will continue to tick.

The second approach starts from the admission that we do not have the tools to quantify the risks created by the banking system. All we can do is to limit these risks by restricting the activities of banks. This is the idea behind narrow banking, which was the core principle of the Glass-Steagall Act introduced in the USA after the Great Depression and similar legislation in many European countries. In this approach commercial banks, i.e. those that hold the deposits of ordinary customers, are told that activities that increase the interconnectedness of risk shall not be allowed. Since securitisation of loans increases this interconnectedness, it will not be allowed. Thus, narrow banking aims at minimising the potential of the banking system to create correlated risks. These risks of course cannot be eliminated, but they can certainly be reduced.

An objection to the idea of narrow banking is that it will reduce credit and thus will negatively affect economic growth. The answer to this objection is that securitisation and financial innovations have led to an explosion of bank credit that has turned out to be unsustainable. It has led to consumption and housing booms that increased economic growth temporarily. The economic growth observed in the US, the UK, and many other countries during the decade prior to the crash was artificially high, sustained as it was by excessive credit made possible by securitisation. After the crash, economic growth will have to return to a lower and more sustainable level, especially in these countries that have experienced these artificially high growth rates. Such a lower but more sustainable growth rates can be achieved in an environment in which banks create fewer risks. It will also be a banking system which generates fewer profits.

Financial innovation will still occur in such a new banking landscape. Investment banks will still be able to develop new sophisticated assets. The limitation they will face, however, is that they will not be able to finance these (most often illiquid) assets by short-term funding. In other words investment banks will not at the same time be able to operate as commercial banks, as unfortunately some can today. In addition, these investment banks will not be bailed out by the state if they fail.

Bankers and their many lobbyists scream that narrow banking is terrible and will reduce innovation and growth. Don't believe them! In fact prior to securitisation economic growth was higher in the industrialised countries. The protests of bankers against narrow banking are self-serving. When bankers make pleas to keep their business models unchanged they are not concerned at all with general welfare. Their only concern is to go back to the situation prior to the crisis that allowed them to generate high profits while making sure that part of the risk was borne by the rest of society.

Should banks be nationalised?

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Many governments have put insolvent banks under public receivership and it may be that these hitherto inconceivable moves should not be only temporary in nature – until balance sheets have been cleaned up and profitability restored – but that at least some banks should become a permanent part of the public sector in a mixed economy.

Crises tend to shake up established certainties and to induce a reappraisal of fundamental assumptions and generally accepted policy conclusions. The 'settled' questions before the crisis are no longer 'settled' questions after the crisis, especially when the crisis reveals, as Keynes pointed out in the 1930s, a sharp contrast between economic reality and established economic orthodoxy. In the current crisis there is a similar tendency towards rethinking and re-evaluating some of the fundamental assumptions and conclusions of orthodox economic theory, in particular those relating to the efficiency of financial markets.

The unexpected re-appearance, after a long absence, of the dreaded N-word – nationalisation – in economic discourse is an interesting example. The current reality is one of massive, unprecedented and widespread actual or effective nationalisation of major banks and other financial institutions on both sides of the Atlantic. However nationalisation in general, and banking nationalisation in particular, is firmly rejected as a policy option by mainstream economic theory. This rejection is based on a number of well known theoretical and empirical arguments: public production is bureaucratic, slow, easy-going, dominated by red tape and political control or interference, and it is usually unable to respond quickly to market opportunities. This behaviour leads to productive inefficiency. The private sector, by contrast, is enterprising, innovative and creative, responding quickly and effectively to market challenges. Nationalisation, therefore, is to be avoided.

The response of the conventional wisdom to the contrast between reality and theory is to view the current nationalisation of banking as a temporary expedient and a necessary evil to be reversed as soon as possible. After nationalisation, the banks are cleaned up, returned to profitability and then re-privatised. The ultimate aim is a privately owned, privately run but properly regulated and supervised banking system.

There is, of course, a long history of socialist support for nationalisation of banks – not as a temporary crisis measure but as part of a wider plan of nationalising key parts of the economy and developing a democratic, socialist society. In this vision 'socialist banks' will be nationalised but not run, as under temporary nationalisation, along 'capitalist' lines.

There is, however, another alternative, which is to consider bank nationalisation neither as a short- term temporary measure nor as a means of achieving a socialist planned economy, but as a more permanent feature and part of a radical reform of the financial system in a mixed economy. Is there any place for non-socialist banks, run along commercial lines, but under permanent public ownership and therefore under an obligation to operate in accordance with wider public policy objectives?

The most crucial function of banking in the economy is the task of allocating resources to those uses that yield the highest, risk-adjusted returns. The consensus view is that the private sector of competitive capitalism can perform this function more efficiently than the government, provided a proper system of regulation and supervision is in place.

A private banking system needs public regulation and supervision because of the danger of 'systemic failure' where reckless behaviour by individual institutions may threaten the stability of the whole system. There is clearly a very serious 'moral hazard' problem in banking. The threat of bankruptcy and failure, which normally acts as sufficient restrain to prevent reckless behaviour and excessive risk-taking by firms in other parts of the economy, is not effective in the financial sector. If failure by one firm can destabilise and even bring down the entire system, the authorities may have no alternative but to bail out the failing part in order to preserve the whole. Knowledge that this is the likely response of the authorities may encourage reckless behaviour and excessive risk-taking by individual parts.

One solution to the moral hazard problem is to have a regulatory and supervisory system in place that detects, discourages and prevents reckless behaviour before it happens, rather than having to deal with its consequences. Nationalisation may reduce but not eliminate the problem, since state banks could also mismanage risk and cause systemic failure. The existence of the moral hazard problem by itself, therefore, does not provide sufficient theoretical justification for permanent nationalisation of the banking system. Permanent nationalisation is neither necessary nor sufficient for solving the moral hazard problem. Regulation in a privatised banking system, on the other hand, is necessary but may also not be sufficient.

Still, nationalisation would almost certainly reduce these risks because it can stop, much more easily and effectively than any regulatory system, the type of reckless behaviour that causes systemic failure. Nationalisation would dispense also with the costly, risky and ultimately futile cat-and-mouse game between the regulated and the regulators whereby invariably the regulated are always a few steps ahead of the regulators.

Indeed, this constitutes one of the paradoxical elements of the 'privatisation and regulation' paradigm. On the one hand, it is claimed that public officials cannot be entrusted with running the banking industry. On the other hand, the same public officials can apparently be entrusted with the vital function of running the regulatory system of that industry efficiently. Concern with such paradoxes would, of course, be unimportant if the probability and the costs of regulatory failure were trivial. Before the crisis, the widely held assumption was that the social benefits of a privatised banking system, mainly the superior efficiency of private production, exceed the potential social costs. It is becoming increasingly clear that, after the crisis, this assumption needs to be re-examined.

In the first place, the benefits of financial innovations, may have been exaggerated. What exactly were the social benefits of innovations such as sub-prime mortgages, collateralised debt obligations or credit default swaps that, presumably, would have to be sacrificed under a system of nationalised banking run by bureaucrats? If they were such great innovations, of great benefit to society, why did they end up as 'toxic waste', impossible to price and polluting the balance sheets of global banking? More significantly, the costs, particularly the costs of regulatory failure, have been grossly under-estimated. The resource costs of regulation may be comparatively low (although they are bound to rise if a more hands-on approach to regulation is adopted). But the social costs of regulatory failure are huge and they transcend both geographical and inter-generational boundaries. If the probability is that systemic failure is much greater when banking is located in the private rather than the public sector of the economy, the cost of subjecting society to this risk must be estimated and added to the total cost of regulating privatised banking. Naturally, if these costs exceed the social benefits, permanent nationalisation of banking would be a better alternative to privatisation.

A great deal of complex cost-benefit calculations, involving analysis of risk and uncertainty as well as issues of inter-generational equity, are, therefore, necessary before a solid case for permanent nationalisation of banking can be established. But, by the same token, this is true for the model of privatisation and regulation. It is no longer self-evident, as is often assumed, that what is needed for the establishment of a more robust banking system is simply improved regulatory systems.

In the aftermath of the global financial disaster, when the seemingly incredible has happened, leaving Alan Greenspan 'in a state of shocked disbelief', the privatisation and regulation paradigm is no longer sacrosanct. It is legitimate to ask, in a comprehensive review of how to establish a robust banking system, whether it is safer in the long run and, on balance, less costly for society if at least some banks – like schools and hospitals – become not only a temporary but also a permanent part of the public sector in a mixed economy.

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Reforming finance

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The American Prospect magazine

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Ten areas of financial reform are regarded as being essential to re-establish the two basic functions of the banking sector, namely, extending credit to households and the business sector, and connecting investors to entrepreneurs. Pure trading and speculating should, meanwhile, be discouraged to the maximum degree possible.

The project of seriously re-regulating the financial sector requires a great deal more leadership than we have seen so far from any of the large nations. In many ways, the Obama government has been the most disappointing. To the extent that the governments of Britain, France or Germany have ventured slightly bolder proposals, they have been discouraged by the government of the United States.

To appreciate the degree of reform that we need, it is helpful to review the function of the banking system. At bottom, the role of the financial sector is to channel credit and capital to the real part of the economy, to make assessments of risk, and to price the cost of credit accordingly. Until the 1970s, the financial sector in most of our countries was well regulated and well behaved. The financial sector itself was fairly small – under 6 percent of GDP in the US. It existed to serve the rest of the economy. With deregulation, more and more of what financial intermediaries did became pure speculation, aided by extreme degrees of leverage and pyramiding. The enlargement of the financial sector became an end in itself.

One can divide the financial system into three broad functions:
— extending credit to businesses and households;
— connecting investors to entrepreneurs;
— pure trading and speculating.

The first two functions add value to the economy. But since the 1970s, more and more of the financial system and an increasing share of its profits have been based on the third function. As many critics have observed, all of the banks want to be hedge funds. But pure speculation and trading adds nothing to net economic welfare. At best, it is a zero-sum game. At worst, as in the recent crisis, it simply allows middlemen to take immense risks with other people's money. If their bets pay off, they can become extremely rich. If their bets fail and they are large enough or interconnected enough, governments often make up the losses.

The historic task of government in this era is not just to discourage or prohibit risky practices, but to fundamentally alter the business models of major financial institutions, so that no institution that makes most of its profits from speculation or from trading is in a position to menace the entire system or to require bailouts from taxpayers. Speculation, to the extent that it is permitted at all, should be a purely private activity, and it should be discouraged.

The Obama Administration has shown little interest in this degree of fundamental reform. On the contrary, its strategy for resolving the banking crisis has been to prop up banks that are effectively insolvent such as Citigroup, and to disguise the degree of their insolvency. The consequence of this policy is that real reform is deferred, and the process of recovery is protracted because traumatized banks are rebuilding capital and setting overly strict lending standards rather than providing credit where it is needed. Though the Federal Reserve has reduced short term interest rates to barely above zero, the real economy suffers from a paradox of cheap money and tight credit.

Large money center banks continue to see speculative activities rather than ordinary commercial banking or stock underwriting as their main profit centers. This is a recipe for the next bubble economy.

The reform legislation recently approved by the U.S. House of Representatives is far too weak. It does not include serious controls on derivatives, or fundamental reform of credit-rating agencies. It leaves the most unregulated kinds of financial institutions such as hedge funds and private equity firms almost untouched. It preserves the doctrine of "too-big-to-fail", and puts the Federal Reserve in the role of "systemic risk regulator" despite the Federal Reserve's failure to adequately regulate sub-prime lenders or bank holding companies, both of which were its responsibility during the run-up to the crisis.

True reform would include the following:
— Capital reserve requirements for all classes of financial institutions. The larger the institution and the riskier the activity, the larger the reserve requirement.
— A strict separation of institutions that perform commercial banking from those that make their profits from trading.
— A strict separation of institutions that place orders for retail customers from those that trade for their own accounts.
— The same disclosure and reporting requirements for hedge funds and private equity firms as for publicly-traded and registered companies.
— A prohibition of the tax favoritism for borrowed money used to acquire companies. A prohibition of payment of special dividends to private equity owners of operating companies.
— Public ownership of credit-rating agencies.
— A requirement that all derivatives shall be traded on regulated exchanges, with capital requirements and limits on overall positions.
— A provision that any firm that locates in a tax or regulatory haven shall not be permitted to do business or have financial transactions in an OECD country.
— A Tobin Tax on all financial transactions, graduated so that very short-term transactions pay the highest rate of tax.
— Corporate governance reform to ensure that shareholders and other stakeholders hold executives accountable for compensation formulas.

One disabling myth of recent years has been the premise that, because of globalization, national governments are relatively helpless to re-regulate finance; any nation that tries to regulate will simply drive business offshore. But the reality is that China and India largely escaped the consequences of the financial collapse because they simply did not permit their banks to traffic in exotic securities. India used punitively high reserve requirements to do the job. Chinese banks commit a variety of sins against free markets, including the use of artificially low interest rates for favored enterprises. But the Chinese government understands that their function is to supply capital to firms, and not to speculate.

It would certainly be useful if the major nations could agree on a more effective Basel III with more consistent and adequate capital reserve requirements;

or on a universal Tobin Tax. But that day will never come and reform should not be delayed in the meantime.

Much of what needs to be done can still be done by national governments. After the attacks of September 11, 2001, the Bush administration initiated a rigorous enforcement program to crack down on international money laundering to prevent movements of funds to finance terror. The same enforcement program could have been used to prevent regulatory or tax evasion—but that was explicitly prohibited.

Another disabling myth has been that any "innovation" should be welcomed as enhancing economic efficiency. But nearly all of the financial innovations of the past three decades have been aimed at evading regulation, enriching insiders, reducing transparency, increasing leverage, and passing off risks to others. The valuable innovations are those in the real economy. The proper role of the financial sector is to evaluate those risks and opportunities and make available financing.

To conclude:

— Banks need to return to their legitimate role of providing capital to households and enterprises.
— Investment banks and venture capital firms need to return to their legitimate role of financing new enterprises, expansions, and transfers of ownership.
— Private equity, as currently defined, is mostly parasitic and changes in tax policy should discourage the entire business model.
— Hedge funds exist only as pools of capital that evade regulation. They add nothing to the net economic wellbeing and should be discouraged as business forms.
— Derivatives, such as options and futures need to be limited to their legitimate role of providing hedges to commercial users against price fluctuations – and not be used as highly leveraged forms of gambling. Taxation can discourage very short-term trading.
— National governments, given the political will, can achieve most of this.

It should be obvious that virtually all of these proposals are far outside the current political discourse. It is our task to make them mainstream, even conventional.

Making finance serve society

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Financial innovation has shifted the banking function of risk transformation towards a transfer of credit risks to society at large. The provision of finance constitutes a public good; therefore, the future banking system should be built on a core of public-service banking which must not be allowed to engage in features typical of the shadow banking system.

Finance at the service of the general public

We are desperately missing any real discussion of what function our financial system is supposed to perform and how well it is doing that job – and, just as important, at what cost. Any regulatory reform should be built on a normative view of which financial system serves society best in terms of growth, efficiency and equity. Today, reform initiatives are mainly based on identifying some of the regulatory loopholes held responsible for the recent financial crisis – such as rating agencies, executives' compensation or securitization. Small regulatory adjustments are envisaged which stand in striking contrast to the decisive actions taken to stabilise banks. The reform initiatives will not put finance at the service of the economy and society but are instead meant to return to the status quo ante, to make the Anglo-Saxon regime of self-regulation more effective. Nor are they suitable for enabling financial crisis to be avoided in the future, because they do not address the systemic and structural roots of the crisis. These roots are, first, regulatory failure as a consequence of excessive deregulation, and regulatory arbitrage due to the lack of a global regulatory legislation and authority; second, rising inequalities within countries (rising income and wealth gap, declining wage shares) and between countries (macroeconomic imbalances); and third, regulatory capture by the financial industry as well as by mainstream economics.

Textbooks tell us that the crucial role of the financial system is to allocate capital investment toward the most productive applications. The system connects savers and borrowers, performs an intermediation function, transforms maturity and risks, and absorbs shocks – cross-sectional and across time. Financial markets were widely believed to be better suited to providing cross-sectional risk-sharing than banks by providing a vast range of financial products, while the capability of diversifying aggregate risk (e.g. macroeconomic shocks) across time is considered one of the main advantages of bank-based systems.

However, we see that the financial sector has not performed at all according to the textbook model.

Shock absorption versus shock origination

A financial system that subordinates its business practices to the interests of the various building blocks of shareholder value turns out to be a source of shocks rather than a shock absorber. A good example of this observation is the credit cycle which is an important source of endogenous risk

Mitigating the pro-cyclical interplay of valuation and leverage is vital so as to enhance financial stability. Counter-cyclicality in regulation could be introduced by tightening leverage ratios, capital adequacy and minimum liquidity requirements in the boom and loosening them in the downturn. Furthermore, reliance on external ratings in risk assessment and mark-to-market valuation in accounting should be markedly reduced. Executives' compensation and bonus schedules should not be based on profits at all, even if derived from long-term averages. Instead, they should be based on indicators reflecting systemic financial stability. Shareholder-value orientation and systemic stability are not compatible.

Intermediation versus extraction of rents and resources

The financial system has performed poorly in fulfilling its intermediation function, the transfer of financial resources to the most productive investments. It created its own circular flows and extracted rents from the real sector. A quarter of a century ago James Tobin warned that Western economies were throwing more and more human and financial resources into financial services, remote from the production of goods and services. He predicted that this would lead to vast rewards for people in the sector that would be out of all proportion to the social value of their work. His prediction proved to be pretty accurate. At the peak of the boom in 2007, 40% of all corporate profits in the United States were accruing to the financial sector, which accounted for 7% of overall GDP. If profits and compensation in the financial sector go up and keep going up, that is a priori evidence of inefficiency, not efficiency.

Moreover, the size of the financial sector undoubtedly has an impact on the nature and quality of regulation. In many cases, regulatory agencies were captured by the regulated financial institutions. The majority of capture resulted from intentional efforts by the representatives of large and powerful financial institutions to advance their narrow interests at all costs and defeat meaningful regulation. Regulatory capture is not exclusively driven by interests, but often also capture by the knowledge base and belief. Exclusively male, technocratic and politically unaccountable international fora and networks were responsible for the global diffusion of Anglo-Saxon regulatory practices.

The financial sector offers a public good. Financial stability cannot be reconciled with the prerogatives and incentive structures of shareholder value-oriented, opaque financial institutions that encourage excessive leverage, thus raising the risk that the taxpayers may have to bail out the bank's shareholders and unsecured creditors. Strong regulation of this sector includes public intervention in the market structure. Financial institutions need to be forced or incentivised to deconglomerate. The degree of interconnectedness and the scale of total exposures, including off-balance sheet exposures, have to be strongly regulated. But today, banks are emerging from the credit crisis bigger than before, posing more risk to the economies.

Instruments to restrain the size and interconnectedness of financial institutions are manifold. First, bank size can be limited by making the required capital ratio an increasing function of bank size after a certain minimum size. The second instrument is to split narrow banking (deposit taking and lending to non-financial corporations and households) from other banking activities (De Grauwe in this volume). The third is to break up existing big banks along lines of manifest conflict of interest. The fourth is active anti-monopoly or anti-trust policy. Another alternative is to set a cap on bank liabilities as a percentage of gross domestic product. In addition to regulatory instruments, financial transaction taxes would reduce transaction volumes and profits (Schulmeister in this volume).

Risk transformation versus risk transfer

Financial intermediaries are supposed to transform risk by having a large number of borrowers, which allows them to absorb default losses because they earn interest on other loans. But financial intermediaries have increasingly developed instruments that allow them to transfer risk instead of transforming it. Securitization, the process of converting non-marketable assets such as loans, into marketable ones meant that risk could be largely ignored while debt was driving the real estate boom. Securitization absolved banks from sensible underwriting as they knew they could sell the debt anyway.

Another financial innovation is the credit default swap (CDS), which insures a security against the risk of default. Provided the purchasing party has an insurable interest, CDS are useful instruments for hedging risk. But the market for CDS is foremost a betting shop. Requiring CDS owners to have an insurable interest is the appropriate regulatory response rather than merely limiting reform to moving the standardized CDS contracts to central clearing houses.

Any regulatory reform with a sustainable impact has to be based on a cost-benefit analysis of each financial instrument. Any innovation has to deliver financial services that people need. Financial innovations could be developed that help to provide financial services to the 'unbanked' poor – some 60 million adults in the US – and minorities or to boost research and development in energy-efficient technologies. The issuer of a new product should be obliged to give proof of the benefits accruing to society as well as evidence of only negligible costs. The cost analysis has to take account of the many sources of costs accruing to society: transaction costs, the cost of effective oversight and the risk of endangering financial systemic financial stability. The principle of deriving regulatory reform from a profound cost-benefit analysis should apply to all areas including the shadow banking system, such as hedge funds, private equity funds and special purpose vehicles.

Summing up

Beyond financial stability considerations, today's global financial system produces high costs and wastes economic resources that could be invested more efficiently otherwise. Furthermore, it is ill-suited to even fulfil its economic functions properly, as promised by simple textbooks. It has turned out to be a source of destruction rather than sustaining growth and prosperity, while shifting economic and political power to the wealthy, undermining the fundamentals of representative democracies.

The financial sector is of strategic public interest. The design of a new financial system and a regulatory framework that serve the needs of society without hampering growth and economic efficiency has to be based on a profound analysis of the costs and benefits of various financial regulatory arrangements that shape the structure of the financial system.

The core of the financial sector should be built by ‘public services banking’. These highly regulated banks should not be allowed to engage in investment banking. Whether these banks are publicly, mutually or cooperatively owned is open to debate. Avoiding pro-cyclical leverage, increasing capital adequacy, limiting the size of balance sheets as well as of interconnectedness is probably more decisive than ownership.

Financial market regulation is mainly conducted by expert committees beyond the political sphere. The same applies to today’s global regulatory reform that excludes those who are affected most by financial crises. Without democratization of financial market regulation, a new financial system is out of reach.

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A better way to regulate financial markets: asset-based reserve requirements

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The introduction of mandatory and variable asset-based reserve requirements for all financial firms would, alongside their stabilising effects on the financial system, also increase the efficacy of monetary policy (especially within the euro area, as national requirements could vary) and act as automatic stabilisers at the macroeconomic level.

There is widespread recognition that the financial crisis which triggered the Great Recession was significantly due to financial excess, particularly related to real estate. Now, policymakers are looking to reform financial systems in the hope of avoiding future crises. But like the drunk who looks for his lost keys under the lamppost because that is where the light is, policymakers remain fixated on capital standards (which require shareholders to provide minimum levels of equity capital) because that is what is already in place.

There is a better way to regulate financial markets through asset-based reserve requirements (ABRR) which would extend margin requirements to a wide array of assets held by financial institutions. ABRR are easy to implement, use the tried-and-tested approach of reserve requirements, are compatible with existing regulation (including capital standards), and would fill a major hole in the existing range of financial policy instruments.

The toleration of periodic bouts of financial excess over the past two decades reflects profound intellectual failure among central bankers and economists who believed inflation targeting was a complete and sufficient policy framework. It also reflects lack of policy instruments for directly targeting financial market excess. With central banks relying on the single instrument of short-term interest rates, using interest rates to target asset prices would be like using a blunderbuss that inflicts massive collateral damage on the rest of the economy. ABRR offer a simple solution to this problem by providing a new set of policy instruments that can target financial market excess, leaving interest-rate policy free to manage the overall macroeconomic situation.

ABRR require financial firms to hold reserves against different classes of assets, with the regulatory authority setting adjustable reserve requirements on the basis of its concerns with each asset class. One concern may be that an asset class is too risky; another may be that an asset class is expanding too fast and producing inflated asset prices.

By obliging financial firms to hold reserves, the system requires that they retain some of their funds as non-interest-bearing deposits with the central bank. The implicit cost of forgone interest must be charged against investing in a particular asset category, reducing its return. Financial firms will therefore reduce holdings of assets with higher reserve requirements and shift funds into other lower-cost and thus relatively more profitable asset categories.

The effectiveness of this approach requires system-wide application. If applied only to banks, ABRR would simply encourage lending to shift outside the banking sector. To succeed, reserve requirements must be set by asset type, not by who holds the asset.

A system of ABRR that covers all financial firms can increase the efficacy of monetary policy. Most importantly, it enables central banks to target sector imbalances without recourse to the blunderbuss of interest rate increases. For example, if a monetary authority was concerned about a house-price bubble generating excessive risk exposure, it could impose reserve requirements on new mortgages. This would force mortgage lenders to hold some cash to support their new loans, raising the cost of such loans and cooling the market. If a monetary authority wanted to prevent a stock-market bubble, it could impose reserve requirements on equity holdings. This would force financial firms to hold some cash to back their equity holdings, lowering the return on equities and discouraging such investments.

ABRR also act as automatic stabilisers. When asset values rise, or when the financial sector creates new assets, ABRR generate an automatic monetary restraint by requiring the financial sector to come up with additional reserves. Conversely, when asset values fall or financial assets are extinguished, ABRR generate an automatic monetary easing by releasing reserves previously held against assets. In all of this, ABRR remain fully consistent with the existing system of monetary control as exercised through central-bank provision of liquidity at a given interest rate.

At the microeconomic level, ABRR can be used to allocate funds to public purposes such as inner-city revitalisation or environmental protection. By setting low (or no) reserve requirements on such investments, monetary authorities could channel funds into priority areas, much as government subsidised credit and guarantee programs and government-sponsored secondary markets have expanded education and home ownership opportunities and promoted regional development. Conversely, ABRR can be used to discourage asset allocations that are deemed socially counterproductive.

ABRR have other significant policy benefits. First, ABRR increase the demand for reserves, which should prove helpful as central banks seek to exit the current period of quantitative easing to avoid future inflation. By introducing and gradually raising asset reserve requirements, central banks can implement a form of reverse quantitative easing that smoothly transitions the financial system to a new, sounder regime.

Second, by increasing the demand for reserves ABRR will increase seigniorage revenue for governments at a time of fiscal squeeze. To the extent that required reserves constitute a tax on financial institutions, that tax is economically efficient given the costs of resolving financial crises. It will also shrink a financial system that many believe is bloated.

In the late 1990s, US policymakers completed the repeal of America's "New Deal" segmented system of financial regulation but they created no framework of matching comprehensiveness. That failure created a regulatory vacuum, particularly regarding the activities of the secondary banking system, and was a major contributing factor to the financial excesses that caused the crisis. Applied uniformly to all domestic financial firms, a system of ABRR can help fill this vacuum.

For the Euro zone, ABRR are additionally attractive because they can help address the instrument gap created by the euro's introduction. The euro's establishment represents an important step in the creation of an integrated European economy. Over time it should yield dividends as increased competition and lower transaction costs generate increased efficiency. However, member countries have had to give up their own exchange rates and interest rates, which have created problems for economic management by reducing the number of policy instruments. ABRR can fill this policy instrument gap because they can be implemented on a geographic basis by national central banks.

Property lending, which has been a major focus of concern, is particularly suited to this. If Euroland is suffering excessive house-price inflation, the ECB could raise reserve requirements on mortgage loans secured by property. However, national central banks should have the power to set reserve requirements above (but not below) the rate established by the ECB. Thus, if Spain or Ireland is suffering excessive house-price inflation, their national central banks could raise reserve requirements on mortgage loans secured by property in those countries. That would raise mortgage loan rates in Spain and Ireland without raising rates in other countries.

Nationally contingent ABRR will create some incentive to shop for credit across countries. That means ABRR will work best when linked to geographically specific assets that cannot evade the regulatory net. This includes mortgage lending that is secured by collateralized property, and shares for which legal title is registered where companies are incorporated. That said, jurisdictional shopping is costly and that cost enables ABRR to create cross-country interest rate differentials for wide categories of assets. That creates space for different interest rates in different countries, thereby giving countries space to respond to their particular conditions.

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A general financial transaction tax: enhancing stability and fiscal consolidation

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Stephan Schulmeister, born 1947, since 1972 research fellow at the Austrian institute of economic research (WIFO), lecturer at the university of Vienna and the university of economics and business administration. Main fields of research: impact of financial speculation on stock prices, exchange rates and commodity prices, and indirectly on the real economy, long-term shifts in the investment behaviour of the business sector between real and financial accumulation.

The contribution offers a detailed examination of various models of financial transaction taxes, providing model calculations for different tax rates of generalised financial transaction taxes and pointing to their mitigating effects on asset price fluctuations and their revenue potential for fiscal consolidation needs after the crisis.

Motives and concept of a general financial transaction tax

The idea of introducing a general financial transaction tax (FTT) has recently attracted rising attention. There are three reasons for this interest. First, the economic crisis was deepened by the instability of stock prices, exchange rates and commodity prices. This instability might be dampened by such a tax. Second, as a consequence of the crisis, the need for fiscal consolidation has increased tremendously. A FTT would provide governments with substantial revenues. Third, the dampening effects of a FTT on the real economy would be much smaller as compared to other tax measures like increasing VAT.

These considerations motivated the Austrian Institute of Economic Research (WIFO) to investigate the stabilization and revenue potential of a general and uniform FTT for three hypothetical tax rates (0.1%, 0.05% and 0.01%). Such a tax would be imposed on transactions of all kinds of financial assets, and would thus not be restricted to specific markets as proposed by Keynes for the stock market, Tobin for the foreign exchange market or securities taxes implemented in the past (e.g. stamp duties). The present paper summarises and updates the results of this study (Schulmeister *et al.* 2008).

Trading practices and price dynamics in financial markets

— The volume of financial transactions in the global economy is 73.5 times higher than nominal world GDP; in 1990 this ratio amounted to “only” 15.3. This increase is exclusively due to the spectacular boom of derivatives trading, in particular on organized exchanges like Euronext (London) or Eurex (Frankfurt).
— Asset prices almost always fluctuate around “underlying” trends across different time scales, e. g. trends based on minutes-data or on daily data.
— Technical trading – the most popular strategy in modern financial markets – aims at exploiting the trending of asset prices. The improved availability of intraday data, the improved trading software and the improved market access through the internet have contributed to the increasing use of intraday data (Schulmeister 2009C).
— Individual traders use different models, trying to exploit asset price runs. This interacts with the aggregate behaviour of all models that lengthen the price runs (Schulmeister 2006; 2009B).
— These price runs accumulate to long-term trends: when an optimistic (“bullish”) market mood prevails, upward runs last for an extended period of time longer than downward runs, when the market is “bearish”, the opposite is the case (Schulmeister 2009A; 2009D).
— All important asset prices like exchange rates, stock prices or commodity prices fluctuate in a sequence of “bull markets” and “bear markets”, each lasting several years in most cases. Hence, asset prices fluctuate in “long swings” without any tendency to converge towards their fundamental equilibrium.

To conclude: asset markets are characterised by excessive liquidity and excessive price volatility leading to large and persistent "overshooting" of stock prices, exchange rates and commodity prices.

Asset price fluctuations and the "great crisis"

The boom of stock prices between 2003 and 2007, as well as the boom of house prices between 1998 and 2005, stimulated the US economy. At the same time, however, the "twin booms" laid the ground for the subsequent "twin busts". The related devaluation of financial as well as housing wealth has strongly depressed consumption and investment.

After the outbreak of the sub-prime mortgage crisis, the third "bull market", i.e. the commodity price boom, accelerated, mainly driven by speculation of financial investors in commodity derivatives markets. This development further deteriorated economic prospects.

Between spring 2008 and spring 2009 the devaluation process of stock wealth, housing wealth and commodity wealth was globally "synchronized". This process set free several contraction forces in the real economy, depressing in particular investment and trade.

How a transaction tax will mitigate asset price fluctuations

A general FTT would render transactions the more costly the shorter their time horizon. Hence, it would specifically dampen technical trading, which is increasingly based on intraday price data. At the same time, technical trading strengthens price runs which in turn accumulate to long-term trends that involve growing departures from fundamental levels. As short-term trading becomes less attractive, price runs will become less pronounced. This effect will in turn reduce the attractiveness of technical trading based on (ultra-)high frequency data (often fully "automated systems").

Since an FTT increases transaction costs more the lower they are (before tax), it will generally hamper derivatives trading to a greater extent than spot trading. Since spot transactions are more long-term-oriented and, hence, based to a larger extent on fundamentals than (speculative) derivatives transactions, one can presume that an FTT will hamper specifically short-term, non-fundamental transactions.

The revenue potential of an FTT

The revenue estimates are based on the assumption that transaction volumes will be reduced by the introduction of an FTT. For each tax rate and type of instrument, a low, medium and high "transactions-reduction-scenario" (TRS) is specified. In the case of the medium TRS it is assumed that transactions would decline by roughly 75% at a tax rate of 0.1%, at 65% at a rate of 0.05% and by roughly 25% at a tax rate of 0.01%.

Table 1 presents the estimated revenues for Germany, United Kingdom, Europe and the world economy, assuming a medium TRS for both transactions on exchanges and all transactions.

Table 1 **Hypothetical transaction tax receipts 2007* (in % of GDP)**

	Germany			United Kingdom			Europe			World		
Tax rate in %	0,1	0,05	0,01	0,1	0,05	0,01	0,1	0,05	0,01	0,1	0,05	0,01
Spot transactions on exchanges	1,320	0,920	0,390	4,980	3,616	1,618	1,166	0,812	0,342	1,100	0,764	0,321
All transactions	1,609	1,137	0,491	9,338	6,885	3,144	2,257	1,630	0,724	1,688	1,205	0,527

* Medium "transactions-reduction-scenario" (TRS).

For the UK, extremely high revenues reflect the fact that the volume of financial transactions relative to GDP is by far the highest – in 2007, it was 446.1 times higher than GDP. In Europe, an overall FTT would yield 1.63% of GDP and 0.81% of GDP if only transactions on exchanges were covered.

Feasibility of a general financial transaction tax

Subject to a general and uniform FTT would be:

— All spot and derivatives transactions on organized exchanges, e.g. trades of stocks and interest rate securities, as well as trades of futures and options related to stocks, interest-rate securities, currencies and commodities.

— Those "over-the-counter" (OTC) transactions which are directly related to asset prices, in particular to exchange rates and interest rates, e.g. spot currency transactions as well as trades of foreign exchange derivatives and (single currency) interest-rate derivatives.

This implies that not all transactions between customers (households and enterprises) and financial institutions would be subject to the FTT, but that only the transaction on the exchange would be taxed. A FTT should also not tax transactions which are simply the financial equivalent to "real-world-transactions" in goods or labour markets.

Taxes on all transactions on exchanges are collected by the exchanges themselves (the buyer and the seller are charged 50% of the tax), based on the electronic settlement systems.

A general taxation of financial-asset transactions in all major economies would constitute the final stage of implementing a FTT. The first stage could be a tax levied only on spot and derivatives transactions on organized exchanges in some major EU economies. In fact, it would be sufficient if only the UK and Germany implemented such a tax (roughly 97% of all transactions on exchanges in the EU are carried out in these two countries).

In a second stage one could include all OTC transactions within the Euro area which involve no other currencies, i.e. primarily euro interest rate derivatives. The third stage would then also include OTC transactions (spot and derivatives), in particular in the foreign exchange market.

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After the financial market crisis – a trade union agenda

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Now that financial institutions are being subsidised by taxpayers and speculative trading is back to pre-crisis levels, breaking the economic boom-and-bust cycles should become a high priority for the European trade union movement. This needs to be underpinned by broad coalition-building, campaigns and targeted lobby work in member states.

Rahm Emanuel, White House chief-of-staff, after his nomination by then president-elect Barack Obama in November 2008, famously said "You never want to let a serious crisis go to waste". A widely held belief in the political spectrum spanning from the centre-left to value-oriented conservatives has been that this crisis would finally open a window of opportunity to eradicate the neo-liberal doctrine once and for all. Only a year and a half after the collapse of Lehmann Brothers and the ensuing credit freeze that brought the global financial system to the brink of collapse on 15 September 2008, however, most governments conspicuously seem to believe that the crisis is almost over, that it is time to prepare for the 'exit' and bring public finances back into order. Hence the question arises: is the crisis over and we wasted it? The policy agenda for financial reform adopted by trade unions in Europe and beyond is indeed far from having been completed.

Policymakers, with the mutual consent of business and trade unions, gave top priority to the immediate stabilisation of the global financial system. At first, it seemed that the historical lessons of the Great Depression of the 1930s had been learned: the pace of return to previous levels of wealth depended on the repair of financial sector damage and the closure of the casino, without which such levels would remain subdued. Yet the price to be paid for this has been high: according to the IMF, the total cost of the financial crisis will amount to an astronomic figure of $12 trillion, representing a fifth of annual world output, and, as a result of short-term interventions from governments and central banks, countries of the G20 face the biggest budget deficit since World War II.

Although governments of the G20 and within Europe have sought to work towards a common approach to financial regulation, there is now a risk that the momentum for financial reform will slowly fade away, while concrete and bold measures are still awaited. The risk is that the policy failures that were the source of the financial crisis will be perpetuated through the next boom-and-bust cycles. Now that global financial conglomerates are being subsidised by taxpayers and global speculative trading is back to pre-crisis levels, breaking the economic "doom loop" should become a high priority for the European and international trade union movement.

Within the EU, the de Larosière report, issued in February 2009, put forward a number of proposals for financial regulation. These were then weakened by the Commission by means of subsequent legislative initiatives. Worse than this, if anything, has been the behaviour of the Council which has sought to substantially water down the proposals for a regulatory package for a European system of financial supervision and for a directive on alternative investment fund managers (AIFM), an instrument designed to regulate the shadow banking system of hedge funds and private equity funds. The European Trade Union Confederation (ETUC) regards as highly significant the European Parliament's moves to strengthen the terms of these draft legislative acts and to establish a genuine European supervisory authority for banks, securities and markets as well as for insurance and occupational pensions. Proposals issued relate, inter alia, to direct supra-national supervision of big cross-border financial institutions, the authority to ban trading of certain products, and the creation of a European Fund

– financed by financial institutions – to protect depositors. Only a truly European approach to supervision endowed with executive power can prove effective in counteracting regulatory arbitrage.

However, the outcome of the European Parliament debate on an effective regulation of AIFM is far from certain. With huge amounts of money in their back, massive lobbying from the financial services sector has resulted in the EP rapporteur receiving almost 1700 proposals for amendment to his draft report. The ETUC and its affiliated unions cannot counter this solely by relying on the superior quality of their arguments. In other words, the effort to influence the legislative process in and alongside the European institutions in Brussels is not sufficient but needs to be underpinned by campaigns and targeted lobbying work in member states. One potentially useful platform to this end could be the "Regulate Global Finance Now" campaign (http://europeansforfinancialreform.org) that was launched in autumn 2009 by the Global Progressive Forum, together with the ETUC, International Trade Union Confederation (ITUC), UNI Global Union, Solidar, the Global Progressive Youth Forum and the Foundation for European Progressive Studies, and joined by the European Green Party, national trade union organisations, notably IG Metall, and NGOs.

Trade unions across Europe will also have to embark on broader coalition-building when it comes to the agenda of downsizing the financial sector and a reversal of the "quiet coup" (Simon Johnson) staged by the financial oligarchy and which is blocking essential reform. At best, such a coalition would span interests that are social and political as well as economic such as SMEs or savings and mutual banks. While it has become common practice among policymakers across Europe and the industrialised G20 countries to emphasise that big banks will have to pay their fair share of the burden, there is no agreement on which measure(s) to apply and how to avoid tax, in other words, on 'burden sharing' arbitration among the key financial centres. As a key part of the agenda of ensuring that finance is socially useful – discussed also by other contributors to Part 1 of this volume – it is essential to tackle the problem of "Too Big To Fail", or, as Joseph Stiglitz put it, "Too Big To Live". This will require, if it is to be successful, a broad debate in our societies on the central question of 'WHO PAYS', a debate that should be placed in a threefold context:

1. Reimbursement of the state aids to banks during the crisis bail-out;
2. Compensation for the social losses incurred so far; and
3. Use of EU competition and anti-trust law, and building 'Chinese walls', to prevent financial crises in the future.

Special tax rates on bonuses, levies on financial institutions to compensate for the bail-out costs, a Europe-wide or global Financial Transaction Tax to dampen speculative trading, as well as an EU-wide mandatory insurance fund, constitute distinct measures that, in combination, would be mutually enforcing and lead the way to structural adjustment of the financial sector.

The US debate on splitting financial conglomerates along the lines of the Volcker rules has not yet begun at EU level. Yet a functional separation between investment banking branches and commercial and retail banking is vital and no deposit-taking bank should be allowed to engage in proprietary trading. The aim, in other words, is to let the gamblers gamble on as they please, but at their own risk and without taking society as hostage. Caps on the size of individual financial institutions should be set using their size relative to GDP as an indicator. Volcker's proposal to limit their size relative to total liabilities would, on the other hand, not prove 'bubble-proof' as long as relative prices in the real economy (e.g. for housing) vary markedly, thus influencing the value of nominal assets and liabilities.

Finally, broad coalition-building among trade unions and civil society organisations for financial reform would also challenge the closed-shop mentality of the financial elites and shed light on the opacity of their business practices and institutions on a wide range of issues, be it non-standardised over-the-counter trading of derivatives, international tax arbitrage or the oligopolistic structure of the credit-rating agencies. Opposing democratic governance to financial oligopolies would reflect Franklin D. Roosevelt's famous phrase that "government by organised money is just as dangerous as government by organised mob."

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Part 2
Building a real economy for equality, social justice and good jobs for all

After the crisis: employment relations for sustained recovery and growth

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Eileen Appelbaum is professor and co-director of the Center for Women and Work, Rutgers University. She holds a PhD in economics from the University of Pennsylvania. Her research focuses on low-wage work in the US and Europe; on the direct care workforce; and on public policies and workplace practices that improve firm performance and facilitate the work and family lives of workers. She is currently conducting a large-scale study of California's five-year-old paid family leave program and is investigating the effects of private equity on employment relations.

Strengthening labour relations and workplace innovations are prerequisites for sustained recovery and future growth. Enabling workers and unions to negotiate wage growth in line with enhanced productivity growth requires the dissemination of high-performance working practices that engage workers, a raising of minimum standards, and substantial changes to labour law.

Stagnant wages, debt and unsustainable growth

The global economic crisis had its roots in the unsustainable build-up of debt in the US – a build-up that had three sources: a growing trade deficit, deregulation of financial markets, and stagnant or falling real wages for most workers. The trade deficit rose to almost 6% of GDP in 2006 and dramatically increased US cumulative indebtedness to the rest of the world, especially China and other export surplus countries. In financial markets, a huge increase in leverage, risky loans and mortgage-backed debt led to bubbles in the stock and housing markets. Stagnant wages, combined with easy access to mortgage and consumer loans, resulted in the rapid rise of household debt.

Much has been written about measures to restore greater balance to world trade and to regulate financial markets. Far less attention has been paid to measures to support income growth for workers, an issue that extends beyond the U.S. The low-wage share of employment has risen to unacceptably high levels in many countries. Exceptions are those countries where the minimum wage is high and employment regulations are enforced (e.g. France) or where union density remains high and there is a continuing commitment to modernization and skill upgrading (e.g. Denmark). In many countries, the decline in union density, low or no national minimum wage standard, unequal treatment of part-time or casual (largely female) workers, unequal access to work-family supports, lax enforcement of labor laws and employment regulations, and the successful efforts of employers to escape the constraints of established labor market institutions all contribute to wage stagnation and a large underclass of people living in poverty despite being employed. These developments have been exacerbated by hedge funds and private equity firms that load companies with debt and then rely on the 'discipline' of high interest payments to pressure them to strip assets, reduce wages and benefits, and downsize employment in order to raise margins – either to increase share prices (hedge funds) or to sell operating business and distribute gains to investors (private equity).

Economic recovery and growth beyond the current period of substantial fiscal stimulus and large-scale deficit spending by governments will require an increase in household consumption. Sustained recovery and growth require that this be based on rising real earnings, and not on rising debt.

Employment relations and workplace policies

Transforming the U.S. and other high-income economies to once again work for everyone requires significant workplace changes in order to create jobs that fully utilize workers' knowledge and skills; to drive innovation, productivity, and profits; and to ensure that workers share equitably in the prosperity generated.

Adopt modern workplace policies: Achieving and sustaining high levels of performance requires practices that leverage employees' knowledge and ability to create value and that are implemented in concert with new capital or technological investments. High-performance work practices (HPWP) (1) foster development of human capital, resulting in increased employee skills and improved customization of services; (2) engage employees in problem solving and performance improvement; and (3) build organizational social capital to facilitate knowledge-sharing and the coordination of work. Research in settings ranging from public schools to airlines has demonstrated the advantages to firms – in terms of improved efficiency, quality and financial performance – of work practices that encourage the simultaneous development of human capital and social capital. Workers benefit from improvements in skills and social capital, and more than 70 percent prefer these work systems over either traditional union or non-union systems. Unions are important – the combination of formal and informal mechanisms for employee voice improves the productivity effects of HPWP. For workers, the combination of union representations with HPWP tends to be associated with higher wages, some of which are achieved through mutual gain-sharing or similar compensation practices.

Establish and improve minimum employment standards: Governments, including the U.S., should establish a national minimum wage at two-thirds the median wage, indexed to some combination of inflation and productivity growth, to eliminate the scourge of working poverty. No one who works full time should live in poverty. But workers need more than a living wage. Too many workers, men as well as women, are still forced to choose between supporting their families and caring for them. Countries with policies that support working families too often exclude casual employees or those on part-time or short-hour schedules from these benefits. Everyone in the labor force should be guaranteed a minimum number of employer-paid sick days and paid vacation days. Employees should have the right to greater control over their work schedules so they are not penalized for care-giving responsibilities. Employers should be encouraged to offer reduced hours in full-time jobs. Finally, employees need tax-financed family and medical leave insurance programmes, similar to unemployment insurance, that ensure job-protected and affordable family and medical leave for all workers.

Enforce labor and employment laws: Governments need to strengthen and modernize enforcement of the regulations governing employment relations both by strengthening traditional enforcement measures and by leveraging the expertise and resources of labor unions and community groups to monitor compliance. Growth of supply chains, subcontracting, and employment of immigrants combined with lax enforcement has degraded wages and working conditions of many workers.

Reform labor law: Fixing or strengthening labor law is necessary to building the labor management partnerships and high-performance work practices described above. Moreover, unions have historically been the strongest and most consistent institutions for achieving improvements in worker wages and for reducing income inequality within and across industries and occupations. The decline in union density in many countries makes it clear that labor laws need to be fixed to support workers' fundamental rights. Restoring workers' ability to organize and bargain collectively is the first step in getting wages and productivity moving in tandem again. The reform of labor law should encourage workplace innovation and transform labor-management relations in ways that contribute to economic recovery and shared prosperity. Most importantly it should restore or enhance workers' rights to join a union and gain access to collective bargaining.

Conclusion

The transformations in labor policy and workplace practices needed to support economic recovery and sustainable growth are achievable. As argued above, what is required is a three-part strategy: (1) adoption of labor management and workplace innovations that create good jobs and the high productivity that will sustain them: (2) strengthening, updating and enforcement of labor and employment policies and minimum employment standards appropriate to today's workforce; and (3) improvements in labor law that create a platform for labor to negotiate workplace practices that enhance productivity and wage growth in line with improvements in productivity.

Employment after the crisis: New Deal for Europe required

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The wrong macroeconomic assignment of economic actors in Europe and the deflationary bias of an Economic and Monetary Union based on the theory of a natural rate of unemployment call for a New Deal for Europe such as to ensure that growth remains above its trend rate for an extended period as a means of bringing down unemployment.

How will employment and unemployment in Europe look after the most severe recession since the Great Depression? Europe's employment future depends substantially on the policies in the crisis. If monetary and fiscal policies hesitate to stimulate growth and employment over a substantial period, Europe will most likely see an unemployment pattern all too familiar from the past, according to which unemployment rises in the recession and then remains at high levels. Such a pattern will be disastrous for our future, but it can be prevented if we recognize that the exclusive emphasis on structural reforms in the past was misguided and that overly restrictive monetary and fiscal policies slowed expansions. Europe's upward jumping unemployment rates are much better explained by restrictive macroeconomic policies than by institutional arrangements.

The political response – pushed by economists – to Europe's upward jumping unemployment rates after every recession since the mid-1970s has been that it needed labour market reforms to correct this pattern. Deregulation of labour markets, deregulation of labour markets, deregulation of labour markets, may be a shortcut for the message sent out by the influential OECD *Jobs Study* fully based on "natural" rate theory. "Old Europe" changed its institutional structure largely by following the blueprint: labour market institutions have been deregulated, welfare state measures tightened, taxes lowered, a common market and a common currency (!) introduced, the Stability and Growth Pact (SGB) has been implemented, and so and so forth. It was promised that all these changes would result in higher productivity growth, more prosperous economies and improved employment, but the results are disappointing: productivity and GDP growth slowed, unemployment remained at unacceptably high levels.

The sole focus on institutional reforms embedded in a "sound" – meaning restrictive – macroeconomic framework was based on "natural" rate theory and the assumption that economies return quickly to a unique equilibrium after a shock. But how to explain upward jumping unemployment rates persisting at higher levels in this framework? Obviously only an upward jumping "natural" rate of unemployment could fit this theory. Did Europe's welfare state measures become more generous in the recessions? Certainly not. Structural reforms should have lowered "natural" unemployment rates. Institutional changes as an explanation for rising and persistently high unemployment in Europe do not fit the timing. Upward jumping "natural" rates became nevertheless the dominant explanation for Europe's unemployment problem. "This remarkable theory was accepted without a qualm"(Solow). Surprise, surprise, aside from "natural" rate theory and "super rational" expectations, there was no or at best shaky evidence that Euro-sclerosis was the right diagnosis for Europe's employment problem, but a "strong" theory seemingly does not need solid empirical evidence.

"Natural" rate theory also introduced a new division of labour: central banks were responsible for price stability only, governments for (de-) regulation, and unions for (low) wages. This division was based on the assumption that monetary policy serves the economy best when following a low inflation path. Monetary policy – although only becoming powerful after the fall of the Bretton

Woods fixed exchange rate system – was declared to be neutral to the real economy, i.e. policies of high price stability were assumed not to compete with growth, but on the contrary high price stability was said to be the precondition for economic growth. In fact, this doctrine led to immunity of central bankers insisting on their independence, but who feel free to give advice on all areas of economic policy. As a consequence, the design of major European institutions created a tight corset for macroeconomic policy. Euroland has the most independent central bank in the world, choosing a self-defined inflation target of 2%, a stability and growth pact which allows the Commission to send letters if the public deficit reaches 3% of GDP, and which supported a decline in tax rates in the belief that a smaller public sector will leave more room for private sector activity declared – but not proved – to be more efficient.

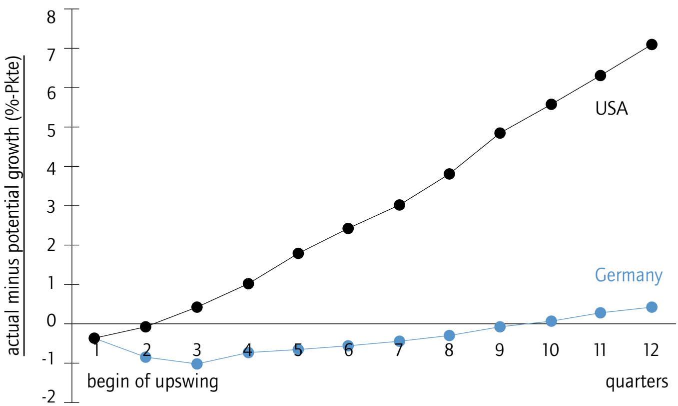
The Bundesbank embraced "natural" rate theory and used its new freedom in the post-Bretton Woods era to implement a deflationary policy. Germany became the champion of price stability only hampered in its world market expansion by a rising value of the Deutschmark, but this restriction disappeared with the euro. Within Euroland, Germany's deflationary policy led German net export surpluses – within but also outside Euroland – to be the major force behind the German recovery of the mid-2000s. Germany, the largest economy in Euroland, followed the Dutch deflationary strategy of declining real exchange rates, but with severely different side-effects. If a small economy like the Netherlands boosts its net exports through improved price competitiveness, it affects Euroland only marginally; if the biggest player follows the same policy, Europe's economy is substantially affected. The low-inflation-export-surplus country looks like the champion, but it is as much part of the problem of European and international divergence as the high-inflation-export-deficit country. The one cannot exist without the other.

Another, although widely neglected, explanation for upward jumping unemployment rates in Europe is that recoveries have not been strong enough because monetary policy was overly restrictive in expansions out of fear of inflationary pressure. According to this theory, the rise in "natural" unemployment was not caused by more generous welfare states, but it was rather the result of overly restrictive macroeconomic policies. For unemployment rates to return to pre-recession levels requires economic growth in the upswing substantially above potential output, productivity growth respectively. If growth remains below this rate, unemployment will persist. Comparing the employment-effective cumulated growth rates over three business cycles between Germany and the US illustrates this point (see figure): the US employment miracle is the result of economic growth overshooting productivity growth substantially in upswings, whereas German employment could hardly recover after recessions and thus unemployment persisted at higher levels after every recession.

The greatest danger for Europe's future employment stems from repeating this policy. If governments and central banks fear inflationary pressure and raise interest rates or consolidate public budgets too early, the recovery will slow and unemployment will remain at high levels. Christina Romer

– chairwoman of President Obama's council of economic advisors and an expert on the policies during the Great Depression – emphasizes exactly this danger for the current recession. In the Great Depression US President Franklin D. Roosevelt consolidated public budgets too early and procrastinated the recovery of the American economy. We do not need to dig holes. The last decades of relatively shrinking public budgets left so many potholes to be filled: educational expenditures in Europe are – with the exception of a few, mainly Scandinavian countries – below OECD average, public infrastructure needs to be modernized and repaired, etc. All this would help to achieve, even if only a little, the goal of the Lisbon agenda culminating in the target to become the "most dynamic knowledge-based economic area in the world". Governments and Central Banks learned a lot from policy mistakes made in the Great Depression and saved us from making a similar experience. Hopefully, they also understand that it needs substantial economic growth for a long period – a New Deal for Europe – to return to pre-recession employment levels. Tightening monetary policy and consolidating public budgets too early will be extremely costly for Europe.

Figure 1 **Cumulated employment-effective growth rates in upswings of 3 business cycles (1974-1998), US and Germany**



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Labour market policies in times of crisis

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The role of labour market policies in mitigating the jobs crisis and supporting a jobs-led recovery calls on governments to develop stronger labour market institutions and broad-based social security systems that can act as effective automatic stabilisers during a crisis.

Starting in the middle of 2007, the crisis has grown from a meltdown in the housing and financial sectors in the United States to a downturn with global reach and a deep impact on the real economy, particularly on the labour market. As evident from previous crises, labour markets tend to recover slowly after such an economic contraction, with unemployment persisting at above pre-crisis levels for a number of years. For this reason, it is crucial for policymakers to consider various labour market policy measures that both mitigate the impact of the crisis on workers and help reduce the lag between economic growth and improvements in the labour market.

The role of labour market policies in mitigating the impact of a downturn

The labour market policy response to a crisis should aim to achieve goals in four main areas: labour demand, match between demand and supply, income support and targeting of vulnerable groups. The relationship between these goals and labour market policies is detailed in Table 1.

Table 1 **Matching goals and labour market policies in times of crisis**

Goal	Types of labour market policies
Maintain labour demand	
Keeping people in jobs	Work-sharing; on-the-job-training (both can be subsidized or unsubsidized)
Creating new jobs	Job/wage subsidies; public works programmes
Improve the employability of the unemployed and underemployed	Job search assistance; work experience and apprenticeship programmes; training; entrepreneurship incentives
Provide income support	Unemployment benefits; social assistance; other social protection measures (including conditional cash transfers)
Target the most vulnerable (youth, women, etc.)	Includes all of the above policies but typically consists of hiring subsidies and training schemes

As illustrated in Table 1, there are a range of different labour market policy tools available to policymakers; however, these interventions all require a certain institutional and financial capacity of governments to fund and successfully implement interventions. Policies that maintain labour demand can be particularly expensive as they require compensation for workers. For example, work-sharing is a scheme where employers reduce the number of hours worked to avoid laying off staff, which directly reduces labour costs and helps them survive a period of low demand. In most European countries, work-sharing is subsidised by the State (typically through unemployment benefit schemes) to prevent a loss in income for workers. Measures that support the unemployed, such as job search assistance or training, require an effective public employment service and providers of training. Despite the best institutional set-up, these policies can, nonetheless, be ineffective in a period where demand is low and firms are not hiring.

Labour market policy response during the global financial crisis

Drawing on a range of recent surveys on the response to the current global financial crisis, it is apparent that a large number of high-income countries have implemented various policy measures that address the different goals of labour market policies (Figure 1). The most commonly used intervention in high-income countries is training for both those threatened by layoffs and the unemployed (including work experience and apprenticeship initiatives) (27 countries), followed by work-sharing (24 countries), increased resources for public employment services, including job search assistance measures (20 countries), and job and wages subsidies (20 countries). The least-implemented intervention in this group of countries is public works programmes (5 countries), which is not surprising given the limited effectiveness of this intervention in such advanced labour markets. In terms of security provided by passive labour market policies, 17 high-income countries have made changes to unemployment benefit schemes (usually extensions of coverage and broader eligibility criteria).

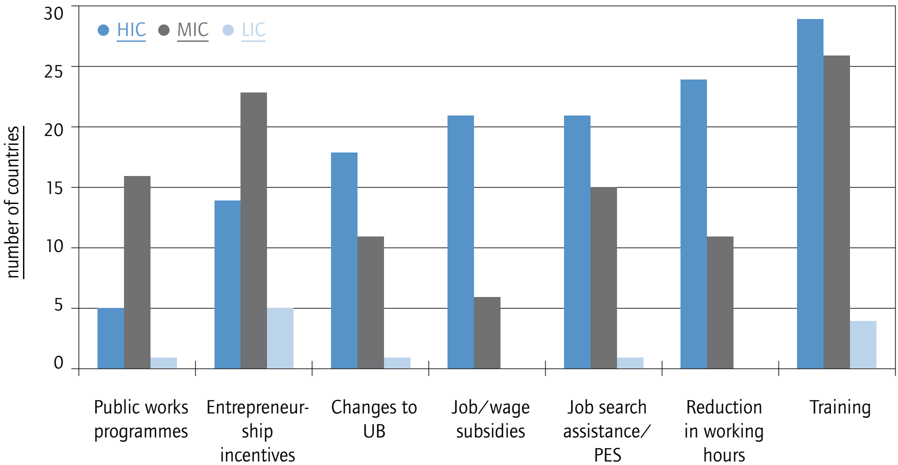
Overall, the use of labour market policies in terms of scope and diversity is declining with the income-level of countries, which reflects the financial and technical constraints hindering the response of these governments. Nonetheless, a range of policies have been utilized in low and middle-income countries, in some cases in a similar fashion to more developed nations. As displayed in Figure 1, the most utilized policy response in the middle-income group is training (with 25 countries), followed by job search assistance, entrepreneurship incentives and public works programmes. There are far fewer low-income countries implementing such policies in response to the crisis. In general, low and middle-income countries tend to rely on labour market policy measures that do not require complex institutional structures and social dialogue. Nonetheless, some governments are turning to more innovative policies that have not been widely used before such as providing subsidized training for threatened workers.

Labour market policies to mitigate the jobs crisis and support a jobs-led recovery

Now that most countries are exiting recession and slowly entering a phase of economic recovery, attention is shifting to concerns about exit strategies and the increasing urgency of tackling the crisis-induced fiscal deficit and government debt. At the same time, a premature withdrawal of monetary and fiscal stimulus would endanger the recovery and have further negative implications for the labour market. In any case, the challenge is to ensure that the recovery is accompanied by employment growth.

Hence labour market policies should continue playing a complementary role in responding to the crisis, along with macroeconomic and other policies, in order to maintain and promote labour demand through both job retention (in high income countries, typically work-sharing schemes) and job creation. Hiring subsidies, especially, have a role to play in ensuring countries experience a

Figure 1 **National labour market policy responses to the current global financial crisis**



Notes: HIC = high-income countries; MIC = middle-income countries; LIC = low-income countries, which are grouped according to the World Bank's classification of countries, see http://go.worldbank.org/D7SN0B8YU0. UB = unemployment benefits schemes. Source: Cazes *et al.* (2009)

jobs-led recovery rather than a jobless one. Governments should consider both job/wage subsidies along with tax credits to encourage employers to start taking on new staff during the coming years. These measures are particularly relevant for individuals who are vulnerable to becoming long-term unemployed or losing their attachment to the labour force, such as youth and the low-skilled. Moreover, governments should continue with training and related measures that improve the employability of the unemployed, which are needed to reduce the risk of long-term unemployment and to facilitate any structural changes in the labour market. Since financial budget constraints will become increasingly binding, Government will need to reallocate resources to ensure that labour market policies move in line with developments in the overall economy and the labour market.

Over the longer term, governments should aim to develop a comprehensive and integrated policy and institutional framework that will enable them to better respond to future crises. This involves the development of labour market institutions and a broad-based social security system, which acts as an automatic stabiliser during a crisis. More efforts also need to be made to monitor and evaluate the impact of specific labour market policies. Finally, mechanisms should be developed to facilitate constructive dialogue between the social partners, the government, employers and workers.

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Labour market policies after the crisis: towards social investment in transitions

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Bernard Gazier is professor of economics at university Paris1 and a member of the Sorbonne centre for economics (University Paris1 and CNRS). He specialises in labour economics and labour market policies. Together with researchers such as Günther Schmid (WZB Berlin) and Peter Auer (ILO) he has developed the "Transitional Labour Markets" approach, principles and applications.

After refuting the revised European employment strategy's inconsistent objective of 'making work pay', the author argues for a new norm of sustainable full employment, taking account of and strengthening labour market transitions, while also advocating an end to the gender-biased division of domestic labour.

The cushioning function of public Labour Market Policies (LMP) has been illustrated in the current crisis, but we have also seen the diffusion of some future-oriented innovation, such as combining short-time working with intensive retraining. Such trends should be fostered. First of all, the timing is right. The speeding up of the ageing process in the EU opens a “window of opportunity”: many senior workers will have to be rapidly replaced in a context of rising skills requirements. However, more profound changes are needed. A new employment norm is possibly emerging, replacing the old one (1) and the idea of organising ‘transitions’ as a social investment is gaining momentum (2).

Towards a new employment norm

An employment norm is a set of interrelated principles indicating what should be considered as “normal”, that is, desirable and possible in this field. It is useful to combine the point of view of the worker and the point of view of the society, and to deal with the central content before looking at its possible evolution as times passes and society develops. Lastly, we may connect this norm to other related social fields, here unpaid work, either domestic or charitable/political, and the connection with environment.

Table 1 **The traditional full employment norm**

Point of view Content of the norm	Worker as family member	Society and natural environment
Central norm	Stabilized full time job, with a guaranteed minimum wage, for the (male) breadwinner	Integration of the working class through access to market production and to economic growth
Dynamic content	Collective skills acquisition through a stable working group	National growth ensured through Keynesian policies
Connection with other useful activities and other social systems	Division of work inside the family, limiting women’s role to domestic work	No environmental concerns No consideration of charitable/political activities

The traditional norm (Table 1), as a retrospective construction centred on the integration of the working class, appears to be gender-biased and at best indifferent to environmental stakes. However, its collective dimension should be stressed: first, qualification appears to increase mainly through collective work experience, and, secondly, there is a conspicuous responsibility of the (traditional Keynesian) state as regards employment matters.

The possible emerging norm (Table 2) is quite different: no longer family-centred (which does not mean that the family constraints are not taken into account, rather the contrary), but rather organized around the individual and based upon collective employability. Four traits are characteristic. First, it could be termed a Schumpeterian norm, putting the emphasis on competences accumulation through networks, innovation and risk-taking. Second, employment should be sustainable as regards social and environmental considerations. Third, the gender and care concerns are now put to the forefront, there should be no more unequal and gender-biased division of domestic labour. Fourth, the norm becomes sequential, and does not contain the same rights and duties set for all ages, especially regarding the number of hours to be normally worked during one week at different points in the life course.

Table 2 **A possible norm of sustainable full employment**

Point of view Content of the norm	Worker as individual	Society and natural environment
Central norm	Individual financial autonomy, mid-term period, gained either through paid employment, or through participation in socially useful activities. Weekly hours modulated according to age. Retraining and leaves	National/regional autonomy, gained in the international division of labour
Dynamic content	Maintenance and accumulation of competences through networks	Collective employability inside the international division of labour
Connection with other useful activities and other social systems	Lifecycle compatibility of family life, personal and professional life; gender equality; crossable and negotiated borderline between different forms of activity	Sustainable development, from a social and environmental point of view

Beyond ‘flexicurity’: transitional labour markets as social investment

We are of course far away from this norm. The prescriptive consequences for LMP in the post-crisis EU economy should be realistic. This brings us to the controversial EU agenda of “flexicurity”, which has to be situated amongst other labour market policy and labour market reform agendas. In our view it cannot be retained as such in the new EU Employment Strategy, but the idea of a better organization of “transitions” in and around the labour market remains, more than ever, a key priority. The important drawbacks and limits of ‘flexicurity’ as it is currently developed in the EU should be avoided without throwing the baby out with the bath water.

Specific attention should be paid to the balance of power in negotiations exchanging “flexibility” and “security”, which all too often are dominated by the pressures towards flexibility. Considering LMP in isolation from other policy decisions should also be avoided, because it unduly leaves the whole adjustment burden to the labour market. The positive idea is to promote “social investment” in a systematic and collective way, and to develop the social organization of better transitions.

This entails:
- Developing the policies needed to improve work and employment quality;
- Strengthening the connection between LMP and other social investments such as education;
- Connecting LMP and a new industrial policy, e.g. through the involvement of local authorities (regions, municipalities, territories) in two directions: setting a portfolio of productive abilities and experiences, in order to attract and retain activities, and organizing transitions;
- 'Equipping labour markets for the people' through institutions enabling more long-term career choices (and not only 'equipping people for the market' through training and information);
- Restoring a better bargaining power for the unemployed, by developing alternative opportunities;
- Restoring a better bargaining power for the workers inside firms, by favouring stakeholders over shareholders;
- Substituting the motto 'make transitions pay' for the motto 'make work pay'. This encapsulates two criticisms of the current European Employment Strategy, which may lead to workers being pushed into any kind of work, even ill paid, through the lowering of unemployment benefits, and which ignores the situations where 'de-activation' makes sense.

A synthetic example may illustrate the application of such principles. In the case of very old dependent parents, LMP should ensure that part-time work is available for senior workers (the children of such very old dependent parents) in order that they may take care of them and continue to work, and should set up incentives and social controls ensuring that such end-of-career working time provision is equally shared amongst men and women. Such policy makes sense only if decent end of careers are available to re-trained senior workers who are not submitted to excessive productivity requirements and pressures. We find here again our starting point: the "window of opportunity" opened by the departure and replacement of senior workers.

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Stress-testing Europe's social systems

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An EU-wide '5P-test' to assess crisis resilience in the areas of Productivity, Poverty reduction, Pensions, Political and social involvement, and Public finances should build the basis for the new EU Commission to set a European agenda to defend and develop social systems.

Behind the financial crisis, the economic crisis and the social crisis there is something more fundamental. The fact is that it is a crisis of the economic development models of the past ten years, particularly in the US and China, models that caused global imbalances and financial bubbles.

These growth strategies were not sustainable, either financially, socially or ecologically. Add to that the fact that Europe had its own bubbles and imbalances, in banking and in real estate. That is why the essence of the present crisis is a global crisis for the growth and development models of the last ten years.

There is a lively global debate about reform of these unsustainable growth models. A rebalancing of the global economy, new stable structures and frameworks for financial markets and a global climate strategy, all are at the top of the agenda.

However, the agenda would be incomplete without new social policies. They are badly needed and have to be part of new global development models. That goes for China, where the World Bank and the IMF are urging the Chinese leaders to build a stronger social safety net to rebalance the Chinese economy from being extremely export-oriented to becoming more based on internal demand, particularly consumption. That goes for the US, too, where a health care reform is on its way, a reform to cope with a huge market failure, which has led to the highest health costs in the world, while still leaving some 45 million people without health insurance. Better social policies are needed also in the EU Member States, where we must maintain our social safety nets in times of deficit reduction, but also make social protection systems more productivity-oriented.

Europe will need a new deal to strengthen both the social dimension and the Single Market – even to save the Single Market from disintegration. It seems that tax competition has replaced currency devaluation as the new beggar-thy-neighbour policy, a more serious form of competition from the point of view of social systems. We have to show citizens that the Single Market and well-functioning social systems are mutually supportive.

The exit strategies now under discussion by macroeconomic policymakers need to be well timed. Too early an exit risks bringing the economy back into recession, too late an exit will lead to new financial bubbles. But the policy mix is just as sensitive as the timing of the exits: to avoid making such exit strategies an immediate failure, they have to be combined with strong micro-economic incentives to skills, employability and recruitment, i.e. to active labour market and education policies.

Thus, we need to start talking about entry strategies, re-employment strategies, to bring people back to work, to new jobs with new skills.

The EU Commission should play a leading role by acting as agenda-setter, and by bringing policymakers together in a constructive dialogue on the co-ordination of macroeconomic exit strategies and of entry strategies and on the design of a bold re-employment initiative.

As an important element in the overall policy response to the crisis I propose that Europe conduct a stress test of its social systems with five main elements.

Why do we need to carry out such stress tests?

There is one simple answer to that question: we have to do what we did with the banks, to ensure that those systems had the strength to serve the economy and the enterprises in a severe situation. Now we have to ensure that the social systems have the strength to serve people when the financial and economic crises are causing a social crisis. I propose a 5P-test, where P stands for Productivity, Poverty reduction, Pensions, Political and social involvement and finally Public finances. These are examples, not an exhaustive list of political parameters.

Productivity – promotion of change and management of change

My starting point is that our social systems have – or should have – a fundamental role in the creation of prosperity by contributing to the improvement of productivity.

The most urgent task is to facilitate re-employment of those who are unemployed. More focus on active labour market policies, education and training and early intervention to prevent long term unemployment is key to success in this field. More emphasis is also needed on the quality of jobs.

Prosperity/ poverty reduction

Second, widely shared prosperity is the goal of all social market economies, which implies both prevention of poverty and a fight against existing poverty.

Our social protection systems are among the most highly developed in the world and yet, today, almost 80 million people live below the poverty line. In most Member States, children are more exposed to this scourge than the rest of the population. Poverty exists among the employed, in-work poverty.

The social impact of the economic crises will be severe. Social protection systems have to be allowed to play their role both of macroeconomic automatic stabilisers, and microeconomic floors against poverty, over several years.

Pensions in an ageing society

The long-term stability of our pension systems has to be tested. Those systems are central in the fight against old-age poverty. Here we can be proud of progress made over the last few decades. However, the pension systems are under stress due to the ageing of our populations. A higher pension age is one way, but that will not help much if workers are unable to stay in working life until the formal retirement age. More than half of the Member States are still below the 50 per cent target for employment for workers aged 55–64. Thus, pension reforms must be closely linked to reform of labour market policies to give new opportunities, not only 'a second chance', but a number of new chances for re-employment all through working life.

Political and social involvement

Fourth, I think that one element in a stress test of our social systems is the degree of political and social involvement. A high degree of involvement is a sign of health, while a reduction in involvement is a signal to observe and react to.

Public finances

Finally, to the bottom line, public finances. How can we return to sound public finances and at the same time maintain our social protection systems? This is the most difficult question. A first step is to identify the automatic stabilisers, recognising that budgets have to serve as shock absorbers. A second step is to make a qualified analysis of the budget deficits – identifying the origin of the deficits, and the difference between permanent tax reductions as one extreme and active re-employment policies as the other extreme – and use such information to shape fiscal policies. A one-size-fits-all approach would lead in the wrong direction; a more nuanced approach is needed.

Let me end by emphasising the political nature of this form of stress test. It is an opportunity to set the agenda for the next five years. The President of the Commission has got a new mandate and made a commitment to "a new, much stronger focus on the social dimension in Europe, at all levels of government". A new Commission will soon be in place. Now is the time to take immediate action to set a European agenda to defend and develop social systems, confirming the basic European ideas and values – competition between enterprises, cohesion between Member States and solidarity between citizens.

Re-cession or He-cession – gender dimensions of economic crisis and economic policy

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A deconstruction of the gender dimensions of the crisis results in rejection of the view that primarily men are hit by the recession. Policy responses to the crisis are not gender-neutral; attention should be drawn to the need for gender equality in developing economic and labour market policies to overcome the recession. Failing this, the crisis would inevitably serve to deepen gender differences once more.

In the developed countries, the prevalent view of many observers is that the current crisis is one that hits men more than women and should therefore be named a "he-cession" and not a recession, the crisis being made by men and hitting primarily men. However the overall impact of the crisis on women and men in a global perspective is far more complex. Nearly all experts in international economic research and policy expect major setbacks in the level of gender equality achieved over the last decades. It seems quite clear that in most developing countries women will face severe economic and social difficulties when production and trade decrease, employment declines, and as a result of the recession, public spending and expenditure – especially in education and health care – is cut (see for example Antonopoulos 2009 and Seguino 2009). This said, however, the following analysis concentrates on EU member states.

During the last decades we saw major increases in women's employment rates in most EU countries, a development indicating that women's employment is no longer a highly flexible "labour reserve". And while women's employment increased irrespective to the business cycles during the last decades (in numbers of employees and not in full-time equivalents, where the increase is less pronounced), there still remain large gender differences for nearly all EU-member states. In 2007, the year before the recession, the EU Lisbon targets concerning overall employment rates and women's employment rates was not reached by more than half of the countries. The gender gap in employment marked more than 10 percentage points in two thirds of all member states and did not narrow from 2002 to 2007. Women's and men's positions on the labour market have remained unequal and resulted in major pay gaps between women and men, with the unadjusted pay gap accounted for 17.4% EU-wide.

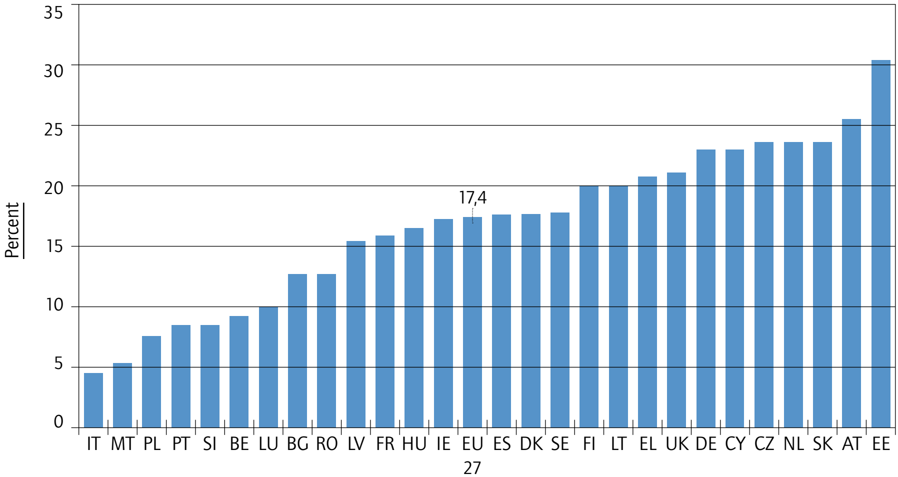
This implies that although there remains a large gender gap in employment and pay, women account for a much greater proportion of the labour market than in previous years (for example, during the last recessions in the early 1980s and 1990s), and as today more households depend on two earnings to make ends meet, jobs losses of women have a significant impact on household incomes and job losses of men in dual-earning households create female breadwinners.

Although the full impact of the crisis on the labour market has not yet been felt in most EU member states, in the early stages of the crisis (until the first quarter of 2009) women's employment was not disproportionately hit; rather there was a decrease in high-profile male jobs in manufacturing industries and construction, followed by losses in sectors with a more gender-mixed composition like trade, banking and insurance and in female-dominated sectors like education and personal services.

In the second quarter of 2009, EU countries report quite substantial differences in the decrease of employment in general and by sex; a first look at the change in the employment rate leads to the conclusion that in a majority of countries men's employment decreased faster than women's, but both sexes were confronted with employment losses. And although, in a minority of countries, females' employment stagnated or increased slightly, the employment gap between men and women remained substantial.

Figure 1 **Pay gap between women and men in unadjusted form in EU Member States – 2007**

(Difference between men's and women's average gross hourly earnings as a percentage of men's average gross hourly earnings)



Source: Eurostat. Structure of Earnings Survey 2006 and national sources (2007) for yearly SES-comparable estimates. Provisional data for EU-27, BE, BG, EE, EL, ES, FI, FR, IT, MT and UK. See introductory text of the statistical annex for detailed information. European Commission 2009

During the last upturn male unemployment rates had in most countries been much lower than women's. When European unemployment rates began to rise in May 2008, female unemployment exceeded male rates in 20 member states, with the EU27 average at almost one percentage point. Since then male unemployment rates have risen and caught up with the female rate at the EU level, but remain still below the female level in 14 member states. In the others male unemployment rates are higher than female rates due to the job losses in male-dominated sectors of manufacturing and construction (Eurostat 2009b).

However, unemployment rates report only parts of the story. As we know from more detailed research, unemployed women are, more often than not, unaccounted for in unemployment data, as they tend to withdraw from the labour market into unpaid or informal work, etc. The impact of the changing economic conditions for either women or men is therefore not fully captured by employment and unemployment data. As with other areas of labour market performance, the statistics often disguise feminised patterns of behaviour shaped by national rules and norms around labour market activity, as well as the constrained labour supply decisions faced by women.

The experiences from earlier recessions and employment decreases show that, even if men's unemployment is higher at the beginning of the crises, women will be affected by the crisis quite substantially:

— Women's employment is often only part-time, in lower paying jobs, with shorter tenure and very often in small firms resulting in less protection against dismissals and mass lay-offs and less included in collectively agreed measures or public-financed programmes like short-time working, e.g. in Germany, only 25% of the participants in the short-time schemes are female;
— Women in maternity or parental leave tend to be disproportionately affected by job losses, compounded by the fact that being an unemployed mother with a small child makes it rather difficult to re-enter employment in many countries;
— Once having become unemployed, in general, women's propensity to remain unemployed is high and women's share among the long-term unemployed is higher than their proportion among the unemployed in general;
— When economies grow, men's employment always grows faster than women's.

Policy responses to the crisis are – like the crisis itself – not gender-neutral either. All policies may affect men and women differently and the policy responses to the crisis may also be gendered.

The actual stimulus packages and other programmes are heavily concentrated in stabilizing manufacturing industries and construction industries, mostly male-dominated segments of the labour markets. As we do not yet have data to assess the gender impact of these programmes, we can not yet fully assess the gender impact of these programmes.

However, given the experiences of earlier recessions and crises, one can highlight some examples of policies which will have a negative impact for women:
— Any policy that aims to encourage parents to leave the labour market will have a negative impact upon women's chances of re-entering the labour market, as it is still women who take the leave – only leave regulations that are bound to fathers can avoid this risk;
— Any policy that encourages shorter time periods in kindergartens or in hospital care exerts an influence on the gender division of paid and unpaid work as it is women who care for the children, the elderly and the sick;
— Any policy that reduces public sector employment and especially employment in education and health care directly affects women. Women are both employees and users of the public services – to a much higher degree than men. Cuts in these areas of public budgets do have an immediate impact on women's position both in employment and as users of services;
— Any policies which increase "deregulation" of labour market conditions may have a gendered impact in the short run, as it is women's jobs which are organized part-time, with less social security and lower wages. Deregulation may exert pressure on full-time, well paid jobs as well and in the end may decrease the overall working conditions of both men and women. Trade unions and others should be aware that concessions between employers and employees around working time may expand involuntary part-time work or part-time unemployment and that concessions made to income, like freezing wages or wage cuts,

may affect women more and may increase the working poor population among women. These consequences are even more dramatic for lone parents.

Despite all rhetoric on gender equality, women's positions in Europe's economies and societies is still far from being equal, and this applies to both the labour market and the family. The recession and the economic policies following the crisis can deepen the gender differences again. The gender impacts of the current policies have not yet been studied in detail – there is still a lot that has to be analysed in detail.

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Salvaging gender equality policy

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The author puts forward five principles to establish a more equal gender order against the risks of recessionary cutbacks. These encompass parental support policies, gender-specific impacts of minimum wage and pension policies, women's rights to economic independence, public sector restructuring, and the need to challenge the power of male elites in the private sector.

As the crisis broke, the idea that the world might not be best run by men enjoyed a brief airing. Indeed, while anyone other than the largely male banking elite could have done a better job, women had the added advantage of not being anywhere near as contaminated by involvement in the failed financial sector. They could also be trusted to be less individualistic and more risk averse, perhaps because no woman would be granted such a soft landing as the bank CEOs.

Only in Iceland, where the outcome of risk-taking has been catastrophic, has that glimmer of opportunity become a form of reality, with women now accounting for 43 per cent of members of parliament under a female prime minister after the post-crisis election. Only one year later and elsewhere it is business as usual; the old governance model is back and with it comes the risk that women, while hardly implicated in the causes of the crisis, may end up bearing a disproportionate share of the adjustment costs.

But let us for a moment turn the clocks back and imagine that the old model was indeed so discredited that a real space did emerge for new solutions, new principles and for excluded groups, including women, to participate in policy formation. In this scenario what could and should be done to establish a new and more equal gender order and to defend existing rights against recessionary cutbacks? I would suggest the adoption of five basic principles.

The first, and somewhat novel principle is that we need a change in the basis on which parenting is supported in employment, from policies that promote women's rights to policies that support the human rights of children. These would include rights to be cared for by either parent, or for that matter by grandparents or any other significant adult in the lives of children. So long as such rights are associated with women's rights, women will be carers first and foremost, and any parenthood policies will be labelled 'luxuries', to be cut back to meet fiscal deficits once the economy no longer needs more women in employment. The urgency of this change is indicated by the speed with which we can already see reversals of parental support policies as the recession bites.

This approach might also help counter the prevailing representation of the decision to have children as an entirely private and voluntary choice, such that resources to support parenthood are characterised as a subsidy for particular lifestyle choices. The fallacy of this argument is revealed by the problems posed to all citizens by the ageing of society consequent on an inadequate supply of 'private' fertility decisions. We need to recognise that children are both a public good and a public responsibility and ask employers to engage with the care commitments of their employees on that basis. They should facilitate flexible working and leave, not as a favour or concession to their specific employees, but as part of a general obligation to contribute to social objectives, in the same way as employers are expected to contribute to clean air policy or to allow employees to perform jury duty. Initially the change might appear more semantic than substantive but a clear focus on the needs and rights of children could provide a long-term basis for a more equal partnership between men and women and between parents and non-parents in social reproduction.

The second principle is that the impact of the recession and recession-induced policies on women should be made visible and not subsumed within a household/family analysis. There is still little evidence that either the EU or member state governments undertake any real gender analysis of policy impacts, even after over a decade of apparent commitment by EU and member states to gender mainstreaming. Many of the effects of crisis policies on women are likely to remain invisible as the discussion focuses on youth or on core male jobs, such as in the attention paid to the fate of General Motors in Europe. A key example of this lack of visibility is in the debate on minimum wages in recession. Policymakers advocate cuts in minimum wages primarily in the belief that they will generate employment for the unemployed and the young. The fact that a relative decrease in minimum wages will affect many more women than men does not enter the analysis. Another area where women's interests remain hidden is in pension reform. The discourse refers to reducing early retirement and extending working lives, with the focus primarily on the retirement patterns of men. The burden of demands for more contribution years falls primarily on the group that already has difficulty fulfilling these requirements, that is women. Debates on defined contributions to replace defined benefit systems are also deaf to the impact on women who are the most likely to interrupt work in early prime age when contributions to pensions are most valuable due to the length of time they are invested.

One reason for invisibility is that, despite the increasing fragility of the family, women's rights to economic independence, as both an individual right and as a protection against poverty, have yet to be embedded as principles in policy formation in most European countries. One way to move quickly to embed women's economic independence in social policy is to reduce the linkages between employment history and the social wage, or to include more activities within the qualifying criteria for the social wage. Another is to resist household-based means testing as a recession policy. This third principle of rights to economic independence provides protection for women in a wide range of policy areas, from access to employment supported by affordable childcare to wage policy and eligibility for benefits.

A fourth principle must be to resist the use of the public bailouts of private failures as a justification for dismemberment of public services and the social wage; the alternative to state support at key life stages is the family, with all the regressive effects that implies, viewed from both a class and a gender perspective. Women are particularly vulnerable to rollbacks of the public sector. Not only are they reliant on public services to support caring activities but also their rights to benefits may be particularly affected if means testing to reduce benefit costs becomes more widespread. Furthermore, they are overrepresented among workers in the public sector where the wage bill feeds directly into the budget deficit. Deteriorating employment conditions associated with pay freezes or an increased rate of privatisation affect men as well as women, as struggles over transport and postal service privatisation reveal, but where jobs are primarily done by women, for example in domiciliary care for the elderly, the outsourcing has often taken place away from the public gaze. There is thus a need for unions and social commentators to adopt a more solidaristic approach to public sector restructuring, focusing as much on the areas of women's employment as on those of men.

Many will argue that these basic social rights cannot be afforded and this brings us to the fifth principle which is the need to challenge the power of male elites in the private sector. Without such a challenge these reforms will be presented as unaffordable luxuries and progress towards a more gender-equal order will be stalled. Economic elites will not spontaneously open up access to excluded groups. Thus progress in this final dimension may be dependent on the type of political change that we see in Iceland. Such a change in personnel would provide a breathing space for new ideas, although any long-term change to the political order would need to be embedded in new democratic structures, as female elites over time may learn to adopt the same behaviour as the present incumbents. Current developments suggest that only an even deeper crisis would provide the opportunity for real change in both the political and gender order.

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Training and skills during and after the crisis – what to do and what not to do

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While politicians frequently insist on the importance of education and training, measures to encourage the provision of high-quality apprenticeships, rather than lengthening compulsory schooling, would represent an appropriate use of public money in many countries.

Across Europe policymakers emphasise the importance of skills policy and lifelong learning as key elements in the response to the current economic crisis. In particular, it is argued, they will enhance economic performance and improve distributional outcomes. Large government subsidies and, in some countries, complex institutional infrastructures are deployed in pursuit of skills and learning objectives. What contribution will skills and learning policies make to softening the impact of recession? Are too many hopes placed upon them? And what results could sensible policies in this area really achieve?

The first key point to make is that there are limits to what skills interventions can achieve in terms of either stimulating economic activity or reducing unemployment. The vast majority of workers currently losing their jobs are not doing so primarily because they lack the skills necessary to make them employable. Job losses have occurred because demand for the products that their employers produce has fallen. If the core underlying problem is a shortage of work, it may be dangerous to overplay what education and training can do, except alter the relative standing of different individuals and groups within the job queue for available employment openings.

Previous recessions saw significant restructuring of the composition of employment. This restructuring was geographical and occupational and in particular reflected a shift from male manual and manufacturing employment towards service sector work. Subsequently, crises at the regional level occasioned by the shutdown of large manufacturing plants threw up similar problems – the injection into local labour markets of a large mass of previously relatively highly-paid, skilled, semi-skilled and manual, mostly male workers whose occupational skill sets were in limited demand. The need, therefore, was for efforts to re-train such workers for new forms of employment.

It is not clear that these considerations will play such an important part in the story of this recession in most developed economies. While it is true that manufacturing jobs have been lost, the scale of such redundancies is now liable to be relatively limited within the overall scale of the changes taking place in employment, if only because in most EU countries manufacturing now accounts for such a reduced proportion of employment compared to earlier times. The key question seems to be what kind of re-training and/or upskilling would be relevant and helpful to the bulk of service sector employees whose jobs now vanish. For example, the employees made redundant with the collapse of the Woolworth's retail chain in the UK were plainly already within the service sector labour market, where other new jobs are expected to emerge, and they were probably perfectly adequately trained and skilled retail workers. It is not clear what the public skills policy response to their unemployment might be.

One of the most likely casualties of the recession is liable to be initial work-based learning (WBL), i.e. apprenticeships. The experience of previous recessions suggests that many employers will reduce apprenticeship provision, not least because they will be recruiting far fewer young people to their workforce. In some countries there is a considerable danger that sharp reductions in WBL provision will impact on the commercial viability of some private training providers, with the result that important elements of training capacity may be destroyed.

Some commentators, particularly in the UK, have argued that a useful response to the threat of rising youth unemployment would be to increase the statutory education-leaving age. Experience suggests that it is almost certainly the case that levels of post-compulsory participation will increase of their own accord as a result of the recession, as youngsters react to dwindling job opportunities in the labour market, and opt to continue in education. What is unclear is whether an immediate resort to compulsion would serve any useful purpose. There are a number of problems.

There have to be meaningful forms of provision available that are both adequately staffed and resourced, and which will engage the youngsters who are going to be forced to participate in them. It requires considerable investment (and thus also time) to ensure that the resources required are available, or that appropriate qualifications and pathways are in place to secure this requirement. Moreover, what we know about those young people who currently opt not to carry on in post-compulsory provision suggests that, insofar as any form of learning might engage them, it would be relatively resource-intensive, need to be closely tailored to their individual preferences and learning needs, and for many of them be centred on WBL (precisely the form of provision that is liable to be under greatest pressure).

Furthermore, there is a danger of confusing participation with achievement. We already know, from the outcomes of compulsory schooling, that in many countries a very significant proportion of young people who participate until minimum leaving age fail to achieve significant qualifications. It may thus be possible to cajole or ultimately force a substantial number of young people to remain in education until 18, but it is much less certain that they will end up achieving useful qualifications.

In many EU countries employers receive substantial public subsidies for training activities. However, governmental financial constraints seem likely to force renewed consideration of the balance of funding responsibilities between state, individual and employer. The sustainability of approaches centred on public funding is now threatened. More generally, education and training expenditure will face competition against the background of tough overall budget constraints from spending areas such as health, welfare and housing.

Lurking behind these short- to medium-term questions raised by the current economic downturn is a much broader and more difficult set of issues that surround the implosion of the model of economic development with which skills policies over the last two decades or more have been linked. This model was predicated on the assumption that the vast volume of extra skills produced would be utilised by employers and that there would be a supply-push impact that would encourage more employers to move 'up-market'. The assumed backcloth was a knowledge-driven economy largely consisting of knowledge-intensive services, and not least financial and business services. The recession will force governments to re-evaluate these assumptions, think about influencing the quality and composition of production more directly, and pay more attention to the demand for skills as well their supply.

What, then, does the above imply for the question as to where the limited public resources available for education and training should be best spent?
- In the formal education system, concentrate on those in danger of leaving school with inadequate basic literacy and numeracy skills. At least we are then increasing their chances in a hostile labour market.
- Do not waste resources by keeping people in formal education simply as a waiting room for employment.
- Target subsidies for work-based training more carefully. In many countries there is evidence of significant deadweight loss.
- Concentrate subsidies on sustaining high-quality apprenticeships which are now threatened by low recruitment rates.
- In providing training for the unemployed, recognise the weight of evidence that to be effective this needs to be accompanied by good job-placement schemes.
- In many countries a significant percentage of the education and training budget is devoted to maintaining complex and expensive administrative infrastructures. Think carefully about how these infrastructures can be slimmed down.

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Industrial and innovation policies in Europe

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A doubling of national and EU resources for industrial and innovation policies is needed to overcome an economic model based on financial rents, focussing on information and communication technologies, ecological restructuring and health services, for which new forms of finance must be tapped, including the issuing of Eurobonds.

The aftermath of the crisis in Europe will depend on the forces at work in reshaping the economy. The dominant players, so far, are large firms with international systems of production. Their responses to the crisis have included downsizing and plant closure; reduction of R&D, innovation and investment; consolidation and acquisitions, further international relocation of production towards industrialising countries. Their decisions affect the possibilities of economic recovery and also of a shift towards 'greener' production. If decisions are left to big business and 'market forces' alone, Europe risks being stuck with old products, low innovation, slow demand growth, heavy environmental impact and growing inequality.

There is no need, however, to accept such an outcome as inevitable. Today's challenges can be addressed by a return to and reinvigoration of industrial and innovation policies. In Europe, they shaped the highly successful expansion of industrial production from the 1950s to the 1970s. In newly industrialising countries they are combining public and private efforts to acquire technologies, invest in new activities, and expand foreign markets. Industrial and innovation policies fell out of fashion in Europe in the last two decades, when governments' liberalisation and privatisation policies largely left decisions on the evolution of the economy to markets. The argument was that markets are efficient in allocating resources and in making decisions on the new activities to be developed. Policies lost their selectivity and were limited to automatic mechanisms, such as across-the-board tax incentives for R&D and acquisition of new machinery, or incentives to producers and consumers of major goods (such as cars). The result has been no change in the direction of industrial activities.

A new generation of industrial and innovation policies

The principles for industrial and innovation policies are simple enough. They should favour the evolution of knowledge, technologies and economic activities towards directions that improve economic performance, social conditions and environmental sustainability. They should support activities characterised by learning processes, technological change and growth of demand and productivity.

The policy framework should reconstruct a virtuous relationship between the generation and use of knowledge, research, innovation, investment and production, that is centred on a view of knowledge as a (largely) public good. Innovation relies on open, shared knowledge, supported by basic research, largely carried out in universities and public R&D centres, funded by public money. As publicly accessible knowledge bases expand, the protection of private intellectual property rights should be relaxed. Investment in new fields is marked by uncertainty and has to rely on public intervention for orienting the evolution of standards, markets, access to finance, coordination among competitive producers and, where necessary, with public enterprises carrying out production and providing services.

Industrial and innovation policies can rely on different policy tools. On the supply side, public funds can support selected R&D, innovation and investment efforts. Public and private institutions can support business start-ups in key fields with credits and venture capital. A new role could be played by public and community enterprises in fields where public goods and public procurement are prevalent. On the demand side, far-sighted public procurement, the organisation and regulation of markets with high growth potential, and support and incentives for early users on new technologies could help 'pull' innovation and investments, shifting production and consumption towards more sustainable patterns. Finally, policies have to build closer relationships among all actors of national systems – firms, financial institutions, universities and policymakers – helping to coordinate decisions of public and private actors. Public demand could direct research and investment decisions in fields such as information and communications technology, environmentally friendly production, and the health sector and social services. Clear priorities for these areas include:

Knowledge and ICTs. ICTs and web-based activities are reshaping the boundaries between the economic and social spheres, as the success of open source software, copyleft, wikipedia, peer-to-peer clearly show. Policies should encourage the practice of innovation as a social, cooperative and open process, easing the rules on the access and sharing of knowledge, rather than enforcing and restricting the intellectual property rules designed for a previous technological era.

Environment and energy. The technological paradigm of the future will be based on 'green' products, processes and social organisations that use much less energy, resources and land, and have a much lighter effect on climate and eco-systems. Such a perspective raises enormous opportunities for research, innovation and new economic and social activities; a new set of coherent policies should address these complex, long-term challenges.

Health and welfare. Europe is an aging continent with the best health systems in the world, rooted in its nature as a public service. Advances in care systems, instrumentation, biotechnologies, genetics and drug research have to be supported and regulated considering their ethical and social consequences. Social innovation should be encouraged in welfare services with a greater role of citizens, users and non-profit organisations, renewed public provision and new forms of self-organisation of communities.

All these fields are characterised by labour-intensive production processes and by a requirement of medium and high skills; innovation in such activities may lead to new products and services that expand output and 'good' jobs; new processes may increase efficiency by reducing materials and energy use more than labour. The result would be a wave of technological and industrial change that is 'employment-friendly' and able to reduce unemployment.

How to pay for policies

Governments and the EU should devote to these policies much larger resources – probably twice as much, on average, as they currently do. Deficit spending for these purposes should be allowed, bypassing the constraints of the European Treaties, because such efforts provide a new foundation for European economic strength.

Part of the resources can be provided by a national tax system that should be adjusted to reflect the new priorities, shifting the tax burden from labour to activities with high use of non-renewable resources, including a carbon tax and higher VAT rates on selected goods that would provide clear incentives to shift to sustainable technologies and products. Personal taxation should include more progressive tax rates on higher incomes and a wealth tax on the richest social groups.

Part of the funds for industrial and innovation policies could be raised through targeted public debt. At the EU level projects could be financed by emitting bonds guaranteed by the EU budget; a role of the European Central Bank in such efforts should also be considered. At the national level, governments could set up agencies funded by public bonds with the mission to provide venture capital, minority stakes, investment credits and R&D support to new activities in the above fields. More funds may come also from the banking sector that could be invited to participate in such new financing programmes. Once these new economic activities start growing in European countries, private equity and lending may flow rapidly, and the public role could then be reduced.

Decisions on the future of the industrial structure in Europe have to be brought back into the public domain. A new generation of policies have to overcome the limitations and failures of past experiences, such as collusive practices between political and economic power, heavy bureaucracy, lack of accountability and entrepreneurship. They have to be creative and selective, with decision-making mechanisms that are more democratic and inclusive of different social interests. These new approaches to industrial and innovation policies could play a key role in pulling Europe out of the current crisis. The politics behind such a new departure has to be based on a wide social consensus over the distribution of the productivity and welfare gains deriving from new technologies and economic activities. In the past decades, firms have largely benefited from higher profits and financial rents. Now, workers and citizens should obtain the benefits of new secure jobs, higher real wages, greater economic and social rights and a better quality of work and life.

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Inequality and the great (wage) moderation

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The idea that market deregulation would bring about increasing employment through lower inflation and declining economic volatility (the 'great moderation') has been discredited. What is now called for instead is a better protection of lower wage-earners and incomes by trade unions, more specifically through an internationalisation of minimum pay.

Worries about growing inequality abound – ranging from exploding top incomes and bankers' bonuses at one end to persistent poverty and growing low-wage employment at the other, with the polarisation of a declining middle in between. In 2008 the OECD's timely Growing Unequal brought this to the attention of the policymaking community. Worries have only grown as a result of the crisis. Do growing inequality and the 25-odd years of economic development (aka the 'great moderation') that culminated in the credit crunch, hang together? And, if so, what can this tell us for the future?

Inequality has become a many-faced animal. It can grow in different parts of the distribution (top, middle, bottom), can involve wages or incomes (gross or net), and can concern households or persons (men or women). In every respect the level or evolution of inequality may differ. For example, one great accomplishment in recent decades was the secular growth of female employment. It greatly reduced gender differences in that field but not necessarily in other respects. The effects on the household-income distribution obviously depend on whom the newly employed women live with in households: enhancing inequality if partners are high earners, reducing it if they are low earners.

Clearly, in a world of rising employment participation the wage distribution becomes ever more central to the income distribution, but they are not identical. Such complications add significantly to difficulties of comparison between countries and over time, hampering proper analysis of causes and effects and, unsurprisingly, also inhibiting collective action and policy making. If the devil is ever in the detail, it is here. A long-run view and profound differences or changes are indispensable for analysing such questions. Now that international financial markets, after three decades of gaining ascendancy, have tripped over their own accumulated waste and fallen into the abyss, the moment may be right. Was the goal of equality a prisoner to these markets? Will it join the fall or be unbound for renewed policymaking?

Almost 30 years of liberal market deregulation were thought to have gone hand in hand with declining economic volatility and increased predictability: the 'great moderation' of lower and more stable inflation rates and of smaller macro-economic fluctuations. Though even Fed chairman Bernanke could not rule out that it might have been due to luck instead of (monetary) policy, policymakers harboured little doubt about the importance of market liberalisation, and continued to press for lowering taxes and weakening social-security provisions and labour-market regulations. The resulting changes have enhanced inequality through three channels. First, the decline of social security bore directly on equality, as it affected the lowest incomes most. Second, the share of labour in economic output decreased in many countries – wages lagging behind productivity growth – but the pressure was often more strongly felt the lower the wage, and especially for those on minimum wages. Third, the growth of the financial sector boosted the high end of the pay distribution because of its higher levels of pay, well before banking bonuses hit the big time.

It is not a matter of simple arithmetic how the aftermath of the crisis will affect inequalities in the future. Uncertainty in financial markets can only increase insecurity in the real economy, and in turn be reinforced by it. Much will depend on where growing unemployment, prolonged pressure on wages, strong budget deficits and concomitant budget cuts and tax hikes will hit, and thus on policy choices. Consider the three channels just mentioned as linking economic developments to inequality. First, social security may now be viewed more positively as a consequence of the sheer size of its effects and the unravelling of the specious rational-market underpinnings of the prevailing approach to labour-market policy. The popularity of part-time unemployment benefits in Europe and the lengthening of benefits in the US illustrate this. On the other hand, the shrinking tax basis and the greater demand for unemployment benefits will squeeze the policy scope for improving lower incomes. Second, the overestimation of financial-services production implies that the decline in the aggregate wage share may also have been overestimated. However, that decline was equally strong in the non-financial economy. Also, a lesser decline of aggregate wages does not in itself imply any absolute wage gain, let alone for the least paid, who may suffer the most because of their concentration in consumer-oriented services jobs. Third, a shrinking of the financial sector may lower wage inequality, again arithmetically and without improving the situation at the bottom.

Looking back to earlier major financial crises gives little cause for optimism. After the Swedish banking crisis the employment rate fell by 12 percentage points up to 1994 and had gained back only 5 points by 2008. The country's employment inequalities rose fiercely as the rate fell much more for younger workers, and it has remained lower, while older workers ultimately bounced back to the initial level. It comes as no surprise that income inequalities also rose relatively sharply. Experiences were similar in Finland.

In addition to the poverty that it usually implies, inequality as such negatively affects society as well as individuals. To contain inequalities policymakers should realise that the credit crunch is only the tailpiece of extended market deregulation. Following up on the labour market – witness the OECD's Jobs Study of 1994 – and product markets, financial markets were progressively liberalised, the most dramatic step coming in 1999 with the repeal in the US of the Glass-Steagall Act of 1933. From then on it took the financial institutions less than ten years to create the current mess. In the process, precisely formulated arrangements for the collective insurance of social risks (unemployment, disability, health, old age) have been traded for rapidly growing individual financial risk-taking, voluntary for some but involuntary for many, along a clear vector of inequality. Uncontrollable moral hazard in finance has replaced manageable hazard attributed to social benefits. At the same time globalisation boosted risks and increased the coverage needed. As, in most countries, labour incomes lagged behind productivity growth and declined relative to capital incomes, it also shrunk the financial basis for carrying these risks. Reinforcing collective insurance is warranted not only because risks are difficult or impossible to cover in markets, but also because here collective economic efficiency greatly exceeds that of the private sector. Health care insurance is a case in point. This implies that a fundamentally different public discourse on taxation is now needed. No longer a priori seen as fettering markets, tax-financed provisions can replace costly markets and, thereby, improve the functioning of remaining markets. In addition, improved taxation can correct for the distortion of financial incentives in markets – read windfall profits in banking.

The corollary for trade unions is to look beyond so-called 'net', after-tax earnings and take public provisions into account, subjecting them to the same scrutiny for inefficiencies as they would market provisions. They also need to rethink the role they have, perhaps unwittingly, played in boosting financial markets, for example via their role in capital-funded pensions that in some countries can comprise up to one third of life-long pay. In addition, unions must focus on the sustainability of employment levels and incomes in the face of bubbles: jobs needed to be rooted in the real economy (including part of the financial sector) not in debt.

The international trade union movement may help solving collective-action problems where single countries primarily act in their own interests. Its voice is sorely missed in the current debate on employment conditions in banking. It may also further international comparability of collective risk coverage – building on the way unions already supported part-time unemployment benefits in various countries. This applies with a vengeance to wage formation – if the international trade union movement cannot agree about the use of minimum-wage setting and internationally agreed principles for this, how can governments? For limiting and reducing inequalities, union protection of lower wages is needed as much as redistribution of high incomes. If banks can 'globalise' bonus cuts (following *Deutsche Bank's* example at the time of writing), unions can internationalise minimum pay.

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A European minimum wage policy for a more sustainable wage-led growth model

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Compressing the wage structure from the lower end would lead to a more egalitarian distribution of income and stabilise the wage share. This can be achieved by a European minimum wage target according to which, in every country, the minimum wage – determined either by law or by collective agreement – should be at least 60% of the national or sectoral average wage.

In the wake of the current crisis there is much talk about re-regulation of financial markets. While this is clearly vital, the focus on the financial system is misleading since it does not tackle the more structural causes of the current crisis.

Apart from financial markets, probably the most important structural cause of the current crisis is the rapid increase in income inequality. Behind this development, which it has been possible to observe during the last two or three decades in almost all industrialised countries, lay a fundamental shift in wage policies, with two main dimensions: first, there was a clear trend towards declining wage shares in national income, which means that wage increases lagged constantly behind productivity developments, leading to a significant redistribution from labour to capital income. Secondly, there was a trend towards much higher wage dispersion which widened from both ends of the wage scale. At the top a relatively small group of wage-earners (including managers) saw an enormous increase in their salaries which were totally decoupled from average wage developments. At the bottom there was a rapid growth in workers with very low wages leading to the well-known phenomenon of 'working poor', with wage levels below national poverty lines or subsistence levels.

The rapid increase in income inequality is mainly the result of a major shift in the power relations between capital and labour which led to a significant weakening of trade unions' bargaining power. Unions have three inter-linked sources of power: organisational, structural and institutional power. As regards their organisational basis, almost all trade unions faced a significant decline in union density. The structural power, which mainly depends on the overall economic framework conditions, was undermined by high unemployment and sluggish economic growth. Finally, their institutional power was systematically weakened by the de-regulation of labour market institutions.

The rapid increase in income inequality led to a situation where private demand from wage income lagged systematically behind the overall economic development and thereby dampened economic growth. This reflects the fact that higher income groups have a much higher saving rate, which was also one major source for the enormous growth of financial markets.

Against the background of an increasing lack of wage-driven private demand, two alternative economic development strategies emerged. The first was a credit-based growth model typified by the United States but also found in some European countries such as United Kingdom or Spain. In these countries growth was driven by private consumption but it was based on household borrowing rather than wage income. A second strategy was followed by countries such as Germany, Japan and China which developed an export-led growth model that sought to offset a lack of domestic demand by export surpluses. Both growth models were interdependent and have created huge global imbalances. The global crisis has now shown that neither growth model is sustainable.

The development of a new post-crisis growth model, which is more sustainable and globally balanced, has to shift the focus again to a more wage-led growth strategy and a much more equal development of incomes. While trade unions have to do their own job to regain their organisational power, policymakers could promote a more equal income distribution essentially through two channels, the first being a more progressive tax policy with an emphasis on higher taxes for top income earners and the second a re-regulation of labour market institutions in order to re-balance the power relations between capital and labour and to strengthen trade unions' structural and institutional power. Considering the high degree of European economic integration, such a reinforcement of labour market institutions should be promoted and co-ordinated at EU level.

A European minimum wage policy

One concrete means of strengthening labour market institutions in Europe is the development of a European minimum-wage policy. Currently all European countries have some regulation to determine a minimum wage floor. In 20 out of 27 EU member states there exists a general statutory minimum wage, while in the remaining seven states minimum wages are determined by collective agreements. In the former group of countries the minimum wage has universal applicability, while in the latter it depends on the collective bargaining coverage.

There are large differences in the value of the minimum wages. In absolute terms, rates range from less than one euro per hour in Bulgaria and Romania to more than nine euros in Luxembourg. While this partly reflects the different costs of living in the various EU countries, there are also significant differences in the relative value of the minimum wage, that is the value of the national minimum wage in relation to the national wage structure. Minimum wages in Europe vary between 30% and 50% of the respective average wage.

The principle aim of a European minimum wage policy would be that every worker in Europe should receive a 'fair' or 'decent' wage. Obviously, such a policy would not be about the harmonisation of minimum wages towards a single European rate. Rather the task of such a policy would be to define common standards or norms for national minimum wages regarding their relative value. One possibility would be to determine a European minimum wage target at EU level according to which, in every country, the minimum wage – determined either by law or by collective agreement – should be at least 60% of the relevant (national or sectoral) average wage. The latter was also demanded by the European Parliament which has called on the EU Council to agree on a timetable for achieving the European minimum wage target in all member states.

A European minimum-wage policy could become incorporated within the so-called open method of coordination (OMC), according to which specific goals and deadlines are set at European level which then have to be implemented via the national institutions for minimum wage-fixing (e.g. statutory minimum wages, national collective agreements, extension of sectoral agreements or combinations of these procedures). The European level then has the task of overseeing the implementation at national level and of contributing, through a comprehensive monitoring of national minimum wage policies and wage outcomes, to the spread of 'good national practices'. Furthermore, the EU has to provide contemporary and comparable data on wage developments in Europe, which allow an accurate evaluation of the relative value of national minimum wages.

For the European trade unions there are two ways of becoming part of a European minimum wage policy: first, both trade unions and employers' organisation should become involved in the development of the concrete aims and procedures of a European minimum-wage policy through the established channels of tripartite social dialogue. Secondly, the unions could support such a policy by setting their own targets for their internal European coordination of collective bargaining and could organise transnational campaigns against low pay.

A significant increase in national minimum wages through a co-ordinated policy at EU level would have numerous positive social and economic effects:

— Compress the wage structure from below and lead to a more egalitarian distribution of income between different groups of workers (including the reduction of the gender pay gap);
— Contribute to strengthening overall wage developments in order to stabilise or even increase the wage share;
— Help to fight poverty and reduce the burden on the state of social welfare benefits;
— Help to stabilise or increase private demand, since workers with low income will spend the largest part of their additional income;
— Support the function of wages as a nominal anchor for the price level in order to prevent deflation.

To sum up, a European minimum wage policy could make a major contribution to the development of a new more sustainable, wage-led economic growth model. At the same time, it would give a concrete expression to the idea of Social Europe.

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Part 3
Stabilising the macro economy through policy reforms and coordination

The state is alive but not yet kicking

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A new code of conduct is needed to balance spending excesses in deficit countries and export excesses in surplus countries. Governments, supervisory bodies and international institutions have a vital role to play to allow society at large to reap the potential benefits of a system of decentralised decision-makers. Only consistent and forceful interventions in financial markets can transform a system of atomistic markets into an efficiently functioning entity.

Preventing the competition of nations

The involvement of many markets and many countries in the big crisis of capitalism that started in 2007 shows that to blame greed and irresponsible behaviour of individuals is to adopt too narrow an approach. The global community as a whole has erred in the belief that in a highly interdependent world with financial markets closely linked by modern computer technologies each country can go it alone and find its way despite many pitfalls and "fallacies of composition". But that is wrong: not all countries can improve their competitiveness, generate a current account surplus and gain market shares: one's advance is another's retreat.

For rising economic welfare to be sustainable, it has to be shared without altering the relative competitive positions of countries. Companies that gain market shares at the expense of other companies form an essential ingredient of the market system. If the overall efficiency of production rises in this process, workers who are negatively affected by corporate competition may find jobs elsewhere in the economy due to higher demand and higher growth. But if nations gain at the expense of other nations, dilemma situations can hardly be avoided. If the "winning" nations are not willing to give up their superior position and to allow a full turnaround of competitive positions over the long run they force the "loser" nations into default. This is the phenomenon that J. M. Keynes, some 80 years ago, called the "Transfer Problem". Its logic is still valid. Properly understood, it would provide a reasonable guideline through the coming jungle of open protectionist tendencies and hidden attacks on the other guy who tries to defend what he perceives as his national interest.

Globalization of trade and finance calls for global cooperation and global regulation. To hold that even in the midst of the crisis free international trade in goods and services must be preserved and the liberalised rules-based multilateral system must be protected, while denying that this is the right approach for global finance is a contradiction that can no longer be tolerated by the international community. It is the failure of governments to deliver effective global governance that is most to blame for the current global predicament. Resolving this crisis has implications beyond the realm of banking and financial regulation, going to the heart of the question of how to revive and extend multilateralism in a globalising world.

At the national level new concepts for economic development have to be designed that can better balance spending excesses in deficit countries and export excesses and long-lasting under-consumption in surplus countries. The most important rule to be followed is to use domestically generated productivity increases for domestic purposes through the full participation of all economic agents in the productivity gains. Moreover, all countries that want to share the potential benefits of trade and foreign direct investment have to understand that the creation of level playing fields for the competition of companies is a desirable target but that competition of nations is a useless and dangerous concept. As UNCTAD has frequently pointed out: all countries can simultaneously raise productivity and wages and the level of trade to improve their overall economic welfare if they follow consistent rules, but not all can increase their market share.

To avoid the fight for market shares through manipulation of the exchange rate, wage rates, taxes or subsidies and to prevent financial markets from driving the competitive positions of nations into the wrong direction, a new code of conduct is needed regarding the overall competitiveness of nations. Such a code of conduct would have to balance the advantages of one country against the disadvantages of other directly or indirectly affected countries. For example, the effect of changes in the nominal exchange rate deviating from the fundamentals (inflation differentials) on trade balances is not very different from that of tariffs and export bounties. Consequently, such real exchange rate changes have to be subject to multilateral oversight, negotiations and decision-making. Only if such rules apply, can all trading parties avoid unjustified overall loss or gains of competitiveness and developing countries systematically prevent the trap of overvaluation that has been one of the most important impediments to prosperity in the past.

Intervention in financial markets is indispensible

In financial markets that are in full speculative swing, nearly all participants follow the same pattern of expectations based on similar information. This uniformity creates manias and panics and huge systemic risks. In a boom phase, there are too few short sellers; and in a bust phase, too many (UNCTAD Policy Brief, No. 3, October 2008). But the similarity of the behaviour of many financial market participants and the limited amount of information that steers them opens a gate for fully justified and non-distorting government intervention. Contrary to atomistic goods and services markets, and the colossal quantity of independent data that help to form the market price there, financial markets are characterized by what could be called oligopolistic information-sharing. Most of the information that determines the behaviour of speculators and hedgers is publicly accessible and the interpretation of these data follows some rather simple explanatory patterns.

There has long been a debate in economics concerning the "equilibrium price" in these markets and the incompetence of governments in identifying it and guiding the market to reach it. But that argument misses the point: Even if well-informed governments and central banks do not exactly know the equilibrium price, they usually do know when prices are in disequilibrium. In other words, the fact that governments have only a very rough idea about the equilibrium price is not a convincing argument against intervention, as we have learnt now that not only do markets have no idea but that they are in fact systematically driving the price away from equilibrium. Take commodity prices: if the oil price doubles in a couple of months, governments and international organisations urge the oil producers to increase supply and in this way intervene in these markets, which obviously means they know that the price is far beyond equilibrium. The same is true for many other markets.

The events of recent months have revealed a huge misallocation of resources and a destruction of enormous values driven by financial markets. The lesson is simple: macroeconomic prices are too important to be left to the vagaries of these markets. However, if the failure has shattered the naïve belief that unfettered financial liberalisation and deliberate non-intervention of governments will maximize welfare, or functional efficiency, the crisis offers an opportunity for a new start. Governments, supervisory bodies and international institutions have a vital role to play to allow society at large to reap the potential benefits of a system of decentralized decision-makers. Only consistent and forceful interventions in financial markets by institutions with knowledge about systemic risk can transform a system of atomistic markets for goods and for services into an efficiently functioning entity. Market fundamentalist laissez-faire of the last twenty years has dramatically failed the test.

Interventions in financial markets that are part of the global economy call for cooperation and coordination of national institutions and for specialized institutions with a multilateral mandate to oversee national action. In the midst of the crisis this is even more important than in normal times. The tendency of many governments to entrust to financial markets again the role of judge or jury over the coming process of reform and indeed over the fate of whole nations is absolutely inappropriate.

Capital management techniques to control financial risks and help achieve fair and sustainable growth

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Well-designed, dynamic capital management techniques that are tailored to individual country needs help to prevent risky financial strategies, excessive debt levels, currency mismatches, and speculative investments. As such, capital controls are an essential tool for countries to stabilise and manage their economies in the interests of balanced and sustainable growth.

The current financial crisis has brought capital controls – and more generally, capital management techniques, that is, the combination of exchange controls, capital controls and prudential regulations - back into fashion, and it's high time. Had appropriate controls over the international sale of dangerous financial products and the speculative flows of foreign capital been widely in place, more countries would probably have been better protected from the financial fallout of the crisis, as were India and China which intensively applied such techniques. Iceland might not have melted down and Ireland might not have fallen off a cliff.

We have been here before. *Laissez-faire* approaches to international capital flows contributed to the collapse of the 1930s. In the aftermath of the Depression and the ensuing, catastrophic Second World War, governments in most of the world – with the reluctant blessing of the newly created International Monetary Fund (IMF) – adopted government controls (exchange and capital controls) to manage the international flows of money and capital. For at least the first three decades following the Second World War, controls over the international flow of capital became the norm in most of the world and helped to support the so-called 'Golden Age' of economic growth in the post-World War II period. Over time, and under pressure from financial interests, governments began to relax restrictions on the international flow of capital and money. Then, the chickens came home to roost. In 1997, the so-called Asian financial crisis hit, creating havoc in many highly successful Asian countries. This disaster was soon followed by the Russian financial crisis. And then a series of crises occurred culminating in the great financial crisis of 2007-2009.

In the face of the current crisis, countries are now trying to apply a wide array of capital management tools to protect their economies from the financial forces that brought the world economy to its knees. The IMF, in a turnaround from several decades of practice, is grudgingly accepting some of these attempts, demonstrating that when reality bites, even the IMF has to respond.

The table (next page) presents a summary of objectives and types of capital management techniques that have been used in practice. As one can see, there are many important objectives that governments pursue with capital management techniques and many tools that governments have at their disposal to achieve these goals.

There has been extensive study of countries' motivations for adopting such instruments and the outcomes (costs and benefits) associated with them. Some useful lessons emerge from this work:

First and most generally, capital management techniques can contribute to currency and financial stability, macro- and microeconomic policy autonomy, stable long-term investment, and sound current account performance. There may also be some costs associated with these techniques, such as the fact that they can create space for corruption. But well-structured controls minimise these costs.

Table 1 **Objectives and types of capital management techniques**

	Objectives	Price-based	Quantity-based	Prudential
Inflows	– Keep a stable and competitive real exchange rate – Limit excessive debt and maturity or locational mismatch to prevent financial instability – Alter the composition of inflows to attract desired inflows – Limit foreign ownership of assets for sovereign purposes or to protect domestic industries	– Tobin tax (tax on foreign exchange transactions) – Reserve requirements on inflows of capital (e.g., URR, unrequited reserve requirements) – Taxation of capital inflows	– Quantitative limits on foreign ownership of domestic companies' assets – Reporting requirements and quantitative limits on borrowing from abroad – Limits on ability to borrow from offshore entities	– Keynes tax (tax on domestic financial transactions) – Reporting requirements and limitations on maturity structure of liabilities and assets – Reserve requirements on deposits – Capital requirements on assets and restrictions on off-balance-sheet activities and derivatives contracts
Outflows	– Protect tax base by reducing capital flight – Maintain stability of exchange rate – Preserve savings to finance investment – Credit allocation mechanisms in order to support 'industrial policy and investments for social objectives – Enhance the autonomy of monetary policy in order to reduce inflation or expand employment and economic growth	– Tobin tax – Multiple exchange rates	– Exchange controls – Restrictions on purchase of foreign assets including foreign deposits – Limits on currency convertibility	– Limits on asset acquisition – Asset-backed reserve requirements
Inflows and outflows	– All of the above	– 'Trip wire and speed bump' approach (Grabel, 2004): identify a set of early warning signals and implement qualitative and quantitative policies gradually and dynamically, with an emphasis on controls on inflows.		

Secondly, successful implementation of controls over a significant period of time depends on the presence of strong fundamentals and a sound policy environment. The former include a relatively low debt ratio, moderate rates of inflation, sustainable current account and fiscal balances, consistent exchange rate policies; the latter include public sectors that function well enough to be able to implement coherent policies (administrative capacity), and governments that are sufficiently independent of narrow political interests to be able to maintain some degree of control over the financial sector (state capacity).

Thirdly, it is important to note that causation works both ways: from good fundamentals to successful capital management techniques, and vice versa. Good fundamentals are important to the long-run success of capital management techniques because they reduce the stress on these controls and thereby enhance the chance that they will be successful. On the other hand, capital management techniques also improve fundamentals by helping to prevent risky financial strategies, excessive debt levels, currency mismatches, and speculative investments.

Fourthly, the dynamic aspects of capital management techniques are perhaps their most important feature. Dynamic aspects mean that controls can be put on and taken off, and tightened and loosened as circumstances require. Policymakers need to retain the ability to implement a variety of management techniques and alter them as circumstances warrant.

Fifthly, capital management techniques work best when they are coherent and consistent with the overall aims of the economic policy regime, or – better yet – when they are an integral part of a national economic vision. This vision does not have to be one of widespread state control over economic activity. Singapore is a good example of an economy that is highly liberalised in some ways, but where capital management techniques are an integral part of an overall vision of economic policy and development.

Sixth, there is no single 'best practice' when it comes to capital management techniques. They need to be tailored to the particular country, goals and circumstances. Luckily there is a broad menu of techniques that can be applied.

Of course, capital management techniques are no panacea for economic problems, and they will not work well unless they are part of an overall, appropriate framework of economic management. For countries navigating the treacherous waters of international finance, however, they can be useful – even necessary – components of the macroeconomic toolkit.

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Reforming global economic governance – towards Bretton Woods III

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World economic governance needs to move towards a Bretton Woods III involving effective supervision of all structural imbalances by the IMF, greater resources for the IMF along with fundamental reforms of that institution, and a shift from the dollar as dominant international reserve currency. This requires cooperation between the G3 – the US, China and the EU.

From ancient Rome to Britain until World War One, the world economic hegemon has always provided the currency for its sphere of influence. At the 1944 Bretton Woods Conference the torch was passed from the pound to the dollar despite Lord Keynes' last-ditch efforts to switch to the Bancor, which would have been the first ever genuine international currency. Wasn't America then the sole candidate for securing the liquidity the world was badly in need of? On the one hand, the dollar shortage exerted a deflationary pressure on the economies hit by the war and confronted with the heavy task of rebuilding their productive capacities. On the other, as the leader of the free world the USA considered the 'dollar privilege' as a sort of seigniorage right for a superpower in charge of the Western camp's security.

As was to be expected, the USA eventually took advantage of that facility, inundating the world with dollars to the point that gold reserves were a mere fraction of the volume of dollars issued by the Federal Reserve. It is worth noting that the main dynamics at work were the successful attempts by Washington, through this massive oversupply of dollars, to dodge the 'guns and butter dilemma': the Vietnamese War and President Johnson's Great Society social program were indeed the two pillars of US policy. Nixon broke the spell by decoupling the dollar from gold: Bretton Woods II was born with the responsibility of financing deficits transferred from the IMF to the market. But trust in American economic dynamism and strategic superiority was such that it made the financial markets very accommodating of a US profligacy which went unbridled through successive Presidential mandates until George W. Bush.

With the benefit of hindsight, it appears that the dollar's 'exorbitant privilege', as President Giscard d'Estaing once qualified it, probably played an important role in the race between America and the Soviet Union, allowing the USA – through Washington's unrestrained external indebtedness and exchange rate policy – to share the burden of defense, including the arms-race which culminated in 'star wars', with its Western allies. The USSR, plagued with systemic inefficiency, did not enjoy the same transfers of resources from its own impoverished camp.

Once the race was over, the extravaganza went on, nurturing world economic growth, this time thanks to the transfer of Asian savings to the USA to finance the trade deficit, mainly through the massive purchase of Treasury bonds. Japan was footing the bill for American security whilst China was buying access to the US manufactured goods market.

The financial crisis that broke out on September 15th 2008, has been shown to have as its underlying origin the Fed's lax monetary policy, which allowed for an abundance of liquidity and low interest rates, enticing households to go into debt through excessive use of credit cards or mortgage credit and financial institutions to take on excessive leverage at an unprecedented scale. The end of the boom sent a shockwave throughout an over-indebted US economy and triggered the subprime crisis. But the ultimate cause was US monetary policy and the fault line lay in the international monetary system.

Has the time of reckoning arrived? The self-interest of the USA may no longer lay in the continuation of the present system because it either makes its economy vulnerable to its Asian creditors or to a sea-change in the assessment of the robustness of the American economy by financial markets. Although it should remain for another generation the world's leading economy, its relative weight is declining. For the EU, being subject to the vagaries of the dollar-based system constitutes the counterpart of the defence burden borne by the USA within the Atlantic Alliance. In this respect the EU behaves as a tributary ally of Washington and it will therefore not raise the issue of revamping the international monetary system. China takes an ambivalent view: On the one hand, as an emerging global economy and strategic power, it cannot satisfy itself with the present asymmetric system; on the other, as a large creditor, it must be careful about the real value of its dollar-denominated assets. For all players, the transition is critical and calls for a cautious step-by-step approach.

A Bretton Woods III must be conceived from now on, building up on the strengths and mending the weaknesses of the present system. This reform should cover a four-pronged agenda:
— Effective surveillance and gradual correction of all structural imbalances (including of the US and China) by the IMF;
— Giving more resources to the IMF so as to allow it to ease adjustment in poor and emerging economies;
— Rebalancing the governance of the IMF and the World Bank, by making more room for China and other emerging countries, and by substituting the EU for individual European Member States, and in particular the eurozone members;
— Switching very gradually and cautiously from the dollar as a reserve currency to a basket of currencies including the renminbi. This implies a move to the latter's full convertibility with the inherent risk of appreciation. This would ease the control of inflation and the move from an export-driven to a consumption-driven growth model in China. This would work towards smoother integration of China in the world economy and would contribute to the medium term recovery and rebalancing of the global economy.

Moving towards Bretton Woods III, calls for collective leadership which the G20 – extended to some poor countries – can provide. But the three largest economies, namely, the USA, China and the EU – a sort of G3 – have a key role to play in shaping the architecture of the system and piloting its implementation. If the EU means to become an effective player in the emerging multipolar world by assuming a growing role in the multilateral economic governance system, it must at the same time gain full autonomy with regard to its currency and more responsibility for its own defence since both issues are narrowly intertwined. This is what the future of the EU is about. A very long road ahead indeed.

Making finance work for development

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The crisis has exposed serious weaknesses in development finance. Lasting solutions for responsible development finance are needed, including a set of binding principles for all development loans, policy space for alternative economic strategies, strict regulatory frameworks to control tax evasion and capital flight from developing countries, a financial transactions tax, and the untying of aid.

Exposing the weaknesses of development finance

In 2007, at the peak of the financial bubble, official statistics painted a rosy picture of trends in development finance: a record high $1.2 trillion of private capital inflows to developing countries and an upward trend of official development assistance were, according to official rhetoric, successfully meeting the financial needs of developing countries. However, this was only a part of the story. During the years of the surge in private capital flows to developing countries, up to $1 trillion a year left developing countries in the form of illicit capital flows. When debt servicing and profit remittances on foreign direct investment are added, capital outflows from developing countries were already negative before the outbreak of the crisis.

About 20% of official development assistance (ODA) was, before the crisis, tied to the purchase of goods and services from donor countries, despite commitments of donors to untie aid. This means that one fifth of bilateral ODA actually never reached developing countries, but remained in bank accounts in the North. More than $300 billion a year was transferred from South to North to service poor countries' external debt. And developing and emerging economies' foreign currency reserves financed Northern current account deficits, at an estimated cost for developing countries of as much as $300 billion or 2 percent of their GDP.

The 2008 global financial crisis has therefore only exacerbated fundamental flaws in development finance whereby poor countries have been subsidising the lavish habits of the rich.

Flying to safety: what's left for the poor?

As a result of the crisis, 100 million people may be pushed back below the poverty line. Foreign Direct Investment (FDI) is projected to fall by at least 30%; migrant remittances to developing countries are predicted to fall by $24 billion; and developing country debt levels may swiftly become unsustainable in 49 Least Developed Countries (LDCs). According to the World Bank this crisis caused a financial shortfall for developing countries of between $350 and $635 billion in 2009 alone. At the same time external flows to developing countries are drying up. After the crisis, soaring deficits in donors' government finances are likely to severely undermine further aid increases, if not threaten existing aid budgets.

Concerned that shrinking aid budgets would be a drop in the ocean to pay the bill that the crisis has left in the South, the G20 decided in April 2009 in London to treble the resources of the International Monetary Fund and increase the capital base of most multilateral development banks, and European Investment Bank lending to developing countries is currently being beefed up to leverage the scarce aid resources.

With private capital flows in free fall, the boost to international financial institutions means that public finance may well overtake private capital flows, regaining a crucial role in development finance. This may sound positive but in fact it is troubling.

In the first place, the official response by Northern governments and international financial institutions to the huge fiscal black-hole in the South is mainly in the form of new non-concessional loans. Together with a surge in capital flight, the fact that much of the external debt borrowed by developing countries is now maturing, and increased costs of borrowing, this makes a deadly combination that threatens to sink developing countries into a new debt crisis.

Second, because low-income countries are not eligible for non-concessional loans, they have only received a small fraction (2%) of IFI lending since the outbreak of the crisis. The bulk of IFI lending is being channelled to middle-income countries and emerging and transition economies.

Third, IMF policy advice after the crisis has not reflected the rhetoric on the need for a counter-cyclical response. Although the Fund has shown slightly greater flexibility in fiscal targets and maintaining priority social protection spending, it has still pushed for pro-cyclical economic policies and turned a blind eye to crucial problems such as capital flight or macroeconomic frameworks that prevent equitable growth. Increased debt distress has been dodged by simply flexibilising the IFIs Debt Sustainability Framework (DSF) while ignoring calls for a lasting and fair solution to developing countries' indebtedness.

Last but not least, the IFIs and Northern governments are succumbing to the temptation to leverage public resources with unqualified support to the private sector. Although necessary to boost growth and development, public support to the private sector needs to be contingent on high standards of responsible finance, making sure that multinational companies fulfil their tax duties in developing countries and that private sector finance is used to support domestic companies and sectors which do not have access to the capital markets and clearly contribute to positive development outcomes.

Turning the tables: lasting solutions for responsible development finance

We must not wait for a new debt crisis, but put in place now the necessary institutional and policy reforms to increase revenue mobilisation in the South and make the most of North-South transfers: plugging the leaks from developing countries is as important as increasing financial flows to the South on the right terms and conditions.

The new global financial architecture must take into account five core reform areas to address fundamental flaws in development finance. Governments and international institutions must take swift action to agree upon:

1. A set of binding principles on responsible development finance – along the proposals in the Eurodad Charter on responsible finance – which should ensure that all loans:
   – clearly state the purpose of the loan and the mutual obligations between borrower and lender;
   – comply with relevant national and international law, including human rights

treaties and internationally recognised social, labour and environmental standards;
- are contracted with public consent and ensure parliamentary and citizen participation, and are aligned to country-designed development strategies and debt policies;
- include provisions for an independent and transparent debt work-out procedure in case of repayment difficulties or disputes. Such procedures should be independent of creditors; mandated to verify validity of claims; and ensure the protection of the basic obligations of the state to meet the essential needs and services of its citizens.

2. Mutual obligations, and not unilaterally imposed economic policy conditions, should regulate the terms of development finance agreements. This should ensure that developing countries are allowed the necessary policy space to adopt alternative economic policies, such as capital management mechanisms (Epstein in this volume) and counter-cyclical policies.
3. Strict regulatory frameworks to curb capital flight and tax evasion from poor countries, including by improving global regulatory frameworks on tax matters and clamping down on tax havens (Murphy/Meinzer in this volume);
4. A financial transaction tax in order to curb speculative behaviour while raising resources for development finance (Schulmeister in this volume);
5. More effective use of aid to achieve sustainable growth and reduced aid dependency, including by putting an end to tied aid policies and practices, and increasing the effectiveness of aid.

Nothing less will do.

Further reading

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What role for monetary policy?

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The mandate of central banks should be broadened to incorporate real economic stabilisation and concern for the stability of the financial sector at the macroeconomic level; to this end, it must have new tools, such as counter-cyclically variable capital requirements. Fiscal and monetary policy must be more closely coordinated, especially in Europe.

Monetary policy has been blamed for causing the crisis and also been hailed for leading economies out of it. In other words, it has been regarded, for better or worse, as the driving force of economic developments in recent years, and experts have criticised or praised central bank actions. In the following a slightly different question will dealt with: what role will monetary policy play when the crisis is over?

The basic assumption of the ideas outlined in the following is that monetary policy indeed has an influence on the real economy, as well as on inflation, by setting short-term interest rates. And the key question is whether the targets of monetary policy should be broadened in the light of recent experiences.

Events since the crisis broke have shown the very real importance of monetary policy for stabilising an economy. By lowering interest rates the ECB not only allowed firms to get cheaper credits – this was by far the least important effect, at least in the short run. A more important effect was, firstly, that cheap money allowed governments to borrow money at low rates and thus made it much easier to finance their necessary expansionary stimulus packages. Secondly, low interest rates allowed banks to raise their profit margins when lending money to their customers. In so doing, they were able to increase their profits and reduce their risk of becoming insolvent. Furthermore, low interest rates made it easier for firms to issue bonds more cheaply, such that they could refinance their debt or their investments at less costs, which helped them to survive. Through all these channels low interest rates were key to stabilising the economy.

In contrast to many fears expressed recently, the effects mentioned above bear no immediate relation to price stability, the primary mandate of the ECB, although one could interpret these measures as a policy to avoid deflation. But this is only indirectly the case. Directly, monetary policy predominantly served to stabilise demand and thus economic activity. Against this backdrop the task of the ECB, as set out in the Maastricht Treaty, seems too narrow to deal with the severe consequences of a deep crisis. This is no accident, since the Treaty is based on the basically new classical assumption that markets are so stable and efficient that there is almost no need for economic policy to interfere with markets. In such a setting, a severe crisis should not occur and there is basically no need to stabilise economic activity since it is never far away from its equilibrium value. In fact, however, the crisis occurred, and the basic assumption underlying monetary policy in recent years has been proved wrong.

These considerations show that in future monetary policy should interpret its role not just in terms of predominantly ensuring price stability, but rather of stabilising the economy more generally, that is, in terms of output as well as prices. The Treaty should, in the light of the recent crisis, either be reinterpreted or even better changed in this direction. That would enhance clarity and appropriately broaden the monetary policy approach.

Furthermore, these considerations show the importance of an at least implicit co-ordination between monetary and fiscal policy. If they work in the same direction, they mutually reinforce each other. Low interest rates make it easier for fiscal policy be expansionary without excessively narrowing the leeway of future fiscal policy by high interest payments. At the same time fiscal policy can take over some of the stabilising task. In the light of these arguments, the ECB should venture to give up its resistance to policy coordination in order to increase the effectiveness of its own policy.

Recent developments have shown that interest-rate policy is not the only instrument of monetary policy in times of already low but positive interest rates. In such a situation, when deflation threatens to trigger a major crisis, central banks have to go beyond interest-rate policy. The ECB, and to a much larger extent the US Federal Reserve, have done just that, buying different sorts of private securities to inject liquidity into the economy. This is highly recommendable at exceptionally dangerous times, when production stalls and unemployment rises, because interest rates cannot be lowered much more. People no longer react by increasing spending to the prospect of even lower interest rates, and the economy is in a liquidity trap. Again this is a case for discretionary fiscal policy action as well as well as a case for considering additional monetary policy instruments. Presently the ECB is very restricted in buying bonds, since it is not allowed to buy state bonds except those that are already in circulation. Thus it is constrained to focus mainly on private bonds. Yet there are no guidelines setting out which securities should be bought and such guidelines are necessary in order to prevent the ECB from giving preference to specific countries, sectors or even firms. One might argue instead that bonds bought should normally reflect the aggregate European economy.

One major task of future monetary policy is its role in an anti-bubble policy. In the first place, there is the task of enforcing new regulations set up after the crisis. The ECB should focus on macro-prudential rather than microeconomic issues. Among these, countercyclical rules should have a very prominent role. That means if – as seems highly likely – the mark-to-market pricing approach is maintained, capital requirements should be linked to the market value of assets. Then at times of a boom when market values are high, capital requirements should be high too. Such a rule diminishes the incentive to increase the respective investment activities in times of a boom, because it becomes more and more expensive to provide the necessary underlying capital. Therefore investors should rather become ever more cautious, leading to a weaker boom, instead of rising prices heating it up more and more as at the present time. On the other hand, if there is an economic slack and the market value of assets declines, lower capital requirements make these investments cheaper. One should expect this to be an incentive to increase investments in these assets and thereby act against economic slump.

In addition to these general rules, specific risk requirements for each asset type should be applied. It would be the task of monetary policy not just to supervise compliance with these rules, but also to conduct ongoing checks on the macroeconomic usefulness of the rules. Such a role is far superior to the request, frequently heard, that monetary policy should become more restrictive over the entire business cycle in order to avoid bubbles. That would adversely affect growth prospects throughout the economy, regardless of whether or not the behaviour is stability-oriented. Hence it is a very rough and costly strategy not to be recommended.

We can sum up these arguments by stating that, in future, monetary policy should play a more active role. This refers to two fields in particular. Firstly, it should expand its targets by explicitly accepting a role, alongside fiscal policy, in stabilising the real economy. Secondly, it should be more actively involved in surveillance of financial markets, where again its main focus should be to ensure macroeconomic stability.

It should come automatically: European coordination to strengthen the automatic stabilisers

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In order to bring about a needed strengthening of the automatic fiscal stabilisers in Europe, the open method of coordination should be utilised. In an extension of existing fiscal supervision, member states should be induced to hit benchmarks for stronger automatic stabilisers. This would not require significant institutional reform and, unlike the Stability and Growth Pact, would be a productive and symmetrical form of fiscal policy coordination in Europe.

The economic crisis has taught us a lot about fiscal policy, much of it knowledge that had been lost during the neo-liberal period. In particular it showed that fiscal policy can stabilise the level of aggregate demand and output. The fiscal reaction by the European authorities was belated, inadequate given the size of the drop in demand, and rather mixed in qualitative terms. But it certainly averted an even bigger catastrophe, and was all the more remarkable given the extent to which discretionary measures had previously been ruled out of court.

The official mantra had been that the stabilising role of fiscal policy should be left exclusively to the so-called automatic stabilisers, the built-in tendency of taxes to rise in a boom and fall in a recession, and for government spending to move in the opposite direction, notably due to changes in unemployment. This was a key idea behind the fiscal framework in Europe as set out in the Maastricht Treaty and the Stability and Growth Pact. The 3% deficit limit was supposed to allow the automatic stabilisers to play, around a structural budget position of 'close to balance or in surplus'. A key advantage of the automatic stabilisers in the eyes of those who believed that politicians could never be trusted was that, unlike with discretionary policy, any increase in spending or reduction in revenue in a downturn was automatically reversed when the economy improved.

Even before the crisis this view was evidently unsatisfactory. Tax and spending systems are designed with other purposes in mind than stabilising demand. There is not the slightest reason to believe that they offer the 'right' amount of stabilisation from a macroeconomic point of view, especially given that the size of the stabilisers varies considerably from country to country (on some estimates being twice as large in some EU countries than others). The idea that countries with larger stabilisers – a good thing – should be obliged to run larger structural surpluses to avoid the (arbitrary) 3% deficit limit is economic nonsense of the first order. A related point is that, within Europe, each country benefits indirectly from the stabilisation, automatic and discretionary, provided by the others. This spillover means that countries are likely to 'understabilise'. Moreover, those arguing for reliance on such built-in fiscal forces were often the same as those arguing for lower (or less progressive) taxation and for cutting the size of the public sector – in other words for the weakening of the automatic stabilisers. Last but not least, it was obvious that, within EMU, with its common monetary policy and exchange rate, the need for stabilisation via fiscal policy was greater and not less than before.

The crisis and the slow response of discretionary policy, hampered as it was by the need for political agreement and the inevitable lags caused by slow-moving budgetary processes – and not any lack of faith in politicians – establish a clear case for making the automatic stabilisers bigger and more effective in Europe. How could this be done?

My proposal is to use the 'open method of coordination' and to expand the remit of the EU's fiscal surveillance mechanisms to ensure a steady and balanced increase in the size and effectiveness of the automatic stabilisers. This can proceed as follows.

The first step is a detailed evaluation of the size of the existing automatic stabilisers in each Member State, with estimates of the contributions from the main revenue and expenditure items. The starting point should be technical analysis already performed for the Council's Economic Policy Committee, which requires political approbation to give it legitimacy. Second, on this basis a target ('benchmark') should be set which all countries should achieve by, say, 2020; this would have the advantage of enabling the proposal to be incorporated into the EU 2020 programme. Similar to the employment-rate target of 70% under the Lisbon Strategy, the target should be ambitious, but potentially achievable by all Member States; those with large stabilisers can be encouraged to go further by committing to higher nationally specific targets. Critically, the choice of measures to reach the benchmark is left to Member States and national 'social preferences' are respected. Third, as part of the already existing system of fiscal surveillance by the European Commission, every year those policy changes that impact on the size and effectiveness of the automatic stabilisers are reviewed and progress towards the targets is monitored. Within the ECOFIN Council and other fora such as the Macroeconomic Dialogue (Koll/Hallwirth in this volume), experts and officials can exchange information on best practices. Fourth, countries failing to make progress towards the targets will be encouraged to comply, following the procedures set out in the Stability and Growth Pact (a graded series of steps from technical advice to warnings and, ultimately, sanctions).

Against this proposal it will be argued that it implies a higher tax burden and a further bloating of the welfare state. This is held to be either undesirable in itself or a matter of social choice that must be left to Member States and on which the EU should not take a view. However, quite apart from the spillover effects and the fact that economic policy is supposed, under the Treaty, to be considered as 'a matter of common concern', this view is incorrect at a more fundamental level. Certainly, higher tax rates and more generous welfare benefits are one way to increase the degree of automatic stabilisation. But there are a whole range of potential policy measures that do not have these effects. The discretionary policy response to the crisis gives some pointers: for example some governments cut the rate of VAT or social insurance contribution rates. To turn such measures into 'built-in stabilisers' they must incorporate two characteristics: they must be automatic and they must be symmetrical.

In other words, in order to be counted measures must have a 'trigger' in the real economy. Depending on the policy measure, that could be a change in output or employment of a certain magnitude. It could even be an official forecast, which would increase effectiveness further. This must then translate, automatically, without the need for time-consuming legislative or administrative processes into a given policy change. To ensure that the change is credibly temporary, either there must be a trigger in the other direction, or the measure is explicitly limited to a fixed period, say 12 months. A broad measure, such as a change in VAT rates, should have a macroeconomic trigger. But more specific counter-cyclical measures are conceivable, for example changes in housing-related taxes triggered by developments on the housing market (cf. Palley in this volume).

Crucially, this symmetrical trigger ensures that policy is automatically tightened in an economic upturn: in contrast, the current fiscal rules have proved unable to constrain governments in economic ‘good times’.

There are certainly other problems with the existing fiscal framework in Europe, such as the almost total absence of fiscal transfers between Europe’s countries and regions and an inadequate central budget. This proposal will not resolve them all. But it would make an important contribution to ensuring economic stabilisation in Europe. This is all the more vital as, apart from dealing with the usual cyclical fluctuations, a failure to reform financial markets and the ‘moral hazard’ caused by bank bailouts carries a great risk of a renewed crisis in the near future. Of course further-reaching, ‘first best’ proposals for ‘fiscal federalism’ would be preferable . But they are fraught with political difficulties. In contrast, the proposal made here does not require any significant institutional reform. It merely brings existing fiscal surveillance mechanisms to bear on national fiscal policies in a productive (rather than destructive) and symmetrical way, leading to coordination that is consistent with the needs of an integrated European economy.

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The tax gap at the core of the current financial crisis and how to close it

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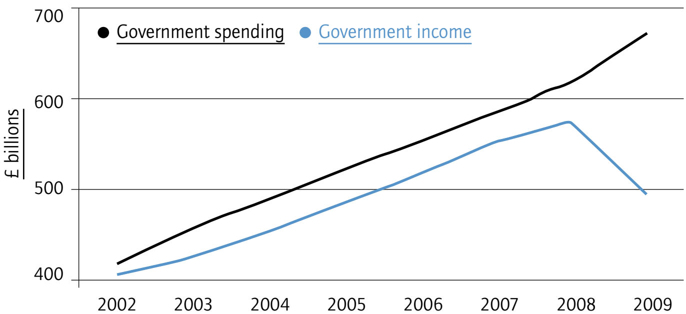
Governments must take energetic steps to prevent the current huge losses of tax revenue to tax evasion and avoidance made possible by fiscal competition between countries. Four sets of measures are proposed: country-by-country reporting for multinationals; general anti-avoidance principles; automatic information exchange between tax authorities; and setting minimum tax rates for the well-off.

A lack of tax revenue did not cause the current financial crisis. The lack of tax revenue caused by the current financial crisis is, however, the problem facing almost all governments, worldwide.

The problem can be exemplified using figures for the UK. Budgeted UK government tax revenue and spending from 2002 to 2009 is shown in Figure 1.

Figure 1 **Budgeted UK government income and spending 2002-2009**



Source: HM Treasury web sites for the budget for each year noted: http://www.hm-treasury.gov.uk/bud_bud09_index.htm

What becomes readily apparent is that the current crisis in government financing is not a spending related issue: it is a revenue related issue. It is the collapse in income that is at the core of our current fiscal crisis. If we wish to continue to enjoy the benefits of government spending, the means has to be found to restore government income when a 'tax gap' of £175 billion has opened up in the UK, and of similar proportion to GDP in other countries.

That 'tax gap' has four major components:

1. Income lost as a result of a downturn in economic activity: this is not the concern of this paper;
2. Tax lost to tax avoidance which is seeking to minimise a tax bill without deliberate deception (which would be tax evasion or fraud) but contrary to the spirit of the law;
3. Tax lost to tax evasion which is the illegal non payment or under-payment of taxes, usually by making a false declaration or no declaration to tax authorities, resulting in legal penalties if the perpetrator is caught;
4. Non payment of tax declared to be due, i.e. bad debt.

The second to fourth items on this list are the issues considered here. Estimates of the size of these tax gaps are rare, and subject to considerable dispute. Again taking the UK as an example, the likely gap is in the range £70 billion to £120 billion, that is between 40% and 68% of the current annual tax deficit. While the situation will vary between countries, there is no reason to believe that similar orders of magnitude, indeed quite possibly much higher relative figures, do not apply in other countries. Tackling this issue is, therefore, of paramount importance.

There are a range of policy initiatives any government can and should take to tackle the tax gap at this time. These initiatives split into two parts. First, tax evasion and the non-payment of tax due must be tackled. This should be done by increasing the number of staff engaged by tax authorities to tackle these issues; this makes particular sense during a period of high unemployment. However, this logical course of action is contrary to policy of many cash-strapped governments. In the UK a significant number of tax offices are to be closed and staff made redundant, leading to low morale amongst remaining staff, chaos in tax administration and rising debt arrears. There is significant danger in this at a time when public services are under threat. Failure to collect tax due undermines the relationship between state and citizen at a time when it will be under stress. Investment in tax collection and tackling tax evasion is vital at this time.

Secondly, challenging tax avoidance is vital. This activity, unrecorded by government in the main because by definition it is legal, shifts the burden of tax payment in society, most especially from capital (and large companies that engage it) onto labour and from the wealthy and self-employed onto employed labour. The resulting perceptions of injustice are politically significant at this time.

A wide range of measures are available to tackle tax avoidance, of which the following are a selection:

Create country by country reporting for multinational corporations

Country by country reporting is a new form of accounting for multinational corporations promoted by civil society organisations. Discussion of country-by-country reporting is well advanced and it has been or is currently subject to active discussion by, amongst others, the International Accounting Standards Board, the Organisation for Economic Cooperation and Development and the European Parliament.

Country-by-country reporting differs from existing accounting in that it would require disclosure, without exception, of the following information by multinational corporations in their accounts:

— The name of each country in which it operates;
— The names of all its companies trading in each country in which it operates;
— Its profit and loss account for each country in which it operates, including details on third-party and intra-group sales, labour costs and head count, profit made and tax paid;
— A limited balance sheet for each country.

This proposal would reveal the use of tax havens by multinational companies and highlight those who are seeking to hide their profits from the view of the public, their shareholders and tax authorities alike. It is the strongest currently known tool available to assist tracking down of corporate funds hidden in tax havens.

General Anti-Avoidance Principles

General Anti-Avoidance Principles are exactly what they sound like. They are laws that say that if a person puts a step or steps into a transaction or series of transactions for the main or sole purpose of reducing their tax liability, then that step is ignored in calculating their tax. Such laws exist and work in Australia, South Africa and even Jersey. Their power is in banning a means of tax abuse before a tax lawyer or accountant has thought it up. They have a strong deterrent effect and this is why they are important.

Automatic information exchange between tax authorities

In a global world it is easy for a tax payer from one state to hide their income in another jurisdiction, especially if the latter is a secrecy jurisdiction. Secrecy jurisdictions are places that intentionally create regulation for the primary benefit and use of those not resident in their geographical domain. That regulation is designed to undermine the legislation or regulation of another jurisdiction. To facilitate its use secrecy jurisdictions also create a deliberate, legally backed veil of secrecy that ensures that those from outside the jurisdiction making use of its regulation cannot be identified to be doing so.

Current measures to tackle this are based on what is called information exchange on request. It has a low deterrent effect because the level of information one tax authority must supply to another before a request for data can be made is considerable: very few requests are made as a result.

The European Union Savings Tax Directive is the best example of an embryonic system for automatic information exchange where tax authorities send data to each other automatically to ensure that income hidden in tax havens is revealed. However, it is limited in geographic scope, is restricted only to interest income received by individuals, and includes loopholes that limit its effectiveness. Using it as a precedent, we recommend the automatic supply of information by the tax jurisdiction where a person who is resident in another tax jurisdiction has an interest in a financial structure – whether it be a bank account, company, partnership, trust or foundation – to that jurisdiction where they are recorded as resident for anti-money laundering legislation purposes. By law this data already has to exist, and this proposal would add essential transparency to the tax system that will shatter banking, corporate and trust secrecy.

Setting minimum tax rates for the well off

Few countries succeed in creating progressive taxation systems, largely because of the wide range of allowances and reliefs available to the well off, meaning that in many countries their tax deductions are worth more than average income. The easiest way to tackle this is to set minimum rates of tax that must be paid once high levels of income are reached. This can be done in two ways: either a minimum rate of tax is set when, for example, income reaches the equivalent of

€100,000, meaning that, whatever allowances or reliefs are provided for in the tax system, a person's tax bill cannot fall below this rate when compared to their gross income. Alternatively, and possibly more simply, a ceiling on allowances and reliefs can be set above which no one can claim more. The opportunity for tax avoidance is therefore reduced considerably.

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The EMU needs a stability pact for intra-regional current account imbalances

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EMU members indirectly share liability for private-sector debt. Existing coordination mechanisms have not prevented the build-up of major economic imbalances within the euro area. To address these issues an 'external stability pact', as an extension of the fiscal surveillance process, is proposed; it would monitor current-account imbalances and penalise excessive current account deficits and, crucially, also surpluses.

The current economic crisis has exposed two fundamental problems in the design of the European Monetary Union. The first concerns the sustainability of public finances in a number of euro-zone member states. Second, inadequate macroeconomic policy coordination has resulted in divergences in the international competitiveness of euro-zone members, threatening the very existence of the euro.

Countries whose public finances seemed fundamentally sound as late as 2008 have come under severe fiscal pressure. Ireland's government debt is expected to rise to almost 80% of GDP by the end of 2010, whereas before the crisis the European Commission projected that it would be below 30% of GDP. Likewise, whereas Spain was expected to decrease its debt ratio, its debt-to-GDP ratio is now likely to double between 2007 and 2010, to more than 60%.

The EU's fiscal surveillance mechanisms failed to predict these developments because they neglect a crucial variable: the dynamics of private-sector debt. Given the high economic costs of a banking crisis, governments are likely to take on the liabilities of their financial sector when a crisis – caused at heart by excessive private-sector borrowing – hits, as recently occurred, for example, in the United Kingdom and Ireland, and in financial crises in Latin America and Asia in the 1990s. The same is probably true when key business sectors near insolvency. A country with sound public finances can thus become a fiscal basket case practically overnight.

Given the increasingly close financial and economic linkages between euro-zone members, rising government debt in one EMU country can have serious consequences for all members. Firstly, no member state will allow another to default. Thus, EMU members indirectly share the liability for fellow countries' private-sector debt, which for this reason should be monitored within the EMU's surveillance framework. Secondly, even if there is no sovereign default or liquidity crisis, excessive public deficits and debt in the Eurozone might, in times of high capacity utilisation, increase pressure on the ECB to push up interest rates which would create monetary conditions suboptimal for those member states pursuing sound public finances.

A second apparent problem is that EMU member states have failed to coordinate their economic policies effectively. Even before the crisis, this resulted in divergences in competitiveness and in the business cycle. The persistent loss in competitiveness over the past decade is one reason why the crisis is hitting some southern European EMU countries such as Spain and Italy so hard. Almost 11 years into the EMU, it is clear that neither market mechanisms nor the existing policy coordination procedures suffice to reduce divergences. These trends pose the risk that some countries might find themselves in a permanent low-growth trap very much like the one East Germany experienced after the German unification or Portugal has experienced since 2002. Such a development will lead to political estrangement of citizens of the crisis countries from EU institutions and possibly with calls for more intra-EMU redistribution which in turn will not be very popular in the countries with better growth performance.

The inefficiency of fiscal-policy control and the lack of economic convergence are a matter of increasing concern to both the European Central Bank and finance ministers, who have started discussing cyclical and structural divergence in the Ecofin and the Eurogroup in parallel to the accelerating debate on the future of the Stability and Growth Pact.

One way to tackle the problems associated with government debt resulting from private sector liabilities, as well as to improve economic policy coordination, is through a simple extension of existing rules: an "External Stability Pact" could be introduced to complement current EMU regulations. This pact would monitor current-account imbalances and penalise excessive deficits or surpluses in the external account.

Monitoring external balances can be an effective tool to measure future default risks, since sustained current-account deficits lead to a growth in net foreign debt. Moreover, there is a direct relationship between the EMU countries' private-sector debt dynamics and their current-account imbalances within the euro zone. So long as a national government is not running more than a modest deficit, a current-account deficit reflects the private sector's borrowing from abroad (or the sale of previously accumulated foreign assets). If the current-account balance is assessed together with the fiscal position, it becomes possible to draw conclusions about risky debt trends within the private sector. While of course the current account is the aggregation of a large number of private and public transactions, the national governments in the eurozone have the tools at hand to influence the private sectors' decisions, in particular through fiscal policy and influences on wage-setting.

The mathematics of debt dynamics suggest that no euro-zone country should have a current-account imbalance, whether a deficit or a surplus, of more than 3% of GDP. Exceptions could be granted for countries with large inflows of foreign direct investment in greenfield projects. The rule should apply both to debtor and creditor countries. After all, payment imbalances always have two sides, and the burden of adjustment should not be borne only by deficit countries.

The External Stability Pact would oblige governments to use fiscal and wage policies as well as overall economic policy to achieve external balance. It would also lead to broader economic-policy coordination, particularly with respect to wage-setting, because governments would be compelled to use national legislation and public-sector wage settlements to influence wage policy in such a way that imbalances among euro-zone countries are reduced.

Furthermore, an External Stability Pact would oblige governments to take into account the consequences for other member states when designing national economic reforms. If a "surplus country", such as Germany, wanted to lower non-wage labour costs and increase value-added tax in order to boost its competitiveness, it would simultaneously have to adopt an expansive fiscal policy to compensate for the negative effects on its partners' foreign trade.

Within the framework of these rules, individual countries would retain the authority to design their policies. The Spanish government, for example, could have met Spain's building boom and foreign-trade deficit with tax increases or by urging domestic wage restraint. Alternatively, it could have intervened by instituting planning regulations or imposing limits on mortgage loans.

An External Stability Pact would not only detect risks to fiscal stability early on; it would also help make a reality of a fundamental principle of EU law, namely that member states finally treat economic policy as a “common interest” according to Article 99 of the European Community Treaty.

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Strengthening the Macroeconomic Dialogue to tackle economic imbalances within Europe

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Intra-European imbalances pose a serious threat to the currency union. In order to strengthen economic governance, the existing Macroeconomic Dialogue at European level should be strengthened and also supplemented with national-level parallel Dialogues in order to ensure appropriate policy mixes including wage agreements in line with the needs of non-inflationary and balanced growth within the monetary union.

Growing income inequalities, imbalanced global growth patterns, housing and asset bubbles, subprime mortgages, and other excessive risks in financial markets, ultimately combined to trigger a severe global economic crisis. Countries characterised by strong imbalances were exceptionally hard hit and the EU, in particular the euro area, has experienced significant and persistent economic divergence. Diverging trends in internal demand and competitiveness between euro-area countries were associated with widening differences in Member States' current account positions. The EU's Lisbon Strategy proved unsuccessful in achieving balanced growth patterns within the euro area and failed in its objective of making EU the most dynamic knowledge-based economy in the world.

At the Pittsburgh G-20 Summit, world leaders committed themselves to "to turn the page on an era of irresponsibility". They stressed the need for a "more balanced pattern of global growth" and decided to work together to develop a "Framework for Strong, Sustainable and Balanced Growth". In Europe, the debate on designing a successor to the current Lisbon Strategy has begun, the aim being to regain economic dynamism while simultaneously restoring balanced growth and employment patterns, sustainable public finances and macroeconomic stability.

To overcome the economic crises as fast as possible and to successfully relaunch the European economy, the new EU2020 Strategy has to take economic interdependencies, in particular within the euro area, more explicitly into account. Within the euro area, spill-over effects of policies designed primarily from national perspectives proved harmful to other EMU countries. There is, accordingly, a need to strengthen partnership between policy actors at different levels of government (EU, Member States, social partners) within a new approach entailing policy coordination mechanisms and procedures.

Experiences of dismal growth, macroeconomic instability, unsustainable imbalances and weak shock resilience have generated a debate as to whether the EMU can survive with its current economic governance structure. In the effort to identify the main shortcomings of EMU, the debate has focussed on many different issues: excessive government debt, savings/investment imbalances, corporate debt, housing bubbles, excessive credit dynamics, insufficient adjustments to external shocks, inadequate institutional arrangements on product, capital and labour markets. Undoubtedly, all these factors are important and their interdependencies are not yet fully understood. However, there are good reasons to assume that the most dangerous risk for the future of the euro is associated with the interaction between divergent wage developments and monetary policy under the conditions of a monetary union. The increasing economic divergence within the euro area observed over the last decade would indeed appear to have been fundamentally driven by differences in inflation and price competitiveness.

Euro-area countries which displayed above-average inflation rates benefited from lower real interest rates, thereby stimulating domestic demand and private investment, especially in the real-estate sector. Favourable demand conditions gave way to further wage rises and more expansive fiscal policy, thus further driving demand and inflationary pressure. For quite some time, this upturn in domestic demand compensated for any associated losses in price competitiveness. Conversely, domestic demand was comparatively weak in countries characterized by subdued wage developments and, for a long time, wage developments in these countries weighed heavily on private consumption, public finance and demand for imports. Competitiveness, of course, improved, as did export performance, but not strongly enough to offset sluggish domestic demand for any significant length of time. Clearly, the adjustment processes in the first decade of EMU proved to be sluggish, and market mechanisms – widely assumed to correct for imbalances rather quickly – failed to impose balanced economic developments over the period as a whole. Moreover, excessive inflation rates in some euro-area countries temporarily seemed to imperil the ECB's target of price stability. Whatever risks to price stability may have existed in reality, it is a matter of fact that the ECB, for fear of compromising price stability, saw no additional room to contribute more actively to growth and employment in the euro area as a whole. Accordingly, existing opportunities to realize more dynamic and balanced growth patterns and to avoid increasing income inequalities have not been sufficiently exploited.

What conclusions are to be drawn? If we want the EMU to succeed we have to learn to treat our common currency in a more appropriate manner. In the absence of the exchange rate and monetary policy instruments at national level, adjustment mechanisms in EMU work slowly and their correction can be protracted and costly. Excessively diverging trends of growth and competitiveness clearly have damaging effects, not only for a country itself but also for the euro area as a whole. Avoiding excessive divergence is therefore important for the functioning and cohesion of EMU and it is vital to detect such trends as early as possible and to take appropriate action for a better functioning of EMU.

Clearly, euro-area imbalances indicate a need for policy adjustment. Insofar as inflation and unit labour cost differentials are key, these should become subject to more careful and continuous monitoring and surveillance, alongside the Stability and Growth Pact procedures with respect to fiscal policies. Inflation developments, as well as the role of wages, wage-setting systems and wage-bargaining co-ordination, should, in particular, be part of the process. As stipulated by Articles 121 and 136 of the Treaty on the Functioning of the European Union, the Council is expected to monitor national economic developments with a view to examining the consistency of national economic policies with the broad economic policy guidelines (BEPG) that were adopted to avoid the risk of "jeopardising the proper functioning of economic and monetary union". If deemed necessary, the Council may address recommendations to the Member States concerned. Guideline 4 of the BEPG calls for wage developments that "contribute to macroeconomic stability and growth and to increase adaptability". Member States, meanwhile, are required to "encourage the right framework conditions for wage-bargaining systems, while fully respecting the role of the social partners, with a view to promoting nominal wage and labour cost developments consistent with price stability and the trend in productivity over the medium term, taking into account differences across skills and local labour market conditions."

Collective wage bargaining must therefore, in all euro-area countries, become more reliably oriented towards the medium-term rate of productivity growth and the ECB price target. In most Member States, wages are formed in a collective bargaining process between employer and employee representatives without any formal involvement of governments. To correct for adverse competitiveness developments in the past, and to achieve more balanced growth within the euro area, there is a need for a coordinated effort of the social partners and policy actors at the European and the national level. Governments should make an active contribution to the establishment of wage-setting processes conducive to balanced growth and more employment. Such a contribution might include provision of quantitative scenarios for the euro area under different macroeconomic policy assumptions, information on wage rules, tripartite agreements or changes to wage-indexation rules. In particular, bargaining systems in euro-area countries should aim at shaping wage developments in compliance with Guideline 4 of the BEPG. Empirical evidence – for example presented by the OECD within its 'Jobs Strategy' evaluation report – suggests that, in this respect, systems with a sufficient degree of centralisation and horizontal and vertical coordination produce better results, as compared to more decentralised systems. Moreover, systems with elements of central bargaining are perfectly compatible with adequate differentiation of wage outcomes across regions and across skill levels.

At the European level, a Macroeconomic Dialogue (MED) was introduced by the Cologne Council in June 1999 as one means of coordinating macroeconomic policy. The MES's main objective is to improve interaction among those responsible for wage development, fiscal and monetary policy. Wage-setting in accordance with Guideline 4 enables social partners to act as macroeconomic actors by contributing to a growth and stability-oriented policy mix. The more wage developments are stability-oriented, the more monetary policy, in line with the Treaty, can provide monetary conditions conducive to stronger growth and more employment without prejudice to price stability. However, the MED has not yet fully achieved its objectives in terms of delivering a cooperative macroeconomic policy stance along these lines. The MED, meeting solely at the European level, does not take sufficiently into account the multi-level nature of policymaking in the EU. To render the MED more effective, and to better comply with its mandate, a renewed attempt to strengthen the MED, in particular by establishing corresponding Macro-Dialogues at national level, should unlock the full potential of macroeconomic cooperation by fully exploiting employment opportunities via strong, non-inflationary and balanced growth dynamics.

The views expressed here are personal and may not be attributed to the Federal Ministry of Economics and Technology.

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Better European financial architecture to prevent crises

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Reforms of the European financial architecture are needed in order to stabilise the economy and promote growth. A variable credit growth stabilisation tax should be introduced to act as an effective built-in stabiliser, to counter bubbles and also to help countries within EMU adjust to a common interest rate. In addition, Eurobonds should be issued to create European-level funds that would aid countries facing constraints on their use of demand-side policies.

The severe worldwide financial crisis, and also the crises in Iceland, Central, Eastern and South Eastern Europe (CESEE), and the problems of Euro-area countries show that there is serious market failure, especially massive overshooting of capital flows, which must be urgently compensated by policy action. The financial sector has a strong pro-cyclical tendency which leads to overshooting and creates boom/bust cycles. Instead of the current piecemeal approach of assisting countries in difficulties, a strategic approach is needed by the EU/Euro area. We need the next step in European integration or risk disintegration.

Better European financial architecture – proposed policy actions

As an exit strategy from the crisis and in the upturn, the introduction of a credit growth stabilisation tax (CGST) on all new private sector credit, to limit excessive credit growth, is proposed. The receipts are used to cover the costs of the crisis, or flow into a cyclical stabilisation fund (CSF) to be used in downturns. This construction would not be traditional Keynesian demand management with deficit spending but act as a sort of automatic stabiliser to counter the pro-cyclical tendencies of the financial sector.

A credit growth stabilisation tax (CGST) would be introduced if credit growth is deemed excessive, e.g. compared to nominal GDP growth. The CGST would be a tax on all new private sector credit. It would start with a tax rate of, say, 0.25 percentage point for all new credits allocated. If this is not sufficient to curb the excessive credit growth, the tax rate could be increased to 1, 2, 3, 4, 5 or more percentage points if necessary. Especially so as to discourage foreign currency loans, the tax rate should be substantially higher e.g. by 1-4 percentage points, for such credits compared to the tax rate for credits in local currency. Also lower tax rates for credits for economically beneficial and necessary investments (green growth) could be considered.

To avoid circumvention through other instruments (e.g. leasing), these instruments could also be taxed. The tax should be collected by the banks but ultimately owed by the debtor. It should also apply to credits taken in foreign countries, with reporting requirements by the debtor and the foreign banks and payment by the debtor, as a means of preventing residents from taking out loans in other countries. If circumvention of the tax is found, creditor and debtor should each pay twice the avoided tax amount, so the fine is four times the amount of tax avoided. One might consider rewarding those who report tax avoidance by others with the tax amounts avoided.

The receipts from this tax should flow into a cyclical stabilisation fund (CSF). This would allow countries to create reserves in the boom phase and help to avoid overheating. The reserves in the CSF could be used in the downswing or bust phase. These counter cyclical policies would act as a countervailing force to pro-cyclical forces in the financial system like mark-to-market accounting and value-at-risk models.

Such a system consisting of a CGST and a CSF would be especially useful for countries with pegs or hard pegs as in this case the scope for using the interest rate instrument is very limited. It could also be used for countries in the Euro area. For example Austria has such a credit tax (*Kreditvertragsgebühr*) which is, however, not used for countercyclical purposes, but could be adapted to function counter cyclically. In the 1990s Austria did make a savings subsidy (*Bauspar-prämie*) automatically counter-cyclical by linking it to the interest rate – high interest rate, higher subsidy and low interest rate, lower subsidy. It works quite well and helped, together with other measures, to lower the savings rate when growth was sluggish.

Alongside the CGST/CSF system, five concrete measures to strengthen the European financial architecture and deepen European integration so that it can cope better with recessions/busts are proposed:

— For euro-area member states the creation of a €200 billion counter-cyclical financing facility, based on Article 122 of the EU's Lisbon Treaty. The funds of the facility would be raised through EU bonds and passed on to Euro-area member states which apply for them, with a mark-up of 50 basis points (bp) or, alternatively, a flexible mark up (20 bp plus 10 bp for each one percentage point the deficit exceeds 3% and additionally each 10 percentage points the debt exceeds 60%). The income from the mark-ups should feed a reserve fund. The Commission would be empowered on behalf of the EU to raise the funds, as it does for the EU balance of payments assistance. The funds would be passed on to euro-area member states which apply for them, up to a maximum of 10% of GDP. The Eurogroup would decide on the distribution of the funds and should also be empowered to increase the €200 billion and the 10% threshold if necessary. This should help Euro-area member states, as markets that were undershooting with sovereign spreads in the past are now in the process of overshooting and the countries have to pay high interest rates on their debt, which limits their ability for counter-cyclical policy.

— For non-euro EU-member states the creation of a €50 billion counter-cyclical financing facility, in addition to the EU facility for balance of payments assistance of €50 billion. Similar mark-ups as in the euro-area facility should apply. This would help EU countries in difficulties; send a strong signal to markets, ease deficit financing and avoid pro-cyclical fiscal policies.

— For European Economic Area, EU candidate, EFTA and EU neighbouring countries, the creation of an EU facility for balance of payments and macro-financial assistance of €50 billion. This facility would also operate, like the EU balance of payments facility, in close cooperation with the IMF, so as to ease the financing pressure on IMF resources. Both facilities could be seen as an EU contribution to IMF financing.

— These bonds emitted and backed by the EU would together create an EU bond market. The risks for the EU would be very low as the funds would flow to EU countries or countries with close relations to the EU, which should be in a position to later pay back the loans. In spite of heated speculation, no EU

member state has gone bankrupt, even before we had a common fiscal discipline (Stability and Growth Pact). The income from the mark-ups could be used to create reserves. The benefits would be high as it would give investors EU bonds which are currently lacking and allow the EU to better compete for international investors.
— Bilateral swaps or Repo facilities should be established between the Euro System and EU, as well as other European central banks. The Federal Reserve has swap agreements worldwide and is acting on its geopolitical responsibility, by helping countries in need. In Asia, under the Chiang Mai Initiative, swap agreements were transformed into a single fund to support the currencies of the participating countries. The fund has recently been increased to 120 billion US Dollar. We could aim at something similar in Europe.

Taken together, these measures would help the Euro-area, EU and CESEE countries to finance counter-cyclical policies that would help stabilize EU growth. Countries in the CESEE region would be able to finance counter-cyclical fiscal and monetary policies and establish and finance their own economic recovery and financial stability plans, which would in turn support EU exports to and FDI in the CESEE region. The correction of imbalances would happen over the medium and long term under IMF programmes. Monetary and financial stability would be supported in and around the Euro area and the EU. This would benefit regional economic, especially trade and financial links. The euro capital markets would benefit from deeper markets in EU bonds, thereby diminishing the disadvantage against the US.

The proposals would help stabilise financial markets, stimulate our economies, correct market failure and deepen European Integration with no cost to the EU taxpayer. Substantial welfare gains for the euro area, the EU and other countries in the extended European zone could be achieved.

Part 4
Creating institutional complementarities and making the transition to ecological sustainability

A change of model requires a new balance of power

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Financialisation and neo-liberalism ruptured the social-democratic alliance between workers and firms, increasing inequalities and weakening the institutions that formerly protected workers. A new social model, based on the interests of the majority of wage-earners, is needed to re-regulate markets, reinforce social protection and defend public services. To this end, a renewed class compromise is required, in order to break down the dominant alliance between finance and high-skilled workers.

The crisis of the past two years is not simply a crisis of 'deregulated finance' or even a crisis of 'finance-led capitalism'. It is a crisis of the neoliberal model of capitalism, i.e. a model of capitalism whose characteristics cannot be limited to the peculiarities of the financial system of the US or the UK. As a consequence, the possibilities for using the crisis as an opportunity to reverse the transition toward the neoliberal model cannot be limited to initiatives toward a 're-regulation' of finance.

The financialisation of the economy is but one aspect of the neoliberal model of capitalism. It has been instrumental in the break-up of the social-democratic alliance between firms and workers and for the emergence of a new alliance between financiers, firms' management and skilled workers. It also plays an important role in the global coherence of the neoliberal model; by imposing short-term constraints on firms, it makes them depend on flexible labour markets for their competitiveness; by increasing income inequalities, it divides the wage-earning classes and reinforces the power of the economic and political elites. But other institutions than the financial system are more important for the stability or instability of the socio-political compromises upon which the European models of capitalism are based: social protection or labour market institutions, for instance.

Over the past couple of decades, the European models of capitalism have been undermined by a series of neoliberal structural reforms affecting many institutional areas: welfare state retrenchment, labour market flexibilisation, privatisations, etc. The consequences have been an increase in inequalities and a weakening of the collective capacities of wage-earners. Reversing this trend implies action that is directed toward the different areas affected by neoliberalisation and the building of a new socio-political alliance.

Two connected trends of the neoliberal model of capitalism, in particular, should be fought: the growth of income and status inequalities and the weakening of institutions protecting workers. Labour market flexibilisation, decentralisation of bargaining and welfare state retrenchment have increased the divergence of interests among workers and made the less skilled groups more fragile. Decreasing these inequalities cannot be limited to the use of the fiscal instrument. This could at best redistribute income but would leave power inequalities unchanged. A new economic system must not simply make the income distribution less unequal but break up the dominant alliance of financiers, firms' managers and skilled workers and substitute a new compromise based on the majority of wage-earners. The emergence of such a compromise demands a radical transformation of political strategies on the left. In particular the fiction of a social-liberal strategy must be ditched and new structural policies should be implemented in the direction of the homogenisation of the various wage-earning groups.

Homogenisation concerns of course income. It implies that centralised solidaristic wage bargaining should be substituted for individualisation and decentralisation. Such a change would have the twin advantage of enabling the implementation of an incomes policy and helping the construction of a common interest among workers, a necessary condition for rebuilding a coherent social alliance able to support a progressive political strategy.

A new model will call for a reinforcement of the institutions of social protection. This implies dumping the so-called 'modern' approach to the question and putting the objective of equality of outcomes, not of opportunities, at the centre of the new politics. The socialisation of welfare expenditure should be an objective too. Regarding pensions, it should not be too difficult, given recent events, to convince the general public that pay-as-you-go systems are in fact more financially stable than supposedly 'funded' systems. The financial crisis is therefore an opportunity for reinforcing the former type that should not be missed.

Labour markets should be regulated. In particular, the idea that employment protection is detrimental to employment will most certainly lose much credibility if the crisis endures and brings persistent high unemployment. This is an opportunity to re-establish a reasonably high level of employment protection where this protection has been most diminished, by prohibiting the most precarious jobs where a sizeable proportion of the workforce finds itself trapped. This would also help the building of common interests among wage-earners.

This institutional transformation calls for a regulation of competition and its strict containment where public services are concerned. If the crisis is the opportunity to celebrate the 'return of the State', this opportunity should be seized to limit the extent of market-based coordination of activities and give a genuinely strategic role to the State in activities that are considered crucial for the future. This is particularly the case for research and scientific activity. The connection of such activities with industrial policy does not mean that research must submit to the demands of industrial production, but that the economy must make the best possible use of the possibilities opened by the advancement of knowledge. This means that the vision of a service-based society that keeps only high-tech activities in developed countries and leaves the bulk of industrial production for the world market to emerging economies must stay what it is: a fantasy.

Such a programme is not the restoration of the institutions of Fordism. The post-war models of capitalism were built on a compromise between capital and labour that left the power of decision to the former in exchange for a steady growth of real income for the latter. The new compromise that is sketched here does not leave such power to capital. On the contrary, workers must have important decision-making powers and not mere consultation. The implementation of such a programme will require the building of new social alliances and compromises. These will be the outcome of political and social initiatives that have exploited the opportunities given by this period of uncertainty and indecision brought on by the crisis.

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Development partnership and solidarity pact: supporting recovery in East-Central Europe

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The crisis has hit the east central European countries in different ways. The liberal recipes currently being promoted for the new member states are inadequate and should be rejected in favour of a longer-term development strategy involving partnership, policy coordination and social dialogue. This requires strong state involvement and fiscal resources to promote adaptation to change.

The crisis reached East-Central Europe with a delay, but once it hit, the blow was severe. Almost all new EU member states had accumulated major economic imbalances, and experienced very steep recessions. Hungary, Latvia, and Romania already had to turn to the IMF in order to defend their currencies and keep their economies afloat. The current crisis in East-Central Europe is not merely economic. Social unrest and the increasing appeal of political illiberalism attest to the end of the happy marriage between EU membership and successful transformation.

To be sure, the crisis hit the region unequally. Some economies have suffered primarily from the breakdown of their major export markets. On the other hand, a handful of countries have been struck by multiple calamities – those countries which introduced currency pegs, profoundly liberalized trade regimes, had balanced fiscal policies, minimal taxes and administrative burdens on businesses, and atomized industrial relations. Their policies thus followed most ardently the framework provided by the Washington Consensus. The pegs led to the appreciation of local currencies, which, while reducing import prices, put a heavy toll on industrial development and exports. Because of rapid deindustrialisation, incoming capital flows in these countries mostly poured into the financial and housing sectors, producing debt and housing bubbles. Households and firms got massively indebted, mostly in foreign currencies. Accordingly, the Baltic states, Bulgaria and Romania (but also Hungary) had already accumulated enormous vulnerabilities before the crisis struck.

The crash-landing of many countries in the region clearly attests to the failure of the Washington Consensus. Rather than recognising this, however, European policy makers and international financial institutions alike are busy administering an even heavier dose of the same kind of medicine. Some of the recent adjustment programs are severe even by IMF standards. What is most worrisome is that while these programs are certainly helpful to redress some of the most urgent balance of payment problems, in the process they further impair the very resources needed for a sustainable recovery. Put differently, the strategy currently pursued in the region is not able to answer the following questions regarding long-term development prospects.

— What resources are at the disposal of the Baltic, Bulgarian, and Romanian economies, in which competitive industries have by and large collapsed over the last decades, and where credits rather than wages have fuelled the rapid growth of domestic markets?
— How can a minimum of social coherence (without which no society can exist) be secured if public expenditures on social programs and job creation are being radically curtailed?
— How can the fragile new democracies earn popular trust when political parties are busy meeting the requirements of harsh adjustment and find themselves unable to respond to citizens' demands for a minimum of safety and predictability in their lives (a major problem especially in Hungary where disenchantment with democracy and the appeal of radical political solutions are most prominent)?

Seen this way, European policy makers and the IMF have embarked on a mission impossible. Any sustainable recovery strategy in East-Central Europe, and especially in the countries hardest hit, has to focus on developing a new economic basis on which these countries can build. This implies the need for a new development strategy. What competitive advantages could the East-Central European countries rely on for their recovery? In the past, such advantages were solely identified and exploited by powerful market actors. Their decisions about investments and outsourcing were crucial in shaping the post-socialist development paths. In the event, transnational actors settled on strategies that were profitable in the short term, but not sustainable in the long run. In order to bring sustainability back in, transnational private actors have to be tamed and more carefully regulated by public actors.

To be sure, almost all East-Central European economies are small or even tiny, and thus strongly dependent on international markets and actors. As Peter Katzenstein argued long ago, small states are not well endowed with the means of strategic intervention. Neither can they afford to (over)protect their economy from international influences. What is often overlooked, however, is that many of the small eastern European states are heavily dependent on the transnational corporations of one or two 'old' EU member states. That is they co-evolve, as it were, with their economically much more powerful partners, and their competitive advantages are also complementary to those of their neighbors. In our view, such complementarity could form the basis for jointly formulated developmental strategies, in which public, private, and civil society (e.g. trade union) actors from the countries concerned could outline a desired longer-term perspective, and negotiate and assign roles and responsibilities.

As Katzenstein further reminds us, successful small states who have to cope with international dependence and the implied need for permanent adaptation, have learned to live with these challenges by compensating those households and firms negatively affected by them, preventing the costs of change from causing political instability. Compensation can take many forms. At a minimum, all East-Central European countries should re-build capacities for training and skill formation, develop active labor market policies, and preserve or build a social safety net worth its name. Such requirements can only be met with more, not less, state involvement, relying on adequate public resources dedicated to this aim.

Increasing the range of available public resources and dedicating them to various forms of compensation for the costs of international integration is especially imperative in societies that share a tradition of state-sponsored social protection and job creation, and in which civil society actors are too weakly developed to successfully fight for social rights. In contrast to the renewed international pressure for further state-withdrawal, we therefore argue for an expansion of targeted state expenditures and policies – wherever they appear as urgent and reasonable. In order to create the appropriate conditions, a European solidarity pact in which the most over-leveraged countries and their creditors would negotiate reasonable and bearable conditions and the timing of debt management (including debt re-scheduling and relief) ought to be concluded. EU-level or national-level public resources should not be alone in backing the solidarity pact. Companies, which in the past made high profits by exploiting the locational advantages and market opportunities of the new EU-member states, should now also contribute to the region's sustainable recovery.

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It's the policy mix, stupid!

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The historically good performance of the Nordic countries is due to a successful, flexible policy mix built around the combination of full-employment-oriented macroeconomic policies, flexible markets, strong welfare states and a key role for negotiation between social partners. It has also proved effective in dealing with the crisis, but needs to be continually adapted to changing conditions.

The financial crisis has turned into a real economic crisis with falling economic growth and sharply rising unemployment, followed by insecurity and growing social inequality. A crisis of the institutions now governing the economy can also be predicted. The institutional order and the governance structures are in danger if political answers to the crisis are not formulated and implemented. With regard to progressive and employment-friendly policy answers, different proposals have been made, including strengthening the control of financial institutions, re-regulation at European level, more public investment, "green" innovation policies, stronger and more active labour market policies (LMP), and life-long learning strategies (LLL).

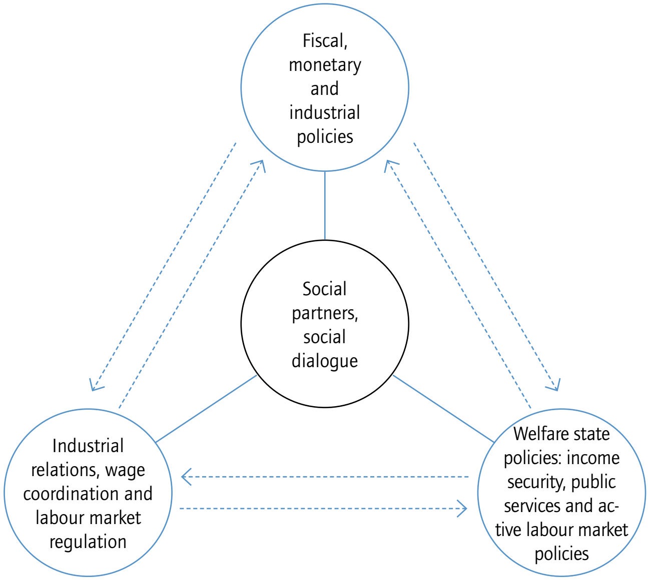
Individual policy measures may seem promising in their own right but they cannot, taken alone, ensure a governance structure able to combine push and pull approaches, instruments that will affect both the supply and the demand side, and which can work and change institutions and behaviour at different levels in society.

Here the Nordic countries offer some important lessons. Over decades, policy mixes have been developed which have proved workable during economic recoveries as well as recessions. Policy instruments must be tuned in accordance with changes in the business circle, and the policy mix adopted has to be accepted by the significant political actors in society. This implies that private associations – the social partners, in particular – have to be placed in pivotal decision-making positions. The Nordic approaches have appeared with different historical formulations. In Sweden, for example, the famous "Rehn-Meidner" model, formulated by two economists associated with the trade union movement, accorded a central role to centralised, solidaristic wage policies. Denmark meanwhile pioneered the currently much-admired 'flexicurity' approach, combining active labour market and lifelong learning policies, income security, and external labour market flexibility. Beyond these differences, however, some common features should be noted – and learned from in the present crisis.

The main elements of the Nordic socio-economic approaches are captured in the triangular figure (Magnusson *et al.* 2008), which highlights the interconnections between macro-economic governance, collective bargaining and labour market regulation, and welfare state and active labour market policies, as well as the key intermediating role of the social partners.

The state has to take overall responsibility for the macro-economic framing, adopting an interventionist approach which must have, as its first priority, the need to ensure full employment. The macro-economic policies of the Nordic countries have been characterised by prudence and stabilisation based on fiscal regulation, cautious use of monetary policies (credit control, devaluations) and close coordination with the centralised wage-setting systems. Collective bargaining, with the exposed sectors in the lead, can be coordinated economy-wide with the aim of achieving moderate real wage growth, low inflation, international competitiveness, and sufficient room for growth in investment and demand. Public investments in infrastructure and public services are needed to support this goal.

Figure 1 **The social foundations of the Nordic approaches**



Cooperation between the political system and the social partners is a prerequisite in ensuring appropriate processes leading to robust results. Social dialogue and tripartite concertation are an integral part of the governance structure and solidaristic wage policies are an important precondition for the development of productivity and restructuring. By creating a proper wage floor, the egalitarian wage policies force unprofitable firms out of business and serve as a mechanism for the reallocation of labour into the most productive firms and sectors, supported by active labour market policies. An important implication of this institutional configuration is that it convinces local unions of the benefits of participating in productivity-enhancing cooperation at the company level.

The welfare state seeks to strengthen the security of wage-earners – also in times of crisis. The third foundation in this system of interlocking policies has been the provision of income security by the evolving welfare state, combined with employment security in relation to the open labour market. By contributing to a socialisation of the individual risks connected to restructuring, by massive investment in improving skills and abilities, and by establishing a proper reservation wage, the income security and LMP schemes facilitate worker participation in rationalisation and adjustment at the firm level and underpin wage policies. And at the macro level domestic demand is secured. Hence, the welfare state must be seen as a productive arrangement, enhancing the policies of growth, restructuring, human capital formation, and stabilising demand. The financing of the welfare state, in turn, is reliant on the success of the overall policy approach in ensuring growth, rising employment and a widening tax base.

The public services are a major arena for (particularly female) employment, and, by socialising care for children and the elderly, further stimulate the growth in female participation in productive work. By redistributing demand via the tax system and by offering decent service jobs, the welfare state plays an important role in fighting insecurity and contributing to job creation.

Of particular relevance in the current context is the way in which the Nordic countries combated economic crisis and high unemployment during the early 1990s by flexible adaptation of their policy regimes. As a first step, floating currencies were established in Finland, Sweden and Norway. The interplay between private collective bargaining and macro-economic policies was then restored, but along different paths: strong recentralisation in Finland and Norway and more decentralisation in Denmark and Sweden. In Norway the trade unions made a pact with the political system, securing welfare rights combined with LMP and LLL initiatives. Finland revitalised centralised tripartite negotiations and the social pacts proved to be a workable response formula. Sweden did not rely on incomes policy but had a general "Industrial Agreement" signed in 1997, also introducing sector-based coordination mechanisms. In Denmark, an agreement between the social partners from 1987 made it possible to take macro-economic considerations into account in collective bargaining. And from 1993/94 a new policy mix was introduced, combining expansive fiscal policy with active LMP. Here the social partners were also placed in pivotal decision-making positions.

The present crisis has been met with correspondingly diverse but strong policy mixes. Macro-economic policies have been made more expansive, bank sector packages have been introduced, and new coordination efforts between public policies and collective agreements are being set up. In Norway, even if the economy has not been that hard hit, the trade union movement is ready for a new "Alternative of Solidarity". LMP measures have been strengthened and social packages set up for the municipalities to help low income groups, support welfare initiatives, and restore the building industry. Sweden is also performing relatively well outside the euro zone. Strong monetary and fiscal stimulus to the economy has, however, been necessary to this end, alongside measures to combat long-term unemployment. Recently, the unemployment figure has been falling again. While Finland experienced a decrease in exports of more than 25 per cent in 2009, domestic demand has been stimulated and new corporatist agreements concluded, including social and LMP measures. Fiscal stimulus packages have been put together in all Nordic countries and further adaptations are planned for 2010.

This is not to imply that there are no weaknesses. In Denmark and Sweden there is excessive reliance on tax cuts and private consumption to solve economic problems. Increasing public investments and public consumption have bigger effects than tax reductions – and this is the way to develop the policy mix further. Here Denmark and Sweden suffer from the ideological and cognitive orthodoxy of their present right-wing governments. Norway is in a better position in that respect.

Of course this sketch of the foundations of the Nordic approaches is a stylised picture. Policy mixes must be shaped according to national traditions and economic and political circumstances – but coordinated at the European level. The multilayered character of the systems must be stressed. Policies at the macro and micro levels need to be embedded in institutionalised patterns of vertical articulation and horizontal coordination. Negotiated solutions are being cultivated in the Nordic countries – more strongly so in Norway and Finland than in Denmark and Sweden at the present time. Linkages between institutions and actors are important, and public policy mixes of both general and selective measures, securing economic as well as social aims, decisive. Defending the goal of full employment and promoting welfare at the same time is possible by the use of interventionist strategies and cooperative decision-making arrangements. Here Europe can learn something from the Nordic experiences.

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Business as usual – means a very different business

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Having failed to recognise the fundamental causes of the crisis, many firms, governments and international organisations are keen, in its wake, to return to 'business as usual'. Instead of this, what is needed is a complementary set of policies, drawing on the ILO's Global Jobs Pact. Employment must be placed at the heart of the recovery and reforms in the area of collective bargaining and public finances are urgently needed. Trade unions must avoid being co-opted into merely 'sharing the pain'.

Imagine for a moment a ship that sails quickly and elegantly around the world. It is the pride of its owners and praised for its efficiency. During a heavy storm, however, the mast breaks, the thin vessel's side cannot withstand the crashing waves, the helm is jammed in stormy seas, and there are only enough life boats for the captain, the first officer and some rich passengers, while the rest of the passengers and crew are left to the mercy of the ocean.

Imagine, then, that experts are called in to help fix the battered vessel and they suggest that, apart from some quick emergency repair work, the same ship should continue to sail as it was, given that it had been so fast, elegant - and profitable. Of course no one would trust such irresponsible experts – unless they were bankers.

Freshly rescued from catastrophe, finance is back in full swing, again making huge profits on the strength of the "mother of all bubbles" currently in the making. Billions of dollars of rescue money is flooding into financial markets, supporting speculation rather than real investment. Confident that the state "lifeboats" will come to the rescue again and that their risks and costs will be carried by the ordinary women and men in the street, the casino is back to business as usual. Total compensation and benefits at the 23 major Wall Street firms are expected to be 140 billions USD in 2009, exceeding the 2007 peak by 10 billions. However this "return to normality" it based on the implicit assumption of massive mid- and long-term cuts in public expenditure and social security provisions to pay for it. If finance and wealth owners get things their way, this may well mean the end of the welfare state as we know it.

In recent decades, wages and transfer incomes have not grown in line with productivity in nearly all countries. In fact, institutional and legal changes to capital and labour markets, combined with aggressive, short-term profit-maximization strategies, enabled the owners of private enterprises and financial capital to appropriate most of society's productivity gains. Moreover, threats of re-location or disinvestment resulted in labour market deregulation and casualization of employment. Global capital mobility led to the rise of tax havens, transfer pricing and tax competition, reducing the ability of governments to tax capital, driving down tax rates and regulation levels. Meanwhile, high profit rates in finance put pressure on the real economy to produce similar results for shareholders. Thus, profits in the financial bubble economy became the benchmark for the real economy; resulting in a decline in real investment and further adding to accumulation of wealth in finance.

In sum, while income differentials have widened, the tax burden has shifted to employees and consumers, further reducing purchasing power. Throughout the world, indecent, precarious and informal employment has been increasing and it looks as though still further deterioration lies ahead.

Recovering from the crisis without immediately planting the seeds for an even bigger catastrophe in a few years time requires fundamental changes in income and distribution. Global imbalances need to be reduced and the downward slide of wages must be reversed.

The ILO suggested a Global Jobs Pact in the summer of 2009 to push for a comprehensive policy approach comprised of public stimulus packages, quality public services, public work, universal social security coverage, living minimum wages, extension of collective bargaining and a fundamental reform of the financial system in order to strengthen final demand based on real income.

However, the macro-economic necessity for growing income and final demand contradicts the micro-economic logic for aggressive cost-cutting at enterprise level. While all enterprises would welcome higher demand, they all turn to aggressive wage and employment cuts to survive during the crisis. There is no competitive, but only a cooperative solution to this dilemma. Left to its own course, this market logic will drive our economies into a downward spiral and intensify the pressure for protectionist measures such as currency devaluation and trade tariffs.

So far, government interventions have avoided the worst, but governments need to do more. In addition to continued stimulus measures they need to stabilize employment and wages through a set of complementary policies. Wages have to be taken as far as possible out of competition to avoid a deflationary wage spiral. This requires a binding, living minimum wage of at least 50% - 60% of average wages. Collective bargaining coverage needs to be increased through appropriate legal and institutional extension mechanisms. Investment in quality public services including stable and attractive salaries for public employees contributes to higher employment and stabilizes the wage level. Temporary public work schemes help to create immediate employment and reduce the downward pressure on wages. Comprehensive social security provision and unemployment benefits are essential automatic stabilizers to maintain income and aggregate demand. Massive investment in a green infrastructure and green innovations are required to address climate change now today, before this has to be done at prohibitive costs and with even more dramatic damage to nature and human livelihoods tomorrow. Investment in public education, health care and urban infrastructure development is central to repair our societies and create opportunities for all after three decades of neo-liberal disintegration.

These measures can and must be funded through new fiscal revenues from a global financial transaction tax (see Schulmeister in this volume), steep progressive income taxation and a substantial wealth and inheritance tax. A global FTT of 0.1 % would generate 1.5 % of Global GDP or 900 billions USD in revenues. Applying the tax rate of 1955 to the 400 highest earners in the US would increase annual revenues by 40 billion USD. In Germany a moderate 1% wealth tax on rich people would generate 20 billion Euro per year.

But the paradox of macroeconomic needs and microeconomic constraints reproduces itself at the level of the nation state. To find sustainable solutions cooperative states have to replace the competitive state of the neo-liberal area.

There is no doubt that raising such taxes is both technically feasible and compatible with a vibrant economy. Indeed, it is a requirement not only for a fairer economic recovery, but also for breaking the harmful process of excessive profits feeding financial bubbles. If countries can coordinate free trade regimes and global bail outs, there is no reason why they cannot coordinate tax rates, close tax havens, and cut the financial sector back to size.

A fairer income distribution will not occur just because it makes macro-economic sense. Winning the intellectual argument is important for building broad alliances for change, but they can't replace the need for determined and capable social movements. In lobbying and in global meetings, civil society is outgunned by the fire-power of Wall Street and its allies. In Washington alone, 3000 lobbyists are on the payroll of the financial sector and over the last decade donations of some 1.8 billion USD to federal election campaigns were made. In return, finance has been able to loot state coffers and present the bill to the public.

Trade Unions are now being invited by governments and capital to help manage crisis adaptation policies. However, this increasingly looks like an invitation to share the pain - not to help shape the future. Governments and business must be surprised how calmly the people and organized labour have reacted so far to the 'rip-off of the century.' This patience might be one reason for the arrogant overconfidence of the elites that nothing has to change. We may all be in for some unexpected and ugly political responses, if this complacency is not challenged.

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The sustainable company: part of the solution to our triple crisis?

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A set of measures is proposed to reorient companies away from short-term stock-market performance towards ecological, social and financial sustainability, setting out a vision for a 'sustainable company'. This requires the development of a corresponding compulsory reporting system, the alignment of managerial incentives to these goals, and the closer involvement of workers' representatives.

We are confronted with a triple crisis – financial, ecological and social – which requires a new approach to corporate governance, i.e. to the way our companies are managed, monitored and regulated. We need an alternative to neo-liberal ideology which has dominated corporate governance reform in Europe for the past decade and a half.

The neo-liberal approach has been based on the following elements:

— Shareholders as the dominant interest in the firm, based on the legal fiction that shareholder capital hires labour, purchases supplies, etc.
— Shareholder value as the optimal performance measure for companies, since the stock market is supposed to best judge of future value.
— Stock options as a key mechanism for aligning the interests of managers and shareholders.
— Corporate Social Responsibility (CSR) as a voluntary approach to addressing the non-financial impact of companies.

Neo-liberal reforms have contributed to the severity of the triple crisis we are facing:

— Stock markets are increasingly dominated by the short-term pursuit of speculative profits. Stock options therefore give managers an incentive to follow strategies with a chance of high payoffs in the short run at the expense of future growth. This can be seen most clearly in the case of the banking sector, whose imprudent lending practices were the root cause of the financial crisis.
— The dimensions of climate change and what we need to do to reverse it are ever clearer. However, the current plans of companies for emissions reduction are woefully inadequate for achieving environmental sustainability.
— The Lisbon Strategy goals for more and better employment, on which there was a notable lack of progress even before the financial crisis, have suffered a serious setback in the past year and a half.

A key part of any solution to this triple crisis will be to reorient companies away from short-term stock market performance towards ecological, social and financial sustainability. One alternative concept for corporate governance is the sustainable company, which includes the following elements:

— A multi-dimensional concept of sustainability as the central guiding principle of the company.
— An externally verifiable reporting system adequate to measure progress on sustainability goals.
— The formulation of concrete sustainability goals and a detailed strategy for achieving these goals.
— The alignment of management incentives within the company to support the achievement of these goals
— The involvement of stakeholders and in particular employees in all of the above processes.

A key part of this effort will be to develop an alternative set of performance indicators measuring environmental, social and financial sustainability at the company level. These indicators are needed for goal-setting, for monitoring (both internally and externally) of company impact and progress on goals, and for the development of incentives to orient management and employees towards the achievement of sustainability goals.

Major progress has been made in developing such indicators by the Global Reporting Initiative (GRI) and, for a narrower set of issues, by the Carbon Disclosure Project (CDP). The GRI, which is a multi-stakeholder organization including NGOs, companies, trade unions and other organizations, has recently issued the third generation of reporting guidelines (G3) which include core, non-core and sector-specific indicators on a broad set of environmental, human rights, labour, community and other issues. The CDP, which is an NGO sponsored by institutional investors, develops an annual questionnaire which is sent out to listed companies. The primary goal of the CDP is to inform investors about the carbon-related risks they face when investing in a company. The questionnaire the CDP sends to companies has numerous questions including topics such as the level of carbon emissions, company strategy and goals for reducing emissions, and whether there are financial incentives for managers and employees for carbon reduction.

However, the current voluntaristic approach has a number of deficits which require action to overcome. The first is that it is mainly large listed companies which are participating, and even among these companies reporting is incomplete. Less than one third of the largest 600 European listed companies issued a sustainability or CSR report in 2008 which drew upon the GRI guidelines. Whereas the participation rate in the CDP was higher (three fourths of the top European 300 companies), a number of companies did not answer the questionnaire completely or else did not make the answers available to the public. Binding legal requirements for comprehensive reporting by companies on a broad set of criteria are needed, e.g. in Europe through an EU directive on non-financial reporting.

Secondly, the CDP data shows that only about half of the responding companies have financial incentives for management and employees for reducing carbon emissions. In many cases, these are limited to general improvement suggestion programmes for employees. Only a few companies have tied a substantial proportion of variable pay for top management to the achievement of goals such as the reduction of workplace accidents or environmental emissions. The number of companies with meaningful financial incentives for sustainability needs to be substantially expanded through political and investor pressure for the diffusion of best practice.

Thirdly, we need to increase the power of long-term stakeholders in the decision-making structures of the company, particularly of employees who have the largest stake and a long-term interest in the companies for which they work. Companies with employee participation (such as European Works Councils or board-level employee representation) are more likely to participate in the CDP, to score higher on the CDP leadership index, to be included in one of the major sustainability indexes (e.g. Ethibel, DJ Sustainability, FTSE4Good), and less likely to have stock option plans for their top managers. Financial regulation also needs to be reformed to encourage shareholders to take a longer-term perspective that includes non-financial performance.

These changes are a major political and technical challenge and therefore not easy; and yet they are necessary if we are to achieve sustainable company policies able to prevent our triple crisis from developing into a full-blown disaster.

Reforming the EU budget to promote sustainable growth

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Reforming the EU budget offers one way to promote sustainable development in Europe. Even given the current limited size of this budget, substantial resources could be channelled into a broad carbon mitigation and adaptation programme with a European value added, either by fully exploiting the 'own resources' ceiling, or by shifting resources from other policy areas. Additional revenues could be generated by a European carbon tax.

The EU budget has been a running sore in economic governance for so long that its potential contribution to our well-being is easily dismissed. Although a review of all aspects of the budget was supposed to have taken place in 2008/9, nothing has yet emerged. There was an extensive consultation, studies were commissioned and libraries of position papers were written, but political timidity has prevailed and an observer from Mars could be forgiven for wondering quite what the EU budget is for.

Countering climate change could offer an answer. A shift to a low-carbon economy is widely agreed to be necessary, and there is growing recognition that EU economic governance beyond 2010 must focus on timely action to change patterns of production and consumption towards a new, low-carbon paradigm. Comprehensive public policies and expenditure programmes will be needed, with funding from different levels of government combining with private investment, aimed at sharp reductions in the energy intensity of GDP and in the carbon intensity of energy.

Some critics portray carbon mitigation as a burden and argue that 'green' economy measures cannot be justified during a period of economic downturn. But research suggests that it may well offer more economic benefits than costs, especially in creating a substantial number of 'green' jobs and stimulating new sectors of activity. There is also a substantial self-interest for Europe in reducing dependence on energy imports, especially from politically volatile producer countries. In addition, any investment programme starting quickly (including one targeted at carbon abatement) could help the recovery from the current recession.

The magnitude of the changes required points to the need for a novel approach to governance, including re-thinking whether EU expenditure can play a pivotal or catalytic role, complementing what is done at other levels of government and by private agents. Economic arguments for assigning spending competences to the EU level include economies of scale and the expectation that if a single Member State is unable to appropriate the full benefits from relevant investments, it will invest less than is socially optimal. Such arguments are especially apposite regarding the prevention of climate change given the obvious cross-border spillovers.

Political sensitivities are bound to arise for some potential EU spending and it is inevitable that decisions on what to assign to the EU budget will reflect political expediency as well as purely analytic considerations. For example, cost-effective cuts in global emissions may be attainable from EU spending outside Europe, but would face internal objections that spending should be 'at home'.

Some priorities are, nevertheless, obvious. Technological developments will loom large in any transition to a low-carbon economy, but need a strategic approach. Short-term gains will, principally, stem from improving and diffusing existing technologies, but there will be a parallel need to boost investment on the known, but as yet uncommercial, technologies that offer bigger cuts over a longer time horizon. Although opposed by some environmental interests, one key technology will be carbon capture and sequestration (CCS), a process which will allow for increased use of coal, an abundant and widely distributed primary source of energy that is especially suited to electricity generation, but with much lower emissions. EU funding could be used to accelerate the construction of full-scale demonstration projects and the infrastructure for subsequent implementation.

It is also important not to overlook the diverse means of achieving lower emissions and thus not to pin too many hopes on existing options, implying a need for funding now to develop the breakthrough technologies that will provide much longer-term solutions. In addition, many of the more difficult options will proceed in stages. CCS, for example, can be expected to go from very costly piloting and developmental stages, through full-scale demonstration, to lower-cost roll-out.

Even timely emission cuts will not reduce atmospheric carbon quickly, and temperatures will rise over the next two decades, fuelling demands for public funding to underpin adaptation to effects such as rising sea levels. Rising energy prices will also have distributive effects, such as ‘fuel poverty’ among those least able to cope. EU funding for adaptation policies could therefore make sense, on much the same logic as for the Globalisation Adjustment Fund.

Further political sensitivities surround the overall annual spending that could be envisaged for carbon abatement. The EU budget today is around 1% of EU gross national income (GNI). If more is spent on countering climate change, either the overall budget would have to increase or other policies would have to be squeezed. Both strategies would face political resistance. Even so, there is a margin between the present level of the budget and the ‘own resources ceiling’ (set at 1.31% of EU GNI for commitments) which gives room for an additional €35 billion annually at 2009 prices. A further impetus could come from raising at least a proportion of the EU’s revenue from some form of carbon tax, offering the prospect of a ‘double dividend’ of more resources overall (or cuts in other taxes), in tandem with incentives to curb carbon consumption.

Devising appropriate spending packages will be hard, but different configurations of spending can deliver similar results, leaving ample scope for the kind of horse-trading at which the EU excels. Elements in any package will appeal to certain Member States more than others, whether because of political preferences or because there is the prospect (or the perception) of net economic gains. A credible portfolio has to balance the short-term and the long-term, the certain and the more speculative, internal measures and support for action elsewhere in the world, mitigation and adaptation. Another question is whether it would make sense to implement carbon abatement policies by creating new EU funds or initiatives, or whether it might be easier simply to assign new tasks within existing programmes such as cohesion policy.

A possible mix, costing around a third of the EU budget, could be:
— Support for technological advances.
— Investment in new infrastructure needed to distribute alternative energy or to facilitate greatly reduced emissions of carbon.

— Initiatives to promote lower carbon use, through education, exhortation and novel approaches to regulation.
— Spending outside the EU to support low-carbon strategies in countries constrained by limited fiscal capacity.
— Dealing with the consequences of climate change or carbon mitigation policies by funding projects or compensation programmes that offset the more extreme negative effects, paying attention to both potential social and regional divergences in the impact.

The political, economic and social benefits of placing sustainable development at the heart of a modernised EU budget are compelling. They would also give a new legitimacy to the EU by showing that it was acting in a domain that greatly concerns citizens. Why hesitate?

A job-rich 'post-growth' economy

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Moving towards a 'post-growth' economy that simultaneously addresses ecological sustainability issues while maintaining high levels of employment requires a radical shift in production structures in favour of care services and the production and maintenance of (fewer) high quality goods. This must go hand in hand with measures to reduce inequality and changes in our concept of growth in favour of a more qualitative approach.

It is a widely held belief among economists that growth is the main determinant of employment, and that the only way out of a crisis is therefore a resumption of robust growth. And yet matters are not quite so simple, since it is possible even in the short and medium term to 'enhance the job content of growth', for instance by means of a negotiated reduction in average working time. But in the long term, above all, it could be possible to create jobs without growth, especially if environmental imperatives are taken into account. This is a plausible and perhaps essential future scenario.

The classic approach to the link between growth and employment is straightforward. Labour productivity is the ratio of output per volume of labour, measured for example in hours. Productivity (taken below always to mean labour productivity) gains are made when a greater quantity of the same items is produced with the same amount of labour. Such an approach postulates that there will always be productivity gains overall, so that human progress is unthinkable without infinite growth, unless working time is reduced at the same rate as productivity gains. That, assuming productivity gains of 2% per annum, would mean a working week of six hours in 2100 and just one hour in 2200.

The problem is that producing larger quantities with the same amount of labour is all very well – if one forgets that it requires more materials, water and energy, that supplies of these are limited, and that certain natural resources are absolutely vital.

Contrary to this hypothesis, one might believe – for many reasons, including the depletion of fossil resources and the introduction of climate policies, but also the expansion of welfare services – that we will witness a collapse of productivity gains (on a macroeconomic scale) and hence of quantitative growth. That could be good for jobs and might equate not with economic decline but with a new idea of progress: progress in terms of quality and sustainability.

Sources of sustainable employment

The challenge is huge: producing goods, or services, in an environmentally sustainable manner (organic farming, renewable energy, 'green' buildings, industry and services with a low carbon footprint, etc.) or in ways that are preferable in social terms (e.g. better quality services for the elderly or in education) requires more labour than producing the 'same' goods by destroying natural resources and the climate, or by industrialising services. Yet quantitative growth calculations draw no distinction between these two types of output. Such calculations would almost entirely disregard a strategy of 'quality/sustainability growth' that would nevertheless represent real progress: the production of sustainable added value.

Major sources of employment and added value could in future lie in an economy whose guiding principle would be to 'take care of' people (welfare services not geared to productivity), goods (making them last longer, repairing and recycling them, or – in the case of dwellings – insulating them), nature, social cohesion, the quality and meaning of work, and democracy. Taking care of people and things requires time, both working and non-working time. That is time wasted from a ‘productivist’ perspective, but time gained for the purposes of a sustainable society, which gives an entirely different meaning to work and ‘production’.

Would the overall balance between the jobs created by these sustainability gains and those lost in ‘unsustainable’ activities, which would need to be gradually retargeted and adapted, be positive? That may well be so, since most of the presently unsustainable sectors are highly capital-intensive and automated, accounting for only a small minority of present-day jobs: just 13% of total employment in French manufacturing, for example, including energy.

In that case, then, we must turn our attention to sustainable demand, both environmental and social. Fordism harnessed various powerful mechanisms (such as advertising, loans, etc.) to arouse constant greed for the purchase of ever-increasing amounts of goods and services. This is what became known as the sharing of productivity gains, but it was also the sharing of an ever more toxic cake. What needs to be organised now, by means of different mechanisms, is the sharing of quality and sustainability gains.

If the market is left to its own devices, goods and services produced in a sustainable manner will on average be more expensive than before, precisely because they are more labour-intensive. In actual fact, one is not paying more ‘for the same thing’ but for something better, based on more labour and less degradation of the environment and society. Be that as it may, many people will initially regard these products as too expensive for them.

Drastically reducing inequality

For as long as these sustainable products are inaccessible to part of the population, the sustainability indicators will remain in the red and job creation will remain limited by the inadequate ‘sustainable purchasing power’ of modest-income households. If we are to save the planet while preserving well-being, we must 1) drastically reduce inequality, both at the upper end of the scale (all the more so as it is primarily the rich who are destroying the planet) and at the lower end, 2) promote material restraint as opposed to consumerist greed in several ways, 3) invest heavily in activities that are kinder to nature and society, requiring a broad range of technological and above all non-technological innovations, and 4) impose stringent standards and operate ‘positive discrimination’ in favour of sustainable products and ‘disincentives’ for others. Civil society must in all events champion this cause, in order to force the public authorities towards new post-Fordist, post-growth and anti-productivist regulation.

Will this huge amount of investment be costly? Yes, but much less costly in the long term than inaction or weakness in the face of the environmental crisis (five to ten times less, according to the Stern review on climate change). Hence it will be ‘profitable’ investment, which should be shared by governments, businesses and – to a much lesser extent – those households that can afford it (e.g. home improvements). After all, tens of billions of euros in available resources can be found in all developed countries by making taxation on higher incomes more progressive, by combating tax fraud and tax havens (Murphy/Meinzer in this volume), and by taking finance back under collective control.

Thus it would appear possible to achieve a revival of social progress with due regard for environmental balance and without any growth other than qualitative growth: education, health and other public services, care of children and the elderly, housing; but also minimum social standards, quality jobs in environmentally and socially useful occupations, and assistance for the adaptation of unsustainable activities.

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Towards a low carbon economy? European coordination of carbon taxation is crucial

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The EU's lofty ambitions on climate change are not achievable without much more stringent measures: the mistakes of the Lisbon Strategy should not be repeated. Key to a successful strategy, alongside an improved emissions-trading scheme, is a coordinated European attempt to tax carbon and prevent carbon leakage through a cross-border levy.

Can the European Union deliver on its carbon emission reduction objectives? The EU has for long been convinced of the necessity of fighting climate change by reducing greenhouse gas (GHG) emissions. Indeed, as early as 1991 the Commission proposed the creation of an EU-wide carbon tax, swiftly rejected by the UK government. In the spring of 2009 the Council adopted a fairly ambitious 'energy-climate package', the '20-20-20 by 2020', with precise objectives for emission reduction, and the ultimate goal of reaching a low-carbon economy by 2050. According to climate scientists this goal would be in line with the commitment, agreed in Copenhagen in December 2009, to limit global warming to less than 2°C., provided, of course, that other countries in the world, in particular China and the US, currently the largest carbon emitters and whose emissions are still growing fast, agree on consistent and binding reduction targets: climate is a global public good, and efforts made by the EU alone, however large they may be, would not suffice to solve the problem, given that EU emissions represent less than 15% of global emission flows; they may even be self-defeating if they induce larger emissions elsewhere. Besides the objective of fighting climate change, the '20-20-20' goals would also entail a significant side benefit, namely the reduction in EU energy dependency, in itself a worthwhile objective. But whereas the broad policy objectives command approval, there are clear signs that current policy settings are not up to the task, so that, in the absence of a major upgrading, emission reduction will not be forthcoming, at least not at the required pace.

EU leadership in decarbonisation: the performance to date

Following the adoption of the Kyoto Protocol in 1997, the EU has been the only region to embark on a program of carbon emission reduction, by mobilizing two sets of policy instruments: on the one hand emission standards and norms and, on the other, the definition and allocation of property rights (emission permits) and the creation of a market for carbon, the European emission trading scheme (ETS). In place since 2005, the ETS has indeed induced a reduction in GHG emissions, especially compared to what has been observed in the rest of the OECD countries. But because of limited coverage – about 11000 industrial plants, representing about 40% of total EU emissions – and of overly generous carbon allocations in the initial phases, translating into an excessively volatile, and on average relatively low carbon price, it clearly has only limited effects to date. Overall, the EU has been doing better than the rest of the world under Kyoto; but because the reference year chosen in the Protocol was 1990, a significant fraction has been achieved by new members from Central and Eastern Europe (CEE), where the collapse of former socialist economies that were equipped with loads of high-emission heavy industrial plants has made a major contribution. Abstracting from this initial collapse, the trend in carbon emission reduction has been, at best, weak, so that the targets adopted in the '20-20-20' package look very ambitious indeed.

Another Lisbon?

Converting the EU into a low-carbon economy is an important endeavour, and might well be regarded as the overriding objective in the 'post-Lisbon' era. But the EU should not repeat the mistakes of the Lisbon strategy: grand common general goals with no common policy instruments and only a weak and ill-conceived 'open method of coordination', essentially relying on peer pressure and intercountry competition. If new steps are not taken and major progress is not made in collective action on climate, further reductions will not be forthcoming. Already in the most recent years, the pace of emission reductions has slowed in most EU member states, and they have actually been on the rise, sometimes quite sharply, in the years preceding the current recession, in most CEE countries, where currently planned infrastructure building and the hoped-for catching-up of living standards could well entail major increases in coming years. Moreover, the signals sent by the 'energy-climate package' have been at best mild: the auctioning of emission permits has been postponed until after 2013 and highly restricted, due to lobbying of firms pleading the dangers of 'carbon leakage', i.e. the outsourcing of carbon-emitting activities to third countries and competition from producers not subject to a carbon price in the latter; and no commitment has been made to reduce allocations in order to increase the market price of carbon.

The need for a consistent set of EU carbon policies

Most of the efforts to come are expected to be undertaken by EU member states individually. Some of them – such as Scandinavian countries – have had a carbon tax for years, while others, like France, are currently introducing one. But without a common policy framework and some coordination, these national initiatives will remain limited in scope and at best achieve small reductions in the diffuse sectors not covered by the ETS and not subject to competition from abroad, either from within the European single market or from the rest of the world. In order to reach the '20-20-20 by 2020' objectives, steps have to be taken in three fields, at least.

First, the functioning of the ETS has to be fixed, by auctioning a larger share of permits, by reducing total supply in order to tighten the price signal, and by limiting price volatility, possibly with the introduction of price floors.

Second, the EU budget instruments, in particular the fund for R&D and structural funds, should be systematically mobilised to help finance carbon-conversion projects and low-carbon infrastructures.

And third, carbon taxation should be extended to all sectors not covered by the ETS in all EU countries on a reasonably comparable basis, in order to limit the dangers of intra-European tax competition and other 'beggar-thy-neighbour' policies that would be detrimental to internal cohesion and to the achievement of the overall, common goals. This implies, at a minimum, eliminating fossil fuel subsidies currently in place in many sectors in most EU countries. Ideally, it should be solved by adopting an EU-wide carbon tax, which could be a 'European carbon added tax' (ECAT) on all goods and services marketed in the single market, whether they are produced in the EU or imported from the rest of the world. Barring this first-best solution, which requires unanimity, a revision of the fossil fuel taxation directive could be used to achieve a high degree of harmonisation of national taxation schemes. But in that case 'carbon leakages' would have to be fought seriously, not by allocating free permits – a false solution that does not reduce the incentive for EU firms to outsource and increase carbon emissions in the rest of the world – but by creating a border carbon-levy on goods imported from third countries where carbon has no price.

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The 'Green New Deal': proposals for a sustainable economy

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Europe needs a Green New Deal. A broad range of policies will be required, going beyond a mere strategy of investing in low-emission technologies, and there is a need, in addition, to introduce regulatory instruments and a comprehensive programme to manage the changes that have to be made to our labour markets and employment systems. Finally, issues of financing change need to be resolved, for example via the European Investment Bank.

Let it clear that the 'Green New Deal' for Europe is first and foremost a political watchword aimed at rallying and enthusing social and economic groups. It is an open-ended notion, a work in progress, which is defined in a variety of ways even by environmentalists themselves.

The term 'Green New Deal' was chosen with reference to the experience of the United States in the 1930s and the responses of the Roosevelt administration. Yet today's geopolitical and economic situation is radically different: we no longer have a first, second and 'third world' but one single world characterised by a balance of power that differs from, and is more equitable than, during the 'age of empire'. For consistency's sake the Green New Deal must also have a global dimension, which of course does not render decision-making any easier - as we saw in Copenhagen.

It is widely believed nowadays that we are living in an economy where resources are scarce and non-renewable, and that our current patterns of economic activity and human activity in general are damaging the environment in such a way as to create an accumulation of 'hidden debt', which surely cannot be externalised *ad infinitum*. This analysis becomes all the more apposite if we bear in mind the likely growth in the world's population and the (entirely legitimate) increase in per capita consumption. There is no alternative: methods of production and consumption must be altered, especially in the advanced capitalist countries.

That said, the economic and financial crisis in the western world puts the debate and the responses in a new context. On the one hand it delegitimises the way in which markets are currently organised, thereby affording a more favourable climate for the introduction of public policies geared to guiding consumer spending and investment so as to accelerate the tailoring of industry to the needs of a sustainable economy; on the other, the crisis has reactivated discussion about the need for growth to boost employment. The main challenge is clearly to avoid repeating the errors that led to the predicament in which we find ourselves today and to seize on the crisis culturally and politically as an opportunity to accelerate change.

The Green New Deal project, narrowly defined, is a proposed means of increasing and redirecting public and private investment with a view to creating an economy that it is more efficient in its use of resources and non-polluting. Applied to the EU countries, this means giving ourselves the wherewithal to meet the targets set out in particular in the 'climate/energy package' (energy, transport, buildings, etc.) and the related European legislation, but also those set out in national programmes (e.g. Germany's renewable energy policy and the Grenelle Environment Forum in France). Several studies have indicated that such investment is a net creator of jobs, often skilled jobs. The benefits of this kind of proactive policy for Europe's economy also include reduced EU dependence on imports of fossil energy (the cost of which will go up again all too soon) and the development of a technological edge enabling us to be competitive as a result of innovation and, consequently, giving European companies a significant presence on global markets.

I should like to highlight a few aspects of the Green New Deal which go beyond a 'mere' investment plan and for the most part still need to be fleshed out.

My first point concerns the content of growth. As we know, there is at present a positive correlation between mounting pressure on the environment and the growth in GDP per capita, which must be reversed. One might well expect that technological progress will not be sufficient, even though it will permit more efficient use of resources, especially if we aspire at the same time to reduce inequality in standards of living; hence the theories about the need for 'de-growth' and the inevitable changes in consumer patterns ('living better with less'). Rather than engaging in sterile conflict between champions of growth and advocates of de-growth, it is more useful to address the problem in terms of the content of growth: certain activities must diminish while others grow, depending on their environmental performance but also on a collective, democratic acknowledgement of real needs. Other indicators of performance and wealth are necessary to help us make these collective and individual choices: this, to my mind, is a key aspect of the Green New Deal approach. Regulatory instruments and taxation have a key role to play in enforcing a change of direction, which no doubt explains why a pitched battle is waged over every proposal for European legislation, as we saw in the cases of REACH and emissions standards for the motor vehicle industry.

My second point relates to training, employment and pay conditions. The Green New Deal presupposes investment in research, education and ongoing vocational training, or what is known as the knowledge society. It calls for safeguards for workers' career paths, above all when jobs are lost as a result of industrial restructuring. Furthermore, the proposed Green New Deal is based on the idea of becoming competitive through innovation and facilitates a reduction in non-wage costs, a point well made in the Wuppertal Institute study. A sharp rise in the cost of inputs other than labour would be another argument in favour of ending wage deflation policies. In this sense, the Green New Deal also proposes a new social and societal contract.

My third point is about public debt and the funding of the Green New Deal. The rescue of the banking system and the downturn in economic activity caused public debt to spiral, reflecting a socialisation of losses. In Belgium, for instance, ten years of cuts in the level of public debt have been reversed at a stroke. Without entering into the debate about budgetary policy, it is clear that there is a serious conflict to be resolved in the public finances. Under these circumstances it is crucial to directly mobilise private savings for sustainable economic projects. That is why we must insist for example on the expansion and redirection of lending by the European Investment Bank but likewise on the expansion of specialised banking activities; this also ties in with the goal of providing clearer information about how savings are used.

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