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Financial Change and European Employment Relations

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Introduction

This chapter explores the changing consequences of financialization in liberal market economies, the effects of its gradual penetration into cooperative market economies, and the possibilities for new forms of institutional hybridity. In doing so, it suggests, first, that the financial changes taking place in many countries have been widely misunderstood and, second, that the consequences of these changes for employment relations, although often adverse, are not necessarily so.

Aspects of Financial Change

What is sometimes referred to as the 'financialization' (for one analysis see Froud, Johal, and Williams 2002) of socioeconomic systems involves a number of phenomena. Three economic aspects of financial change are frequently referred to; it is important to distinguish between them. (There are also important cultural and linguistic aspects—such as the widespread perception that financial institutions and financial markets are central locations in society today.)

The Growth of Finance

First, there is simply the growth of finance and of the financial sector. There is more finance about in that economic agents today hold more financial claims on each other than in the past, relative to GDP as a measure of economic development. Expenditures, both for investment and consumption, are more likely to be supported by credit or other forms of finance than in the past. The balance sheets of households and businesses carry a higher level of both financial assets and liabilities relative to real assets such as buildings or equipment.

This expansion of finance involves an expansion of the financial sector, of the corporations and other institutions which collect monetary resources from the public and channel them either to the agents who will use them or onto the financial markets. This is now a larger sector by all measures—the percentage of the workforce it employs, the share of national income for which it accounts, and the size of the financial flows and financial assets and liabilities involved. This expansion goes along with the expansion of closely related activities such as real estate: some commentators speak of a spreading finance, insurance, real estate (FIRE).

Disintermediation and Securitization

The second aspect of change is in the nature of finance. Financial markets, for company shares, bonds and other debt instruments, foreign exchange (FX), and derivatives, such as options and futures based on these assets, play an increasingly important role in the financial system; at the same time classical bank finance—the advance of credit from a bank, based on the deposits it receives from the public, is becoming relatively less important in quantitative terms. This shift, sometimes referred to as *disintermediation*, is linked to a liberalization of finance which allows investors in securities and issuers of securities to operate in many countries. The move away from classical bank intermediation should not be regarded as implying a decline in the importance of banks as institutions. In fact, the big banks are the key players in the whole transformation. Although deposit-taking and bank credit today make up a smaller proportion of the banks' activities, they are involved in every aspect of the security market-based finance which has emerged in recent decades. The banks issue securities on their own behalf and on behalf of corporate customers; they make markets in many securities; provide many of the services linked to security trading, such as investment analysis, fund management, and the settlement of transactions.

This change in the nature of finance, however, also involves the rise of other financial corporations to rival the banks—these are the institutional investors: pension funds, insurance companies, and investment companies such as unit trusts in Britain or mutual investment companies in the United States. In classical bank intermediation the provider of funds, the depositor, has a claim on the bank, not on the borrower who actually uses the funds. He or she relies on the solidity of the bank to make the claim safe and liquid. In the security-trading financial system which has to some extent displaced classical bank intermediation, the provider of funds relies on the existence of a deep and wide market in securities to secure the same objectives.

In the 'secondary' markets, which account for the vast bulk of security trading, investors are able to liquidate their positions by selling to other investors. The 'primary' markets, where new securities are issued, are very much smaller—but it is usually price movements on secondary markets which set the terms on which corporations or governments can raise new money on the primary markets.

It has been known theoretically for a long time that portfolio diversification can reduce some of the risks of investment for a given expected rate of return. In practice, effective diversification is costly and only the richest investors could achieve it on an individual basis. The institutional investors (Davis and Steil 2001) offer the same advantage to the middle classes by aggregating thousands of small positions into an overall portfolio. But a savings plan with an institutional investor differs from a bank deposit in that it is the customer not the intermediary institution, who, in the first instance, bears the risk of the investment.

This process of *disintermediation* or *securitization* is not easy to explain. Why did one form of finance expand at the cost of the other? A full answer will not be attempted here, but it is interesting to see that this process might be *cumulative*: the ease with which securities can be traded, and hence the liquidity of an investment in securities, depends crucially on the scale of the security market. Thus, if security-based finance secures an advantage over bank intermediation, that advantage will tend to increase over time.

High Interest Rates

The third aspect of 'financialization' which will be discussed is financial tension—the pressure of financial constraints on economic agents. The same era—roughly the last quarter of the twentieth century—which saw the growth of finance and the changes in financial structure which have been referred to—was also marked by exceptionally high interest rates and thus by extraordinary pressure on debtors and on agents seeking finance. The most catastrophic result of these tensions has been the third world debt crisis, still unresolved some twenty years after it struck. But there have been other victims—for example, the EU member states failed to find a clear common response to rising interest rates in the world economy, and this put their socioeconomic systems under enormous pressure: both Keynesian economic intervention and high welfare standards became very difficult to finance. Likewise, the pressure for downsizing and closures in their manufacturing sectors were, although not caused, greatly exacerbated by the cost of credit.

Because the era of financial transformation coincided in this way with that of very high interest rates many commentators have closely associated, or even identified, the two developments (e.g. Duménil and Lévy 2004). This is one source of the misunderstandings that will now be explored.

Financial Demonology

A stylized account will be attempted here of the interpretation of the financialization process within critical political economy. Most of the difficulties are caused not by errors, but by emphasising rather contingent or medium-term aspects of processes which have a wider significance. Financial sectors today are seen as overblown and parasitical; their growth is explained by political decisions taken in error or under the pressure of interested parties; the increasing role of security markets is seen as sacrificing enterprise to speculation and strategic concepts of investment to the short-term; where security trading is not put down to speculation it is attributed to the equally dysfunctional behavior of security dealers themselves, swelling transactions to gain commission.

Such positions obviously affect the positions adopted in wider debates on globalization, since the understanding one forms of the global economy is conditioned by the way one views financial change.

None of these positions is false—in fact all of them can be easily documented and illustrated by gruesome episodes of malpractice and inefficiency. The parasitism, the speculation, the abuse of political power—all are facts. Nevertheless, if one interprets the entire range of financial phenomena in these terms, significant developments in the nature and functioning of capitalist economies may be underestimated.

From Tight to Easy Money

Not all these issues will be addressed here, but as a start, it can be pointed out that the era of high interest rates seems to have come to an end, and thus that the changes in financial structures cannot be seen as essentially dependent on exceptional tributes extracted from borrowers. The eighties and to a lesser extent the nineties were characterized by exceptionally intense financial pressures, which in themselves tended to swell the profits of the banks. These developments suggested that financial transformations could be seen as a 'revolt of the lenders'. Indeed, the reactions of wealthholders to the inflation of the seventies was a key moment of the transformation, but, it is becoming clear, not an essential feature of it.

It is more difficult than is sometimes assumed to identify the interests which are advanced by the financialization process. We could distinguish debtors (and other issuers) from creditors (and other investors) and both from intermediaries. The general tendency to identify financial change with financial tensions would make the creditors the big winners; but this view is not easily reconciled with the position of the United States as the world's major debtor. A focus on the most powerful institutions and intermediaries is perhaps more realistic, but globalization has meant that even the largest of these are subject to new competitive pressures—and it is easy to find casualties among them, such as Deutsche Bank, Crédit Lyonnais, or the Midland Bank, all of which came to grief in their international strategies. It is clear, again, that stock markets are subject to much more competitive pressure in the new financial regime.

In retrospect, there may have been two forces behind the era of very high interest rates. First, a flight of investors toward liquid assets, prompted by the decline in profitability in Western economies to the late seventies and the uncertainties which this induced. Second, and partly in consequence, the turn of macroeconomic policy toward monetary disinflation, which drove up nominal interest rates while bringing down inflation rates, and thus led to a sharp rise in real rates of interest.

This era may now be at an end,[4] so that the surplus of capital which has been latent in the world economy for several decades has now broken into the open. This clearly has implications for employment relations in that the massive rates of return which investors have sought in recent decades are becoming quite clearly impossible. (In fact, it is not only the fall in interest rates which is bringing down rates of return; it seems that the risk premium between bond and equity yields may also be coming under pressure.[5] This would be a consequence of the risk-reducing portfolio diversification made possible by globalization and brought about by the institutional investors.)

A Casino Economy?

A second widely held view of finance today is that it is dominated by 'speculation'. Of course, if speculation is defined in a very wide and loose sense this becomes true almost by definition; capitalism as such involves buying in order to sell but one does not usually interpret all capitalist enterprise as speculative. If one adopts a tighter definition of speculation as the adoption of an open position (long or short) in some asset in the expectation of a favorable movement (up or down) in that asset's price, then it is by no means clear that current financial activities are dominated by speculation. Speculation is always present in financial markets and may even be necessary to their effective functioning but it has not been shown to be the dominant feature of their recent expansion.[6]

Consider first the special case of FX, where the Tobinistas of the social movements deduce from the sheer scale of transactions that only speculation can be taking place. This is a simple error, although one which is at least partly to be explained by the absence of any coherent account of FX markets in the orthodox literature. A glance at the currencies which are traded should be enough to call the speculation hypothesis into question. A handful of currencies—the most stable—account for virtually all the trading in FX

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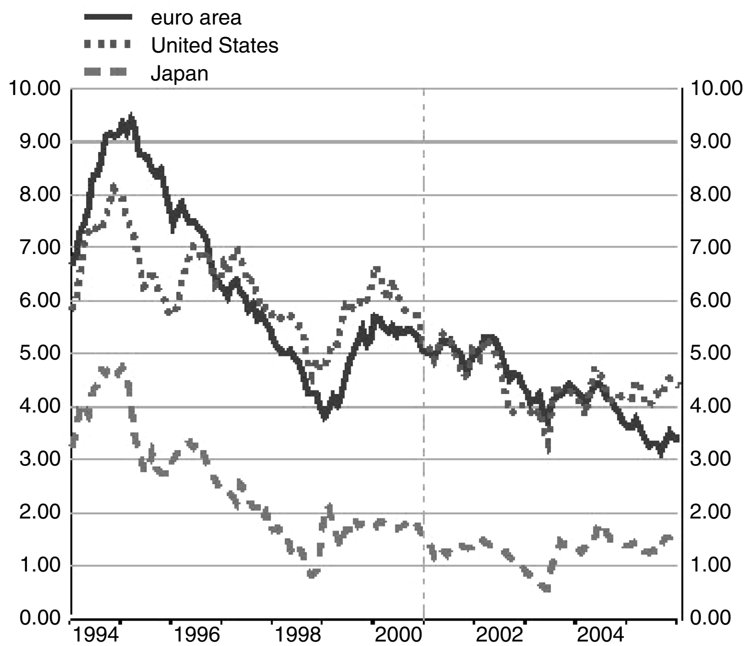

Figure 6.1. Yield on ten-year government bonds.
Source: ECB 2006.

markets, with the exchanges among the three largest, dollar, yen, and euro, making up 48 percent of the total. The currencies of the developing world have, of course, been subjected to massively destabilizing speculation on many occasions. But it is a confusion of two completely different phenomena to believe that the $1.8 trillion FX trades taking place every day have anything to do with third world currencies.[7]

As well as the currencies traded, the character of the traders points in the same direction. A handful of giant banks do most of the dealing among themselves—and they are known not to take open positions in FX. But the most striking evidence comes from the *instruments* used. Transactions are dominated by the FX swap, which, because it combines a spot trade with a forward trade in the opposite direction, is a closed position as far as currency fluctuations are concerned. Today, these swaps account for half the transactions in the FX market.

In fact, most of these transactions are standard banking and money market operations, recycling liquidity from surplus to deficit agents in the normal way. The swap dealers do not even sit on the FX trading floors—because they

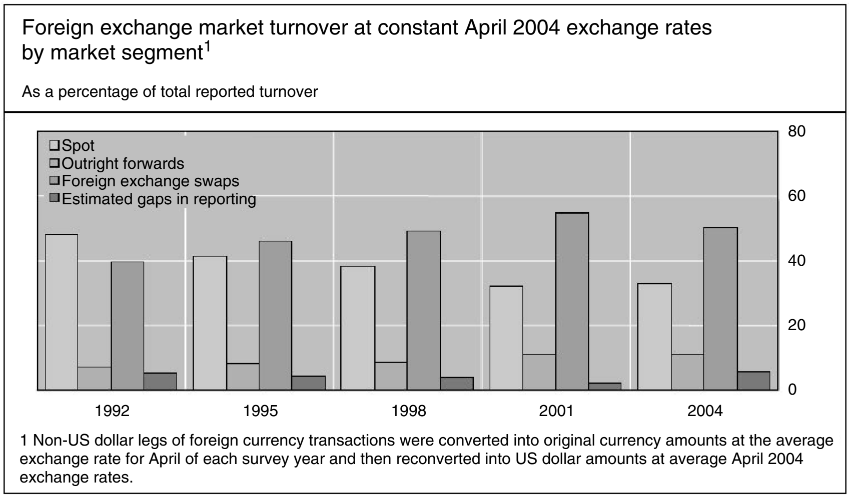

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Figure 6.2.
Source: BIS 2005.

are not taking open positions the price of currency is of no consequence to them. They sit where they belong—on the money market desk.

The size of the FX market testifies not to speculation but to integration—the very close money market integration of the major economies despite the persistence of separate currencies (for this argument in full, see Grahl and Lysandrou 2003).

Speculation in Securities

The same dubious notion of speculation as dominant prevails in many discussions of the securities markets. Clearly, such a view makes the broad move away from bank-intermediated toward security market-based finance an essentially negative phenomenon. It will be suggested here first, that this notion has little factual basis, second, that it obscures certain systematic features of financial development which are of considerable importance.

As with the FX markets, a simple examination of the structure of security market trading militates against an interpretation in terms of speculation. Markets—trading is concentrated on the oldest and most liquid markets with almost negligible fractions of turnover being found on the newer securities markets of emerging economies. Instruments—trading in bonds, especially those issued by the governments of rich and stable economies, dwarfs trading in equities. Within equity trading, it is the shares of blue-chip companies, least susceptible to price volatility, which are most traded.[8]

Likewise, with agents. The institutional investors which today predominate over individuals prefer the largest and most liquid security issues.[9] For example, the NASDAQ, massively affected by the dot.com bubble, is dominated by individual traders; the NYSE, much more stable, and much more quick to recover from the collapse of 2000–1, is dominated by institutional investors.

Of course, many bubbles and speculative episodes have been observed on security markets. But these exceptions are not the rule and it is certainly the case that more traditional financial systems, centered on bank credit have been far more exposed to speculation and upheaval than have the emerging, more market-based, systems. If a perspective based on speculation exaggerates some phenomena, it may obscure others. One substantial strength of the security-based financial structure is its capacity for expansion—because these markets are open to investors and issuers from different countries they are well placed to establish financial linkages across national boundaries, whereas classical bank-based systems, relying to a much greater extent on 'inside' investors, may have more difficulty in functioning outside the social environment in which they developed (Grahl 2001). In other words, there are good reasons why global finance should tend to take the form of security trading rather than bank credit.

Critics of the global system often trace crises and instability to liberalization as such. But it is equally plausible to trace them to premature or rushed liberalization and to the confrontation between primitive domestic and highly developed external systems.[10] Once again, as with the notion that financialization is linked to financial tensions, specific or temporary phenomena are being seen as essential to the emerging global system.

Hypertrophy of Finance?

The notion that there is, in some sense, 'too much' finance has a simple basis in everyday experience, in the observation that financial enterprises, financial products and advertising, employment in the financial sector and so on have grown explosively in recent decades. From there, however, it is a large leap to the conclusion that the increased prominence of finance is, in some way, dysfunctional. If more specific charges are laid, then differentiated judgments are required. On the one hand, the landscape of retail finance, in countries such as Britain or the United States, where market-based finance predominates, suggests very strongly that there are very often too many products and too many enterprises. Although the needs of the population for savings products, credit facilities, and payments services are relatively homogeneous; on the supply side there is massive differentiation. This is particularly the case in Britain where a series of authoritative reports, prepared by insiders, have issued comprehensive condemnation of retail finance for its high charges, opaque products, excessive marketing costs, and general failure to provide value for money.[11] Much of the sector is rather clearly characterized by Chamberlinian competition, centered on marketing rather than price and with the usual consequences—failure to obtain scale economies, excessive advertising and marketing expenditures, spurious product differentiation and so on. In the United States, very similar phenomena are seen but with rather more progress toward the control of these malfunctions by a standardization of products and procedures.

The other frequent claim that the sector is overdeveloped relates to trading on security markets. Here, as indicated above, it is much more difficult to reach a clear conclusion because the forces behind trading are not well understood. There are, however, good reasons to believe that the bulk of routine trading relates to portfolio management by the institutional investors, that it is not speculative in nature but rather heavily concentrated on the most stable and cognizable securities, and that it is not encouraged by 'excess liquidity' in and around the markets because, for the purposes of the big institutions, these markets are far from liquid.

More generally, the notion of hypertrophy has to be measured against the evidence that the expansion of financial activities is a reliable indicator of economic development in general, although the evidence concerning forms of finance and the structure of the financial sector is much more questionable.

Politics and Financial Liberalization

A very correct position, in the general debates on globalization, is that any simple opposition between the role of markets and states is likely to distort understanding of the processes involved. Many studies have analyzed the active policy measures leading to capital market liberalization as well as the reform strategies which inspired them (Helleiner 1994; Loriaux et al. 1997). Equally, the emergence of large integrated financial systems at an international level is dependent on a process of regime construction which has been going on for several decades and which has necessitated very high levels of intergovernmental cooperation and the construction of supranational authorities. The convergence of both institutions and practices in the field of financial supervision is an impressive example of this activism (Lütz 2002).

From this perspective, it is easy to interpret financialization as the latest wave of a neoliberal political strategy, designed to reshape the framework in which markets operate. The danger in such an assessment is that the economic forces behind these processes will be underestimated. Yet, many of the key developments were economic in their origin—for example, the first emergence of offshore finance, centered in London, arose out of the activities of US multinationals; it was accepted by governments but in no way their design. Similarly, the rise of the institutional investors, which worked to restore the central role of security markets in the financial system was an essentially economic phenomenon.[12] More broadly, the rise of global finance is logically linked to the growth of international trade, international investment and migration, and international technology transfer. Once scale issues are dealt with realistically, by applying the criteria of a security-based financial system rather than those of a bank-based one, the dimensions of the global financial system correspond well to those of the global economy. Of course, in both instances, relations among wealthy economies are much more developed than those with the South, but this is a general characteristic of contemporary economic life, not a consequence of financial relations in particular.

The Crash

One obvious objection to the argument made above is that the dysfunctionality of security-based financial systems is clearly demonstrated by the recent bubble and then collapse in share prices. Often, however, these dramatic episodes draw too much attention away from the more regular working of financial markets in less interesting times.

What lessons are to be drawn from the recent stock market crash and associated scandals?[13] No doubt, a great deal of *Schadenfreude* is well justified but it is not clear that the move toward a security-based financial system will be or should be reversed. Reactions by the authorities, on both sides of the Atlantic, seem inadequate to the problems revealed, both in corporate behavior and in the financial system. There have been strident calls for more 'transparency' but these are not obviously pertinent. The very status of the modern corporation can surely be called into question by malfunctions on the scale revealed. Similarly, the very ability of market agents to make rational assessments of investment proposals can be doubted after the excesses of the Internet boom.

As regards the first of these, the 'Corporate Social Responsibility' so much in fashion today seems to be essentially a cosmetic device designed to stave off the necessary recasting and tightening of regulatory structures to protect customers, employees, small businesses, local communities, the environment and, by no means least, investors from these overmighty subjects.

As regards the formation of expectations within the financial system, what is confirmed is the existence of a public good—the stabilization and crystallization of individual perspectives which public investment permits. Yet, there are at least two reasons to doubt that the transition from an 'inside-investor' and bank-based financial system to one centered on security-markets will be affected by the crash and its aftermath. First, although the gyrations of the stock market (encouraged by the Federal Reserve Bank) gave rise to the bubble, when it burst the economic damage was limited just by the highly developed system of security markets which moved risks away from the banking system. In less advanced financial systems it is the concentration of risks in the banking system which turns asset market collapses into major economic crises. Second, there is the simple fact that the whole EU economy was dragged into the bubble, and the supposedly more stable and conservative nature of the European business classes offered no immunity. In fact, huge outflows from the EU were attracted by the US bubble which they also helped to sustain. Much of this investment (quite legitimately characterized as speculation) took the form of FDI as EU corporations went on a spending spree in the United States. But the basic aim was the same as for stock market placements—that is to get exposure to United States and high-tech assets. (This outflow was the main reason for euro weakness in the early years of the new currency.)

It is also useful to distinguish the NASDAQ boom and bust, from the much milder developments on the NYSE. The former is much more influenced by individual investors, the latter by the big institutions. This is by no means

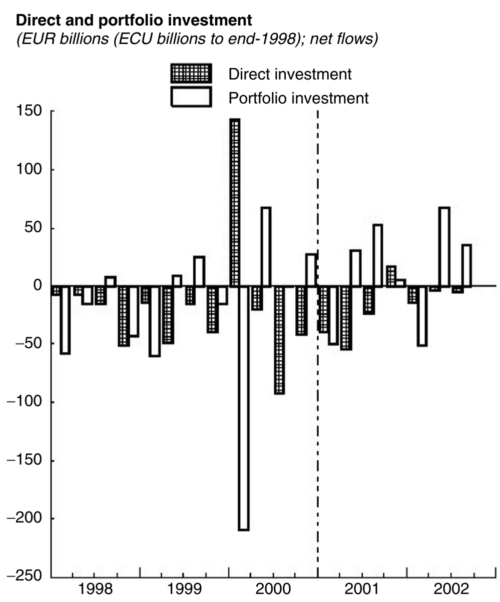

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Figure 6.3. Eurozone financial outflows.
Source: ECB 2006.

to exonerate the latter but merely to point out that the bubble in high-tech stocks was in the first instance the consequence of speculation by individual investors.

Consideration of the bubble, however, leads us to a key question. To what extent do the 'Anglo-Saxon' economies, that of the United States in particular, correspond to the necessary features of the security-based financial system? To what extent, in other words, does the financial transformation now taking place in European countries necessarily involve an Americanization of economic life? Clearly, this is a question of some significance from the point of view of employment relations.[14]

The question has tended to receive the same answer from political elites in Europe, whose frenzied imitation of all things American is well represented by the Lisbon agenda as from critical commentators who have often made the same identification of financial change with (undesirable) features of the US system.

The Shareholder Drive

An important issue where market-based finance has tended to be identified with the US practice concerns the role of shareholders. In the United States in the eighties, a drive for shareholder value was launched as means of resolving the conflicts of interest resulting from the separation of ownership and control in the corporate sector.[15] The new salience of the problem was to some extent contingent, in that very tight money and the pursuit of quantitative targets for monetary aggregates favored a further disintermediation of finance; however, the rise of the institutional investors, representing middle class wealth-holders, was working in the same direction. As the problem was formulated at that time, investor interests were mainly impaired by corporations undertaking excessive expansion, at rates of return less than the shareholders could expect to obtain elsewhere.[16]

The shareholder response involved several elements. One was a very positive assessment of the 'market for corporate control' and takeovers, especially hostile ones, which were seen as an important means of disciplining managements. A second feature was the use of new metrics to assess corporate performance. These attached a heavy weight to cash flows as a means of reducing managerial discretion in the presentation of results to shareholders. A third important element was the use of incentive systems intended to align managerial and investor interests—the massive use of stock options for this purpose began at this time. Various other devices attempted to strengthen the hand of dispersed shareholders against that of incumbent managements, including restructurings and disposals intended to refocus the enterprise on core activities and render it more transparent to investors. It was also often seen as useful to increase a company's indebtedness since this would both leverage shareholder interests and limit managerial discretion.

Now this entire agenda has to be seen as a comprehensive failure in that, although it certainly encouraged brutal corporate restructuring exercises, it failed to prevent managerial predation on a colossal scale so that in the course of a decade, 1992–2002, US CEOs raised their personal stake in corporate America from 2 to 12 percent (Brenner 2003). Michael Jensen, perhaps the most influential advocate of the shareholder agenda, recognized the need for major changes in his position. One key consideration was that the 'discipline' imposed by the stock market fails completely if a company is overvalued—indeed, when this happens, managements are able to find cheap finance for any project at all, no matter how contrary it might be to investor interests. Jensen has also changed his views on managerial incentives; whereas he used to argue that higher rewards were needed he cannot repeat that position today (see Jensen and Murphy 2004).

How then can the continuing tensions between principals (shareholders) and agents (managements) be addressed? The future performance of the US economy may depend on effective social and economic reforms to stabilize savings and restore general confidence in financial mechanisms. The issue will not be pursued here—rather the question of European financial development will be raised.

European Finance

The centrality of the United States to the global financial system arises in the first instance from effects of *scale*. The existence of a continentwide economy with very high incomes led to the initial advantages of market-based finance, because in such a context the ability to raise capital from dispersed investors and allocate it to any part of the economy is of particular value. Subsequently, the process became cumulative as the size and liquidity of dollar markets attracted investors and issuers from around the world.

This genesis of the global financial system clearly gave the United States enormous influence over the standards which governed financial practice. For example, regulatory structures have often followed American patterns, although there is certainly nothing optimal about them. Similarly, US interests have been promoted in international systems, such as the Basle accords on banking stability (see again Lütz 2002).

However, it is important to distinguish those characteristics of the US financial system which are indispensable to its functioning and its contingent features. Among the former are scale, liquidity, and a supportive macroeconomic policy; the latter, on the other hand, include many of the practices, in both finance and corporate governance, which have been called into question by the bursting of the high-tech bubble and the subsequent scandals.

Now, for very different reasons, both political leaderships and some of their strongest critics have neglected this vital distinction between intrinsic features of the global financial system and contingent practices and structures in the so-called 'Anglo-Saxon' economies. There has often been an empiricist tendency to conflate the two.

The European elites who formulated the Lisbon agenda seem to have been dazzled by the stock market boom which was then in full swing.[17] Their assessment of the productivity performance of the United States, which raises very thorny statistical issues, was close to a moral panic. The response was an attempt to ape the most superficial aspects of the dot.com bubble. In the realm of finance, the main components of Lisbon were the Financial Services Action Plan and the Venture Capital Action Plan (for an assessment, Frangakis 2005). The main objective of these initiatives—to build big, liquid capital markets in Europe on the basis of the euro—was very rational. The expectation, however, that such measures could transform the EU economies within a matter of years was utopian, while the endorsement of every aspect of the US financial model displayed much the same kind of 'irrational exuberance' that gripped stock market investors at that time.[18] As the weaknesses of US finance were dramatically revealed in the following years, the European Commission echoed the American authorities in demanding more transparency but rejected any deeper criticism of US practice.

Some influential critics of official Europe, on the other hand, also seemed to identify market-based finance as such with its US form. The notion of 'varieties of capitalism' emphasizes the mutually supporting nature of institutions and structures within a given model. These institutional complementarities together with path dependence are supposed to immunize given socioeconomic systems against piecemeal change or the introduction of foreign elements incompatible with their overall logic. Such a view may in practice coincide with that of the elites who drew up the Lisbon strategy: financial transformation amounts to the wholesale adoption of the US system in all its concrete details. As a corollary of the same view, preservation of the main characteristics of the 'coordinated market economy' might be seen to depend on the maintenance of its established, bank-based, inside-investor-dominated, financial mechanisms.

As against these excessively holistic approaches, more and more discussion seems to invoke the notion of *hybridity* in economic relations. Of course, the term itself only poses a question—what combinations of 'Anglo-Saxon' and European practice are viable or desirable? To indicate the scope of the question, reference will be made to two questions: corporate governance as it affects takeovers and executive rewards; and the changing strategies of German corporations.

Corporate Governance Issues

The Takeover Directive

Hostile takeovers, 'the market in corporate control' have often been presented as an essential feature of the market-based financial system. The capital markets will tend to mark down both the equity and the debt issued by an unsuccessful company but it was often suggested that the sanction of a higher cost of capital was not in itself sufficient to discipline underperforming or delinquent managements. Takeovers, encouraged by a low-share price, and resulting in the wholesale replacement of corporate leaderships, can be seen as a much more effective mechanism.

The European Commission clearly accepted this somewhat romantic view of shareholder capitalism. It took the view, first, that a uniform takeover code was necessary for the integration of EU security markets—if the conditions under which a company could be taken over were not the same in all member states, then the securities issued by these companies would not be fully comparable. Second, the Commission argued that the uniform code must be completely liberal—no barriers to hostile takeovers, determined by the acquisition of a controlling fraction of the target company's equity, were to be permitted. The Commission asserted that the decision to sell securities concerned only their owners—both an illogical and a cynical judgment in the context of a change in the control of an enterprise which obviously concerns many people. The draft directive on takeovers, however, was rejected by the European Parliament (EP) in a dramatic tied vote. The document subsequently accepted by the EP was a clear dilution of the original proposal and permitted, according to the country, a variety of defences to be used by incumbent managements. The appointed Commission did not hesitate to express its dissatisfaction with the elected Parliament: the compromise Directive was contrary to market principles and therefore unacceptable.

However, the hostile takeover may no longer be a key feature of the security-based financial system. On the one hand, the days when the key shareholder interest was to squeeze cash out of bloated corporations may have gone; the condition for the greenmail attacks of Carl Icahn or T. Boone Pickens was a level of interest rates so high that investors had no problem in placing their funds. Today, the hunger is not for cash but for assets, even if the yield is low. In the United States itself the excesses of the 1980s led to legislation in many states to obstruct hostile takeovers.

On the other hand, relations between corporations and the capital markets have evolved and are becoming more normalized: the liquidity of their equity (the more liquid the lower the required yield) is now a key consideration for the major corporations who are therefore constrained to pay continuous attention to the price of their shares. Under these new circumstances noncontested takeovers, often influenced by shareholder power, are increasingly frequent and can act to displace failing corporate leaderships. In Germany, for example, the takeover of Mannesmann by Vodaphone in 2000 did not introduce a wave of hostile takeovers in the way some commentators anticipated, but the continuously high level of agreed mergers suggest that a functional equivalent has been found, less at variance with German industrial traditions.[19]

The social costs of the associated restructuring were a key factor in the EP's refusal to endorse the Commission's proposals on takeovers.[20] In France the existence of strong regulations governing mass dismissals has not prevented vigorous growth in the equity market. No doubt, the present legal situation on mergers and takeovers is not ideal: rules are different from country to country and, although incumbent managements are permitted to build obstacles to hostile takeovers, there is no clear indication when or in whose interests they should exercise this power. But a codification of the existing rules, with a strengthening of the safeguards for employees in cases of restructuring, would be quite compatible with the growth of European security markets and there is no convincing rationale for the extreme position adopted by the Commission.

Managerial Rewards

Similar considerations seem to apply to the incentive structures for senior managers which have developed in the United States. The usual justification for managerial excess has been that it is necessary to align the interests of top management with those of the shareholders, although the predation of CEOs has been on a such a scale that this rationale has lost any plausibility it may once have had. Quite apart from this direct cost to investors there are the broader socioeconomic problems which an explosion of high incomes generates throughout the income distribution. The case of Britain, where there are few signs of the dynamism and international competitive success which these rewards are supposed to induce, is particularly egregious.[21]

But once again there is no good reason to take this malfunction as an essential component of a market-based financial system. The same contingency governed the development of the key practices—that is, interest rates so high that the extraction of cash reserves from corporations raised no difficulties in terms of alternative placements. Huge payouts to the top managements concerned might make some sense in that context but through the nineties and into the new century seem increasingly anachronistic.

The lack of countervailing power to the big corporations has meant that the momentum of executive pay inflation is still unchecked but there are some signs that institutional investors, in a changing political climate, are increasingly hostile to this predation.

The forms of control exercised by institutional investors will never replicate those available to 'inside' investors in the socially embedded financial systems of Germany or Japan in the past but increasingly they do not need to do so. Both parties are increasingly focused on the securities markets. The investors, especially the institutions which now dominate among them, want strong enterprise performance primarily to underpin the quality and the tradability of the securities they hold. Managements want good investor relations to support their share price and to maximize the liquidity premium above the price justified by profits alone. This does not mean that top managements are now in harmonious relations with investors but it does indicate that, as the securities markets become more important to both parties, their conflicts are more constrained by market forces. Of course big gyrations in security prices and unstable expectations among investors will negate this proposition, but one should not take exceptional episodes as typical of the functioning of the markets.

What is being suggested is not that market forces will rein in the explosion of corporate incomes, merely that it is not clear that market forces would prevent social and political forces from doing so. Thus, in this case, as with the codes governing takeovers, the EU may have much more scope than it realizes to challenge the norms and practices of the 'Anglo-Saxon' financial system (for an extended argument around this point see Aglietta and Rébérioux 2005).

Corporate Strategies in Germany

The impact of financial change on the strategies of European business is a vast question, and debates are in an early stage. By far the most developed discussion concerns the impact on large German corporations and this is the only case which will be considered here. However, it is obviously a case of central importance, given the strength of these enterprises and their weight in the eurozone economy.

Until the last ten years, Germany was a paradigmatic example of 'inside-investor' and bank-based finance. German companies were closely held and not for sale. There were many cross-holdings among financial and industrial companies; these were stable and worked to cement collaboration among the enterprises concerned. The equity market was much smaller than its counterparts in the United States or Britain. Big enterprises were seen, in 'stakeholder' terms, as coalitions of interest in which codetermination laws supported a strong voice for labor.

How extensive are the changes induced in Germany's 'coordinated' market economy by the emergence of an international financial system centered on the security markets? One tends to get conflicting answers, depending on whether what is examined is corporate strategy or employment relations. In the first case, the story is one of almost revolutionary reorientation; in the second, more of continuity and stability.

The adoption of shareholder economics by big firms in Germany has been rapid and comprehensive (Streeck and Höpner 2003). A closed system of corporate finance has been opened up to FDI and many companies have actively sought external investors. Legal changes have been introduced to permit the dissolution of cross-holdings among industrial and financial companies. The banks, although they still hold a lot of industrial equity, now tend to see these holdings as portfolios rather than as the support for specific relationships. Profitability metrics, oriented to the equity market, are increasingly deployed within the big firms, both to assess investment projects and to set targets for divisions. A host of other changes, for example, in accounting practices, have been stimulated by the same general shift.[22]

Within the financial sector itself the major banks are pursuing active globalization strategies, and an increasing share of their activities is connected to securities trading. As pointed out above, although the hostile takeover has not been institutionalized in Germany, merger and acquisition activity has grown very rapidly in close correspondence to stock market activity. Longstanding relations between big companies and their suppliers are, if not being dissolved, being placed under considerable pressure. From this point of view the stakeholder enterprises of the past seem to be dead.

A consideration of employment relations, on the other hand, calls this judgment into question. There are certainly unprecedented pressures on the German employment system. Not only have legislative changes reduced the level of social protection, but employers are also seeking to reverse some of the gains, especially on working time, made by the unions in the 1980s and 1990s. The Western employment relations system was never fully established in the Easter *Länder* and smaller companies especially in the East are pulling out of industrywide collective agreements. However, within the large enterprises, employee voice systems and structures of representation are stable (see, e.g. Vitols 2003). They may even be gaining a new importance because the shareholder economy emphasizes the enterprise as against the industry as a locus of decision-making. It certainly does not seem to be the case that *Mitbestimmung* and the high level of employee participation which it promotes are perceived as disqualifying the companies concerned in the securities markets. Indeed, the functional flexibility which depends on these systems is today, as in the past, a source of competitive strength.

Of course, large German enterprises are not the same thing as the German economy. Indeed, the dissociation between the two is certainly widening as the big companies pursue global strategies which many small and medium enterprises cannot imitate. A clear national economic interest then becomes harder to define, for instance because companies with an export orientation have a very different view of developments than companies dependent on the stagnant home market. It may also be the case that it is the smaller enterprises which are adversely affected by the financial changes under way, as they find it harder or more costly to obtain bank credit. It is probably within the *Mittelstand* that one finds the greatest pressures on employment relations. The larger enterprises on the other hand continue to derive enormous competitive advantages from the excellence of their industrial systems although this no longer has the same meaning for the national economy.

The suggestion here is that it may be an error to regard market-based finance as simply working to dissolve all established and socially embedded economic relations. The capital market's demand for transparency implies that the outcome of negotiations within the enterprise should be disclosed to outside investors and the profitability calculations which are intrinsic to the security-based financial system certainly apply a general test to established relations. However, the continuity and density of localized economic relations, including especially employment relations, are a real factor in the productivity and profitability of enterprises and cannot therefore simply be cast aside by the new financial system.

Conclusion

The general interpretation of 'financialization' in general and 'shareholder value' in particular is probably that they represent the latest wave of a neoliberal strategy which has now dominated European economic policies for more than two decades. This interpretation emphasizes above all the political determinants of economic change. Neoliberalism promotes, in a very selective way, the intensification of market forces in order to achieve specific objectives, such as reversing many of the socioeconomic gains of organized labor. Although an understanding of economic processes is obviously necessary to this view, the key issues are political—how such a strategy is arrived at, how it wins acceptance, how it is implemented.

This interpretation is not wrong. In the present context, for example, the Lisbon agenda of the European Union demonstrates that the rapid transformation of the EU's financial system was a clear choice of Europe's political elite. Their objectives were various but certainly not incompatible with those of neoliberalism and the adulation of the US economy they exhibited was hardly consistent with their professed attachment to the European Social Model.

However, this interpretation, although not wrong, may be incomplete and this is what the present chapter has tried to suggest. Particularly at the international level, we observe a massive growth in the scale and intensity of economic interactions which seems to go well beyond the scope of any of the political strategies referred to (Grahl 2005). Indeed, although the opening up of markets to external forces is very frequently part of neoliberal strategies, not all aspects of the global economy are welcome to neoliberals since overwhelming pressures are released in a way which tends to undermine the stable and conservative social order which most of them wish to combine with the market economy.

Many developments in the global economy are the result of basically economic forces and this is true of global finance as well. Indeed, when unrealistic notions about the appropriate scale of the financial sector are discarded, then global finance—in today's world inevitably *market* finance, can be seen to be intrinsic to emerging structures of international trade, international production, and international resource flows.

But, just because there are powerful economic forces working to transform financial systems, it is important to distinguish which features of the transformation are necessary and which are more or less contingent. This involves an assessment of finance in the United States where most of the ongoing changes began. The United States holds this pioneering position because the scale of its continental economy worked to promote deep and liquid financial markets. But this does not mean that financial markets in Europe have to replicate every feature of the US system. On the contrary, if the emerging European system builds in effective measures for the social control of corporate behavior and for the stabilization of investor expectations, then it may be able in some ways to outperform its US rival.

This argument applies to European employment relations. It cannot be denied that financial integration and the dissolution of existing financial structures are often a threat to employee interests. But it is suggested that this threat is not inscribed in financial market relations as such. More ambitious European strategies are possible which would combine the construction of an integrated financial system with effective measures for its social control.

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