MARKETS AND THE FINANCIAL CRISIS

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i. Global Greed Paves the Way for a Better Globalisation?

by Poul Nyrup Rasmussen[1]

For years progressives have been making the case that the actual neoliberal globalisation is not a law of nature. There is a way for a better globalisation; for a better managed globalisation. We have made the speeches, worn the badges, gone to the events, and sometimes wondered if we were making any headway.

While many indicators of global well being are getting worse rather than better, progressives have been labelled ‘anti-globalisation’ by conservatives. It’s a lie! We are the keenest and most natural globalizers. We celebrate the breaking down of the walls that divide us. National, cultural and religious barriers are not for us. We believe passionately in respect for diversity, in the benefits of sharing ideas, of working together for common goals. Don’t believe the free market fundamentalists: we are for economic globalisation, not in order to spread inequality and exploitation but to bring decent work and an end to poverty. We know that the market is a good servant but a bad master.

We face the deepest economic crisis in 80 years. And it is in the midst of crisis that the value of democratic government, the value of progressive new policy, is tested. We must act together to safeguard jobs and prosperity! Get it right, and they can build not just an economic recovery but also a better, more stable economic governance, a healthier democracy and a more progressive society.

Now after years of frustration there exists a real opportunity to press home the case for a better globalisation. There is a willingness to rethink that we must seize. There is a unique chance to engage in a new and fresh dialogue on the sort of globalisation we should pursue. We must create momentum, otherwise our moment will pass and it will be our children or grandchildren who will make the breakthrough.

It is not poverty or AIDS or climate change that has created that momentum, as many might have predicted, but the failure of our banks. It is the greed of international financiers that has demonstrated beyond serious debate to all decision-makers that deregulated globalisation has not worked. The previously unheard of phrase “a new global financial architecture” is on the lips of all politicians, those on the right as well as on the left. It is time for us to move.

Warning number one.

We do want a new global financial architecture but beware it will take years to agree and there are those who make the case for it precisely because they believe it will never happen or who use it as a bad excuse not to do anything at the regional level, for example in the European Union. There are enough political leaders who realise it is needed, and who know it has to be done with fast-growing economies in the east and the south on board, to make it happen. But it is not enough on its own.

We also need the largest economies like the US, the EU and Japan to give momentum to global reform by bringing in their own financial regulation. There are internal battles going on, but my assessment is that we will see new regulation on both sides of the Atlantic, in the US and the EU. If the Democrats can win elections in

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Japan we may also see new financial regulation in the Far East. It calls for a new global politic, one of coordinated actions with complementary but different legislation in the biggest economies; moving in the same direction and converging in the years ahead. And the new G20-Summit must be enforced to be the dynamic decision centre for a new global regulation of financial markets.

We must unite all progressive forces to create new global regulation of financial markets. Regulation of the greediness, the permanent tendency of using excessive debt, the lack of transparency and responsibility, and the abuse of dominant positions. We must never again risk meeting a financial credit bubble and crisis of the present kind which is destroying millions of jobs, people's savings and good companies.

What sort of regulation are we talking about? I think progressives could unite around 9 pillars of reform for the global financial markets:

1. Legislation covering all financial players including investment banks, prime brokers, private equity, hedge funds and anyone else who has been exempt from the rules of transparency and disclosure that have applied to everyone else. As this ‘alternative’ sector accounts for a very sizeable chunk of all new debt, they clearly need to be brought inside the tent if new debt crises are to be avoided.
2. Transparency and disclosure of debts, amounts and sources of funds, identification of large shareholders, executive pay and bonuses for ALL investment products.
3. Compulsory ‘capital requirements’ for ALL financial players, like those that already apply to banks and insurance companies. It means that to reduce extreme risk taking and excessive debt, all financial players need to have and to keep a certain amount of capital. To end the systematic risks and herd-behaviour, the capital requirements must be anti-cyclical: stronger build-up in good times and move flexibility in bad times.
4. Rules to prevent excessive borrowing including excessive debt caused by ‘leveraged buy outs’ and to protect viable companies from too much capital being paid out to shareholders or to service debt.
5. Greediness must be effectively kept down. Limits on pay and remuneration and mechanisms to ensure that earnings reflect losses as well as profits.
6. New rules to prevent conflicts of interest.
7. Protecting workers interests such as ensuring that employees are informed and consulted during all takeovers including leveraged buy outs and by obliging pension funds to inform employees how their pensions are invested.
8. End off-shore tax havens. It has been calculated that tax revenues lost through companies and individuals registering in tax havens could completely pay for the Millennium Development Goals to be implemented!
9. A new enforced IMF and financial stability forum to ensure early warning in case of bubbles and effective monitoring and supervision of the financial markets.

This is what we must argue for. It has to come out of the closet where we keep obscure, technical demands and into the light of day. It is here we can begin to forge a better globalisation. It's time for action now. The G20 Summit in April must take action.

Many, but not all of these proposals are contained in a report I steered through the European Parliament last September which was adopted with the support of conservatives and liberals who, until the financial crisis struck, argued that the market was already more than adequately regulated. Like in all times of change, things are moving fast and the facts are on our side. I cannot forget that just a year ago the conservatives and liberals were against any form of regulation "of the free market".

Warning number two.

While we fight to put in place a new global financial architecture, we must be equally engaged in the fight against a global depression. A new global financial architecture built on the foundations of mass unemployment is hardly an enticing prospect. If unemployment means misery for millions in our European welfare states, and worse in the US, what will it mean for Chinese workers whose goods are not longer being bought in the west, or for African agricultural labours who are having extreme difficulty coping with the ever fiercer global economic competition.

The US and China are trying to make serious investments in stimulating economic growth. At the time of writing, European efforts look inadequate. As the crisis worsens I believe we will have to demand new measures. The right is reluctant; they argue that increasing public debt is no way to deal with a crisis caused by debt. We must argue that public finances will get better if people are working, but with millions unemployed public finances will get worse. Business as usual is not an option. Extraordinary measures are needed for very tough times ahead. The demand made by the PES at the end of 2008 that Europe should not allow employment levels to decrease, should remain our objective even as unemployment is predicted to increase dramatically. Already we see the dangers of social and political unrest,(at the time of writing), strikes in the UK and France, and riots in Greece and the Baltic States.

We progressives must take action in the format of a New Global Deal - a New Recovery Plan. Worldwide, it is the most vulnerable who bare the brunt of the financial crisis. The ILO has estimated that 150 million jobs will disappear next year throughout the developing world, as a result of the rich world's credit crunch. Much needed capital is flooding out of less developed countries as the financial institutions search for save havens for their money.

Europe rightly prides itself on being by far the world’s biggest aid donor. Yet we have no hope of achieving the Millennium Development Goals until the underlying rules of the global finance and trade systems are re-established on a more stable and progressive basis.

The lessons from the financial meltdown are clear; coordinated European action succeeded where national effort has failed. In the real economy too, coordinated action at both a European and at a global level, will be far more powerful than purely national solutions. We join the call for a new Bretton Woods to create a new, more accountable, more stable and fairer global financial governance.

In the short term, the G20 recovery plan must ensure that the IMF, together with central banks and governments in the developed world and in the cash-rich SWF's, makes enough credit available to developing emerging countries to fight off recession. And the Doha trade round must be brought swiftly to a successful and development-friendly conclusion.

Recession is the world's most immediate challenge, but by far the biggest challenge of the coming years is climate change. Our only hope of avoiding ecocatastrophe is to shift rapidly towards low-emissions, low-energy economy, but until now the scale of investments needed has been daunting.

Europe is a world leader in rapidly growing sectors such as eco-technology, environmental goods and renewable power generation technology. European social democrats have set out an action programme to create 10 million new jobs by 2020 through green growth. But to achieve these goals and meet Europe's climate change commitments will require massive investment. We call on Europe's leaders to rise to this challenge, with a package of smart green investment that puts Europe back to work and brings us closer to meeting our climate and energy goals.

We must turn the rhetoric for investment in green growth into reality. There is broad consensus on the urgency for the battle against climate change, and broad understanding that replacing our dependency on imported fossil fuels with more locally produced renewable energies would also increase the security of our energy supplies. Now we must generate real determination to act decisively on the growing understanding that investing in renewable energies and actions to reduce energy waste has the potential to create millions of much needed jobs. There will be those who claim we cannot afford during a recession to finance the fight against climate change. But this is a false argument. The costs for people, societies and for the planet of not doing anything serious are vast and irreversible. We cannot afford not to act; furthermore we cannot afford to miss the opportunity to create millions of new jobs in doing so.

This leads also to the opportunity for a new and stronger global climate deal to replace the Kyoto Negotiations for a new deal open in Copenhagen later this year. With leadership from the EU and US we can hope for an ambitious deal that sets tougher limits on emissions, that puts in place new actions such as a global emissions trading system, and that encourages and helps developing countries to contribute to saving our climate.

We must not neglect decent work, basic workers rights and social and environmental standards when we talk about world trade. ‘Fair trade’ is a progressive idea that we strongly support. The economic recession should not be a reason for a race to the bottom; social rights and environmental protection should not be the victims of the current crisis. On the contrary, respect of ILO Core Labour Standards and respect of bio-diversity and environment must be integrated in a progressive strategy to re-launch the economy.

We must not forget the UN Millennium Development Goals, and the fight against AIDS and other infectious diseases, poverty, maternal mortality to lift millions of people out of poverty. We fear that 2015’s objectives will not be fulfilled. The EU and the US, together with other industrialised countries, must respect their commitments.

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The current crisis demonstrates that the market alone can’t solve the problem. It also demonstrates that codes of conduct or self-regulation are not enough. What is necessary now is to strengthen the international institutions for better cooperation between states and state institutions. Only with better global governance will we be able to face the current crises: economic, financial, climate change, the food crisis, etc... New tools to promote general interest and public goods are necessary in the framework of the multilateral system.

The time is right politically and economically for a big shift towards managing globalisation in a better and fairer way. Politically right because the Reaganite/Thatcherite idea that government is bad, markets are good is dead.

Politically right because President War Against Terror and President Tax Cuts for the Rich has been replaced by President Hope. Belief in the ability to achieve change, captured in that brilliant slogan ‘Yes we can’, is essential if we are to tackle the challenges facing us. For many the election of Barack Obama is in itself proof that change is possible. Our joy at the election of an African-American President is combined with the knowledge that his politics are far more progressive than those of President Bush. He knows there is far more to global politics than the war against terror. He has witnessed, and participated in, the very personal struggles of those trying to create a future for themselves and their families in developing nations such as Kenya and Indonesia, as well as in the poorer suburbs of Chicago. Economically right because the questions being asked about unregulated global capitalism in the context of the financial and economic crisis need to be answered.

We have already shown that the crisis in the international financial markets and the deep recession we are in also creates the biggest opportunity for years to make a decisive change in the way globalisation is managed. We have argued that one of the keys to getting out of the recession is to invest in ‘green growth’. But most of all we must remember that the keys to managing globalisation better are two-fold. Combining the fight against global unemployment with the fight against climate change, and implementing new regulation for the international financial markets are the keys to opening the door to a better future.

The failure of the markets, worshipping, "greed is good" philosophy of the last 30 years, must finally lead to fundamental self-examination by both economists and politicians. Economists have to rediscover a wider vision of how their profession can contribute to building a better society. And politicians must learn to think long and hard before contracting out their responsibilities to the magic of the market. That's where our Progressive New Global Deal for this planet comes in.

ii. Tax Havens: Tax Evasion, Regulatory Avoidance and Uneven Globalization[2]

By Christian Chavagneux[3], Richard Murphy[4], Ronen Palan[5]

In September 2007, only a month after the beginning of one of the most devastating financial crisis ever experienced, the British bank, Northern Rock, was on the brink of collapse. Northern Rock had expanded rapidly prior to its failure, funding its growth as an aggressive player in the international market for Collaterized Debt Obligations (CDOs) and emerging as the fifth-largest mortgage provider in the UK. Those bonds were, however, issued not by Northern Rock itself but by what became known as its shadow company, Granite Master Issuer plc and associates. What was intriguing about the arrangement was that Granite was owned not by Northern Rock but by a UK charitable trust established by Northern Rock. Much of the management of the resulting, supposedly independent, structure was located in Jersey, well known as a European tax haven.

In March 2008 came the collapse of Bear Stearns, a leading American investment bank. Bear Stearns had haemorrhaged funds through its hedge funds, many of them registered in the Cayman Islands and Dublin's International Financial Centre - both well-known offshore finance centres.

This was not a coincidence. If you think of tax havens as sun-kissed exotic islands reminiscent of the Garden of Eden where a few billionaires, Mafiosi, and corrupt autocrats hide their ill-gotten gains, then think again. Tax havens are the underlying constant theme of the financial crisis of 2008-9. Lehman Brothers, the next to fall (its collapse triggered a month of financial panic throughout the world), was registered in Delaware, a state that has served as an internal tax haven in the United States since the late 19th century. The Lehman collapse was followed by the Madoff scandal, a supposed $US 50 billion Ponzi scheme orchestrated by the well-known Wall-Street financier, Bernard Madoff. It took little time to discover a link between Madoff's scam and tax havens'. 'Madoff Spotlight Turns to Role of Offshore Funds', announced the New York Times (30 December 2008)

We do not suggest that tax havens caused the financial crisis of 2008-9, but we do believe that they were one of the most important actors precipitating the crisis. We argue that their regulation is key to any future plan to stabilize financial markets.

We are not alone. The French, German and British governments, and the administration of President Barack Obama, are all keen to pressure these havens, for the sake of stability and, not unnaturally, for other, more traditional reasons as well. For tax havens are places where one can avoid or evade at least one of life's absolute certainties, taxes, and so they leave a gaping hole in most states' finances. Tax havens also help those who use them escape other regulations, launder money,

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2 This is an edited and revised article based on the introductory and concluding chapter of Tax Havens: At the Heart of Globalization, by Christian Chavagneux, Richard Murphy and Ronen Palan. Copyright (c) 2009 by Cornell University. Forthcoming from Cornell University Press in Fall 2009. All rights reserved.

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hide money from partners or spouses and secure secrecy for their commercial activities.

Individually tax havens may appear small and insignificant, but in combination they play an important role in the world economy in two respects. Firstly, they undermine the regulatory and taxation processes of the mainstream states by the provision of what may be described as 'get out of regulation free' cards to banks and other financial institutions, to international business, and to wealthy individuals. Secondly, in doing so they skew the distribution of costs and benefits of globalization in favour of a global elite and to the detriment of the vast majority of the population. In that sense tax havens are at the very heart of globalization, or at least the heart of the specific type of globalization that we have witnessed over the past three decades.

Money, wealth and tax havens

The names of offshore jurisdictions have appeared with monotonous regularity in every financial crisis or scandal that has erupted over the past 20 years, whether financial crises in East Asia, Russia and Argentina or the corporate fiascos associated with companies such as Long Term Capital Management, Parmalat, Refco, Enron, and more recently Northern Rock, Bear Stearns and Madoff's Ponzi scheme.

The sense of fiasco perhaps reached its pinnacle when it was revealed in February 2008 that a dog named Günter joined 1,400 of his fellow German citizens (most of the conventional homo sapiens variety) and set up anonymous trusts managed by Liechtenstein's LGT bank to avoid German taxation (Dinmore and Williamson, 2008). But relatively unknown banks in very small havens were not alone in pursuing such activity: in June 2008, an employee of UBS, the premier Swiss bank, pleaded guilty to helping a Russian oligarch evade millions of dollars' worth of taxes in the United States. In November 2008 a senior Swiss-based employee of the same bank was indicted on charges of tax evasion in the USA. The UBS employee estimated that $20 billion of assets were involved and the total fee income to UBS each year might have amounted to $200 million. He stated that UBS chose to ignore regulations with regard to the operation of offshore accounts for its U.S. clients and in the process facilitated tax evasion.

The evidence is clear that tax havens and the tax evasion that at least some of them facilitate are serious business. At some point quantitative growth accumulates to a qualitative change, and the impressive figures associated with tax havens suggest that they play an important if often overlooked role in the contemporary world. We hope that anyone who still believes that tax havens are a mere sideshow, the playground of the rich and famous, will think differently after they read this book.

The statistics are certainly impressive. In our estimate there are between 46 and 60 active tax havens in the world right now; they are home to an estimated two million international business companies (IBCs), a term used to describe a bewildering array of corporate entities, most of them extremely opaque, and thousands upon thousands (if not millions) of trusts, mutual funds, hedge funds, and captive insurance companies. About 50% of all international bank lending and 30% of the world's stock of Foreign Direct Investment (FDI) are registered in these jurisdictions. Some very small islands are among the world's largest financial centres: the Caymans, a small set of islands in the Caribbean and a British Overseas Territory, is the fifth-largest international financial centre in the world. That list contains, in addition, the small British Crown jurisdictions of Jersey, Guernsey and the Isle of Man, as well as what we call intermediate havens, such as Switzerland, Luxembourg, Ireland and Singapore.

The global rich - the ‘Richistanis’ as Frank (2007) calls them - hold between them approximately US $12 trillion of their wealth in tax havens. It is as if the entire U.S. annual Gross National Product (GNP) were parked in tax havens.

The hedge fund industry has discovered the delights of tax havens. According to some estimates the ‘big four’ Caribbean havens - the Caymans Islands, the British Virgin islands, Bermuda and the Bahamas - are home to 52% of the world’s hedge fund industry. But these figures are disputed. The Cayman Financial Services Authority claims that 35% of the world’s hedge fund industry is located in its territory alone (Cayman Islands Monetary Authority (CIMA) figures as reported in GAO 2008) and some cite an improbably high figure of 80%. This unresolved debate is disconcerting: it shows how little we really know about the hedge fund industry.

The statistics are staggering, but these are only numbers and numbers need interpretation. What these figures represent can be captured in one word: avoidance. They are the abstract expression of the collective efforts of the state, corporate and business elites of the world to avoid the very laws and regulations which they have collectively designed.

Such elites seek to avoid, first and foremost, taxation. They seek to avoid or reduce their share in the collective effort that pays for the ‘collective goods’ provided (or supposedly provided) by states, such as security, economic, political and social stability, health, education and infrastructure. However, elites also seek to avoid regulations. The regulations they seek to avoid are often the financial and business rules and norms that states introduced to maintain order and stability-without which the rich would not have become so rich in the first place. Tax havens allow people to manage many other, more esoteric social regulations, among them the avoidance of gambling and pornography laws.

Granted, not all taxes and regulations are necessary or socially beneficial. Not long ago, most advanced capitalist countries heavily regulated their broadcasting industries, allowing only state-sponsored broadcasting companies to operate. The growth of offshore radio stations such as Radio Luxembourg and Radio Caroline, both of which operated on the tax haven principle (Palan 2003), appears in retrospect to have been a beneficial development. Here, ‘offshore’ proved to be a modernizing force compelling governments to abandon intrusive regulations. Broadcasting, however, is uniquely accessible to all. In most cases - indeed, in all the cases discussed in this book - entry barriers to the range of benefits offered by tax havens are high, limiting their clientele to a small and extremely wealthy minority. As a result, unfortunately, tax havens benefit the rich and the powerful, while the costs are largely borne by the rest of society.

This is the crux of the matter and what makes tax havens a highly political issue. Tax havens are among the most significant, if persistently overlooked, structural factors that are determining the distribution of the benefits and costs of globalization among the world’s peoples. That they skew the benefits of globalization to favour a small minority of the world’s rich and powerful is a matter of the highest political importance.

We can find examples of people taking advantage of collective goods for private pleasure at every level of society, of course, from the poorest to the richest. The tax haven phenomenon, however, and the figures cited above are testament to this, and is a massive organized attempt by the richest and most powerful to take advantage of collective goods on a scale rarely seen; and it is, perhaps for the first time, taking place globally. Tax havens are, therefore, at the heart of a particular type of globalization; globalization that is characterized by a growing gap between the very rich and everyone else. Such globalization is neither necessary nor inevitable. Rather it is a product of a complex set of factors, key among which has been lenient and forgiving attitudes toward tax havens that have characterized international politics (and most especially those in which the United States has been involved).

What are tax havens?

It is not easy to define tax havens. At this point we suggest that tax havens are places or countries (not all of them are sovereign states) that have sufficient autonomy to write their own tax, finance and other laws and regulations. They all take advantage of this autonomy to create legislation designed to assist non-resident persons or corporations to avoid the regulatory obligations imposed upon them in the places where those non-resident people undertake the substance of their economic transactions.

An additional characteristic that most tax havens share is an environment of secrecy that allows the user of structures created under local law to do so either completely anonymously, or largely so.

The third common characteristic is ease and affordability in gaining access to the entities incorporated in the territory.

Evasion and avoidance

Tax havens are used, as their name suggests, for tax avoidance and evasion purposes. However, these two terms are often confused and so some clarification is essential at this stage.

Individuals and companies just about anywhere in the world have the opportunity to undertake what might be described as ‘tax planning’ within the law of the territory in which they live or operate. For the vast majority of the world’s population, however, including most people in advanced industrialized countries with reasonable wages, the concept of ‘tax planning’ is largely meaningless: tax is normally deducted at source from earnings, and that is more or less that with regard to the settlement of tax liabilities.

For the wealthy minority of the world’s population and for most companies, tax planning is, in contrast, an important part of their business and personal lives. There is even a special term to describe the life experience of some: they are called PTs, the ‘permanent tourists’ or those who are for tax purposes the ‘permanently not there’ (Maurer 1998). This is an extreme, however, and in practice tax experts distinguish between three basic approaches to tax strategy.

The first is ‘Tax compliance’. This happens when a company or an individual seeks to comply with tax law in all the countries in which they operate, makes full disclosure of all relevant information on all their tax claims and seeks to pay the right amount of tax required by law (but no more) at the right time and in the right place where ‘right’ means that the economic substance of their transactions is consistent with the form in which they are declared. These people are considered tax compliant.

At the other end of the scale is tax evasion. Tax evasion is an illegal activity undertaken to reduce an individual or company’s tax bill. It occurs when a taxpayer fails to declare all or part of his or her income or makes a claim to offset an expense against taxable income that he or she did not incur or were not allowed to claim for tax purposes. Tax evasion is a criminal offence in most countries but a civil offence in a minority of countries, such as Switzerland and Liechtenstein. The difference is significant. Countries cannot legally cooperate in civil matters and hence the Swiss authorities' most common response to other countries' requests for assistance in cases connected to tax evasion has been that eager and keen as they are to stamp out such unsavoury practices, sadly they are unable to cooperate because tax evasion is a civil matter in the Swiss Federation. Their hands are therefore tied, and Switzerland, is of course, a democracy.

This characteristic response has been highlighted in recent events. In 2008, when massive tax evasion through highly secretive Liechtenstein foundations was made public, a Liechtenstein spokesperson explained how surprised and disappointed they were to 'learn' that these secret foundations, set up under a law passed in 1926, could be abused by foreigners for tax evasion purposes. Liechtenstein, she said, was perhaps a tad naïve, believing that most people in the world would behave just like its own citizens and would cheerfully pay all taxes due - but naivety, she said, was not a crime. The implication was clear: Liechtenstein wished us to believe that it was taken for a ride by these nasty foreigners. Liechtenstein had been known for nearly a century as one of the world's most secretive tax havens and was associated with a string of scandals. Few were deceived by the response.

Finally, there is tax avoidance. Tax avoidance is the grey area between tax compliance and tax evasion. This is the favourite area occupied by an army of accountants, lawyers, bankers and tax experts. Strictly speaking, a tax avoiding individual or a company seeks to ensure that one of three things happens. First, they might seek to pay less tax than might be required by a reasonable interpretation of a country's law. Second, they might hope that tax is paid on profits declared in a country other than where they were really earned. Third, they might arrange to pay tax somewhat later than when the profits were earned.

Legally, there is a clear difference between evasion and avoidance. Tax professionals like to cite a series of court rulings, mainly from the major countries in the world, which appear to support the legality of tax avoidance. The reality, however, is more complicated. First, the tax rules of almost every country are complex, and much avoidance relies on the existence of doubt. Second, when transactions take place across international boundaries in a world that has no global tax rules, the opportunities to play off the taxation law of one state against that of another (a process that tax professionals call 'arbitrage') is often difficult to resist. The consequence is that the line differentiating tax evasion from avoidance is often too difficult to determine in general terms, and is way beyond the ability of most of those who participate in tax haven practice to either know or understand - a fact that the tax professional can easily exploit. For that reason, we talk of avoidance and evasion without significant differentiation, relying in doing so on the maxim of former UK Chancellor of the Exchequer Dennis Healey who famously described the difference between the two as being 'the thickness of a prison wall'.

How much tax is evaded through tax havens? The most candid and accurate answer we can give is that nobody knows. But as States feel that they are losing more and more tax receipts, some figures have been coming out. Richard Murphy calculates that annual avoidance in the UK is about £97 billion – 16.6% of expected tax receipts or 6% of Gross Domestic Product (GDP). The IRS believes that the US tax gap is about $330 billion a year or 16% of federal revenue and 2% of GDP. Official figures in France indicate that the French state loses 40-50 billion euros a year, roughly 3% of GDP. The European Union estimates the tax gap for the entire Union at 2-2.5 percent of GDP. The numbers at stake are very high.

Tax havens and the professionals

The debates on tax havens rarely acknowledge one crucial factor: the role played throughout the years by commercial firms of accountants, lawyers, bankers and tax experts that service them.

The biggest accounting firms, together with lawyers and bankers, tax experts and financial traders, plus their associated trust and corporate services companies, are to be found in most tax havens, but most prominently in the thirty or so largest jurisdictions. These professionals are crucial: as far as we can tell, they were present at each and every legislative innovation designed to avoid tax and regulation. They advised and coaxed the politicians to provide the legislation they needed to pursue their trade, and on occasions they drafted that legislation for the states in which they had located themselves. The professionals have also been present in each and every redrafting of the laws of offshore, while the professionals are the ones who actually set up the offshore facilities that such legislation enables; the professionals innovate new techniques of evasion and avoidance, which they sell to clients; the professionals lobby against changes in the laws against tax havens; the professionals are also there to argue that tax havens are an entirely legitimate form of business.

The professionals are therefore absolutely irreplaceable, for they ensure that the business of tax havens flourishes. Most tax havens are very small jurisdictions and do not have the manpower and skills to operate on a global scale. The State of Jersey provides a perfect example. Probably few if any members of the State of Jersey have any real understanding of how ‘the offshore finance community’ within Jersey works or what it is its denizens really do. They are simply a legislature for hire, doing what is asked of them. So, for example, Jersey’s obnoxious Trust Law of 2006 was passed without a vote since no one objected, or as far as we can tell even commented on it, in that Island’s State Assembly. But legislators did do exactly what was asked of them: they provided what the local financial services industry demanded. In so doing they implied their understanding of something very simple and straightforward: that in exchange for legislation the tax havens collect revenue from some activities that the offshore community brings into their jurisdiction without encountering any obvious costs. It seems to be a win-win situation serving the interests of all, and so why spend time on the boring details of trust laws?

These professionals make up the so-called Offshore Financial Centre (OFC) community. They are international, transient, and interested only in following the money. If for any reason the money leaves a tax haven, you can be fairly sure that the OFC community will follow it. The perfect example of this type of behaviour is found among the Big Four accountant firms, which are all, almost without exception, present in all the world’s significant tax havens, including the most abusive. The people who service these firms are rarely local, and, it is now becoming increasingly clear, they rarely integrate into the local community. They service a client base that is almost never local, unless it be the local lawyers who are servicing offshore clients, and their reason for being there has little to do with geography but everything to do with the money flows they are managing.

Precisely because these people are transient, they have little real regard for local regulation. They may pay lip service to it as part of their costs of operation, but they can also afford to ignore it, as they evidently did in the case of UBS in the United States, some of the consequences of which we have already noted. Their belief is simple: if a problem of compliance were to arise, they could simply move on. As a result, compliance is not a real issue for them, and that is why, we suggest, it is obvious that despite the theoretical soundness of the local regulatory systems, actual compliance rates are so low.

Any effective regulation of the offshore world (a hot topic of debate for the past decade, and likely to be equally hot in the next), would require not just that tax havens be regulated, but that the professional operators be regulated as well - and not just with regard to what they do in such places, but with regard to what they facilitate. They will resist such moves, but this is a battle that must be won. Not only because tax havens are not really home to the vast amount of money that the figures suggest. They are very largely ‘recording havens’ or, to use the jargon, ‘booking centres’ that serve as legal domains for the registration of contractual relationships that take place elsewhere (although they collect license fees and other revenues in return). The staggering statistics belie the fact that at heart, tax havens are largely a fiction, one almighty fictional world that is aimed at one thing: at the avoidance of taxation and regulation in the world in which the transactions they record actually take place or have real impact. Their activity is entirely parasitic, feeding on both the world economy and the system of states. That is why tax havens are one of the most important political issues of our times.

Regulatory responses to tax havens

The astonishing statistics associated with tax havens tell us, therefore, that they have played a central role in skewing developments in the world economy in two ways. First that they have helped to undermine the international financial regulatory environment, as well as the taxation policies of all those countries and regions that participate in globalization, as well as those that do not. Second, that in doing so, they have served collectively as a vehicle for skewing the allocation of costs and benefits of globalization. The degree to which modern business, large and small, have become embedded in tax havens, while astounding, is rarely acknowledged. An international company or business with no links to a tax haven is a rare species nowadays. But the impact of tax havens is felt largely indirectly, revealed through the statistics that show a persistent growth in the gap between rich and poor since the 1980s all over the world. The role that tax havens are playing in undermining financial regulations has come to light only recently.

Yet, all this was known for a while. How could the leading industrial countries allow these small jurisdictions to rise and flourish? Well, they did and did not. On the one hand, countries such as the US, the UK, France and Germany sought from time to time to close certain loopholes, pressurizing this or that tax haven to change some of its rules and policies. There were also some feeble attempts, dating back to the interwar period to try and develop a coordinated international response to tax havens. But frankly, not much was accomplished. Worse, the very same countries, with the possible exception of France and Germany after WWII, were indeed major players, as we will see, in the development of the tax haven phenomenon.

For a number of reasons, however, the sentiment has begun to change towards the end of the 1990s. Since then a number of initiatives, led initially by the OECD ‘harmful tax competition’ campaign, began to gather steam. In 2006, however, Jason Sharman (2006) exposed these efforts largely as futile in an excellent detailed analysis. Yet, only three years later, it appears that tax havens are under greater threat today than ever.

While concern with tax havens has gone on a long time, the full impact of tax havens on the world economy took a long time to mature and may have dawned first on the leaders of the European Union. While the OECD campaign was largely in a doldrums, the EU has emerged as the effective leader in the global struggle against tax havens.

Since 1997 a Code of Conduct on Business Taxation is in place. The code does not have the status of a legal instrument, but it provides an informal approach to regulation which is proving surprisingly effective (Radaelli 2003). In adopting this code, member states work to eliminate several harmful tax competition practices and avoid new ones. Whereas the OECD campaign is limited to financial and other services, the EU Code looks at business activities in general, with greater emphasis on mobile activities. It thereby avoids charges of a bias against mobile capital lodged by Luxembourg and Switzerland. The code of conduct also overturned another traditional objection of tax havens. To avoid the charge of imperialism, the code does not elaborate a principle of "just taxation" and impose it on recalcitrant states. Instead, taking a line adopted by the OECD, the code accepts the principle of tax competition, allowing states freedom of choice in this matter. However, the EU insists that the tax regime's rules be applied equally on all businesses in the jurisdiction, domestic and foreign. The Code targets the practice whereby non-residents are provided 'a more favourable tax treatment than that which is generally available in the Member State concerned'.

The code confronts, therefore, jurisdictions that have created a niche for themselves in the global economy precisely by distinguishing resident and non-resident companies for tax purposes. Citing the code, for example, in 2006 the Commission forced Luxembourg to abandon its 1929 holding companies. Similarly, the adoption of new tax regimes by Jersey, Guernsey and the Isle of Man from 2008 onward (notably the 0% tax rate on business profits) may be taken to task for not respecting the code.

The EU is also pushing for the harmonization of company taxation across the continent. Multinational companies with subsidiaries in more than one European country pay taxes in countries where they operate, but they tend to shift profits to the lowest-tax country through complex systems of transfer pricing. The EU is proposing a European-wide tax base that would reduce the incentives to shift profits by applying a "formulary apportionment." In this process group profits will be taxed just once in the EU and tax revenues distributed among countries according to an agreed criterion (e.g., amount of capital invested or sales turnover) as is already done between states in the United States and between provinces in Canada. The Commission gave itself until 2008 to come up with a directive for company taxation, but the Irish 2008 no vote in the referendum on the Lisbon Treaty, partially won on the claim that the EU supposedly threatens the Irish tax system, has delayed the directive.

Any state can serve effectively as a tax haven by sheltering savings from taxation. The EU put forward a clear set of proposals to deal with this sort of abuse as well. Since July 2005 all member states are required to exchange information with the relevant national authorities. Austria, Belgium and Luxembourg retained their bank secrecy rules but are required to impose a withholding tax on earnings from deposits starting at a rate of 15% from 2005 to 2008, rising to 20% from 2008 to 2010, and to 35% thereafter. The Liechtenstein affair in early 2008 reinforced France and Germany's resolve to increase the scope of the European Savings directive and European states are now engaged in negotiations to determine an extended directive.

Is the mantle of the driving political force against tax havens likely to pass to the USA with the Obama administration? The issue was certainly known to both the Clinton and the George W Bush administrations, and the Clinton administration was one of the drivers of the multilateral efforts against tax havens. But one of the first acts of the Bush administration was to withdraw support from multilateral efforts to combat harmful tax competition. President Obama, however, has already played an important role as a Senator in various initiatives to combat tax havens and some declarations he made by the end of 2008 seem to confirm his political will to clamp down on tax havens. Whether the US will emerge as an ally of some of the leading European states such as France and Germany in the fight against tax havens is still to be seen. But it will be amongst the most important political choices made by the Obama administration with regard to the regulation of international finance.

The next step in the battle against tax havens

It is very obvious that the world's tax havens have a significant impact upon its economies and the distribution of income and resources both within those economies and between states. What then are the most crucial next steps in the battle against tax havens?

The answer, we argue, at this point is secrecy. Without the deliberate veil of secrecy that tax havens create, those using tax havens for the purpose of tax and regulatory avoidance would be readily identifiable, and as such would either desist from doing so of their own volition, either for fear of the effect on their reputation or from fear of prosecution, or they could actually be prevented from doing so by the states in which they really undertake their economic activities. Tackling secrecy, however, is likely to be insufficient by itself. There remain legacy issues arising from the existing international architecture which will have to be addressed as well. Our recommendations are clustered around these two themes.

Secrecy is created within tax havens under the pretence that as sovereign jurisdictions, it is their sovereign right to write their laws as they wish. The impact of these provisions, however, is felt outside tax havens. Those who wish to address secrecy have a choice: they can either try to break the secrecy that these jurisdictions create from within those places, or they can seek to break it in the places where it has impact, or finally they can try to work around the issue. Despite tremendous pressure from civil society groups, tax havens have been very reluctant until now to give up their secrecy provisions. We do not believe that they are likely to change their position on the matter in the short term, particularly when reform in the United Kingdom, Delaware, Nevada and other locations appears to be a necessary prerequisite of any action in the secrecy jurisdictions.

As a consequence the attempts to break this secrecy from outside these jurisdictions are at present receiving greater attention. One line of attack consists of a proposed extension of the EU Savings Tax Directive. This directive was a substantial step forward, as we saw, but it was limited in its impact because all privately owned trusts and companies were excluded from its scope. In December 2008 the EU published a proposed revision to the Directive. In what can only be described as a bold move, it has sought to link together the information that banks must hold on the beneficial ownership of the entities with which they contract and the obligation to either automatically exchange information with the country of residence of the beneficial owner of an account, or to withhold tax of up to 35% from payments made as an alternative. This requirement will apply to all paying agents who operate within the EU, and any additional states that apply this directive. This proposal, in effect, means that the actual beneficial owners of those entities located in tax havens must be known and indentified. Offshore entities, such as International Business Companies, or offshore trusts, will be treated for tax purposes as being located in the countries where the beneficial owners are. Information will then be exchanged with the countries where the beneficial owners are, by-passing the jurisdictions where the entities are registered. The entities include both companies and trusts and all other similar structures.

This is an extraordinary breakthrough: it basically sweeps aside all the tax planning that is undertaken offshore and says that the entities in question are owned by and must be taxed in the countries in which they really reside. There are, of course, obstacles to progress: the Directive must be supported by all EU states and it is not clear that support does exist as yet, with particular opposition coming from Luxembourg, but the mere presence of this proposal gives a clear indication of the direction of travel in which the EU wishes to proceed.

Similar indication is available from the USA. The Stop Tax Haven Abuse Act is drafted legislation before the U.S. Senate, but has the advantage of having President Barack Obama's name on it from the time when he served in that body. The fundamental presumption of the pack is that the person who engages with a tax haven entity has control of it, enjoys the benefit of its income and has the duty to declare that income in the USA unless they can prove the contrary. Legislation with similar intent has been tabled in Germany in January 2009 as well, whilst Germany is also seeking to deny tax relief on payments made to tax haven entities, even if within commercial groups of companies. In both cases, this is a blunt legislation that has the effect of presuming the taxpayer guilty until proven innocent! No doubt, this approach is likely be the basis on which it is criticised.

Another approach to tackling secrecy has been proposed for multinational corporations. With minor exceptions, the vast majority of corporations have to prepare accounts in accordance with the requirements of the International Accounting Standards Board (IASB) or its US equivalent, the Federal Accounting Standards Board (FASB). Under the rules of both bodies, multinational corporations at present do have to submit consolidated accounts to their members. These eliminate all intra-group transactions from view, including transfer pricing. In addition, under the now common rules issued by the two bodies, almost no geographical reporting of the transactions of the entity is required. As a result it is almost impossible to establish where a multinational group of companies trades, where it makes its profit, where it locates its assets and where it pays its tax.

Civil society groups, led by the Publish What You Pay coalition and the Tax Justice Network have argued that these corporations should be required to account on a country by country basis, meaning that they would report their sales by location, both the party and intragroup, their costs on a similar basis, where they employ their staff and what they pay them on the country basis, and by country what profit they make, what tax they pay what assets they have located in that place. Their argument is that this reform would substantially reduce shareholder risk; that it would enhance the allocation of assets and reduce the cost of capital within groups of companies and so bring economic benefits, and that it would make these corporations accountable for the actions they undertake in all countries in which they trade. By arguing, however, that this disclosure should be made for all jurisdictions, without consideration of size or the volume of trade undertaken there, the disclosure would also expose the use of secrecy jurisdictions by these groups, and for both third-party trading and poor intragroup transactions, with the latter having particular significance for transfer pricing issues, where it is thought that much of the tax abuse of developing countries is perpetrated.

This proposal, in common with those from the EU, USA and Germany, works round the secrecy provisions offered by tax havens. Hence, the consent of those locations is not required for the policy to work, or for the accounting of these corporations for their actions within them to be put on public record. The direction of policy is indicative of the state of frustration that has been reached: negotiating for the reduction of secrecy in the jurisdictions is not working. It is widely acknowledged that the Tax Information Exchange Agreements that should supposedly ensure information exchange between those who have signed them and the major state participating partners is not giving rise to any meaningful exchange (just four exchanges had taken place between Jersey and the USA between 2002 and 2008) and therefore measures have to be taken to attack secrecy which do not require these places consent.

That being said, considerable problems within the jurisdictions need to be addressed as well. There is an obvious and continuing problem with regard to the regulation of banking in these places. As has been shown by banking failures in Iceland, Ireland and the Isle of Man, the capacity of small governments to support the depositors of a bank that is failed is very limited. It exposes those who have acted in good faith to unnecessary risk, potentially burdens the population of these places with debts which they have not reasonably afforded, and ultimately transfers risk onto the rest of the banking system that suffers from the failure of counterparties to many of their transactions.

Whilst it is true that very few independent banks indeed are actually located in the smaller secrecy jurisdictions, there does remain considerable risk in the tax havens where the ratio of banking assets to local GDP can be astronomical. In excess of 500:1 in the case of the Cayman Islands, and at least 80:1 in the case of Jersey. This is particularly troublesome to the United Kingdom who has responsibility for both those jurisdictions. Until very recently, banks have vigorously fought previous attempts to exchange information for taxation purposes: the major UK banks did so in the case of the 2007 exercise by HM Revenue & Customs that revealed that more than 40,000 of their customers in the Crown Dependencies were evading tax. But as a consequence of the financial meltdown of 2007-9, many banks in many countries are now at least part state-owned. The attitudes by those banks towards information exchange may therefore change.

In the same vein, it has also been suggested that regulatory reform might require that the parent company directors of these banks be responsible for the activities of their tax haven subsidiaries. In addition, the major financial centres have to decide if they wish to bring the funds, notionally resident in tax havens inside a domain for regulatory purposes on the basis that the funds management is located within their territory. Their right to do so is obvious: as the liquidation of hedge funds managed by Bear Stearns in the Cayman Islands revealed, there was no local substance to the Cayman Islands management of these entities; all decisions were taken in New York. If that is true for liquidation purposes, it is equally true for regulatory purposes: it is up to the regulators to make this point, and to claim their right to regulate these entities which would then become substantially more transparent as a consequence. All these reforms follow the familiar theme, noted above, of imposing control from outside the tax havens.

Some of those jurisdictions will refuse to cooperate. It is apparent that many have reacted to previous attempts to regulate them by promoting yet more secrecy, providing ever more sophisticated and obscure financial entities. This trend may well continue in some locations, such as Panama, Dubai and Singapore which remain largely outside the political control of other states which have made clear their commitment as the basis of their financial services industry.

For these states, sanctions are needed to ensure their compliance with internationally agreed standards of conduct. The cost of financial failure has now been identified, and its imposition upon the ordinary taxpayer of the world will in due course be quantified. As a result it is likely that the political will to reduce risks will be substantial. Those small states that refuse to participate in that process are likely to be the subject of considerable pressure. Many will succumb relatively easily. For example, all those jurisdictions under the influence of the United Kingdom will almost certainly be brought within the regulatory environment as a result of EU action. Others, such as Bermuda and Switzerland are clearly in the US sight lines. As they are targeted, the pressure on the remaining secrecy jurisdictions will increase. Then, and only then, will sanctions be imposed because the chance of further additional capital flight to another location will be eliminated as the number of available territories is reduced at that time.

How far away is this? It is hard to tell. Few would have predicted the progress in the battle against secrecy abuse that has been seen in 2008, or the change in the political climate that it created. The progress of the initiatives that have resulted will depend, in no small part, upon the severity of the recession in which the world now finds itself. But if, as expected, the impact of that recession will be long-lasting then the progress of these initiatives will be rapid simply because the governments of the world will need all the resources they can muster to support the creation of a new financial architecture in which stable banking institutions can trade. As their experience of owning banks progresses they will realise that the use of the capital that they provide to support secrecy jurisdiction transactions is not in their best interests. Then we can expect change. It might come as a result, sooner than anyone might have predicted. There is nothing like self-interest to spur action.

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iii. The case for Europe as a Global Rule-setter

By Pervenche Berès[6]

The economic crisis or the failure of the model of deregulation:

The crisis that has been unfolding since the summer of 2007, first on the US financial market before spreading globally, hitting our economies and causing major social consequences, has shown how deeply intertwined the global economy has become. It has made the case for global governance, including all-encompassing regulation and multilateral surveillance. It also re-opens the pending debate between supporters of self-regulation or business-friendly attitudes on the one side, and partisans of public intervention on the other side. Finally, the crisis triggers a reflexion on how to organise the checks and balances of the global financial system.

These debates were biased for a long time, because the advocates of market regulation were accused of hindering financial innovation which is seen as a major source of investment for the economy, and of chasing away capital through over-regulation. The financial innovation of the last years has undoubtedly enabled a considerable development of financing mechanisms for the economy. But it has also brought about a financialization of the economy that in a period of cheap money didn't result in an optimal allocation of capital. Capital looked for high returns first before thinking about long term investments that are essential for our economy to adapt to the vast challenges posed by globalisation, demographic ageing and climate change.

Today this crisis brings back to the agenda simple but healthy principles that had been forgotten; especially that high profit often bears high risks. After the collapse of the Bretton Woods system, 30 years of financial liberalisation on the global scale and ten years of cheap money that was driven by politics and promoted by the international organisations, this system has reached its limits. It is the end of the Reagan-Thatcher decades that have brought us to this real first crisis at the heart of the system. It shows that markets can't be trusted to settle things on their own; they need rules within which to evolve. That is why I am deeply convinced that we socialists are actually the best allies of well functioning markets. We should act as regulators and not mere facilitators of market mechanisms and we must always keep in mind the global picture and long term objectives. Liberals perceive self-regulation as better regulation, but in doing so they are mislead. Markets are neither perfect, nor tend towards equilibrium. They are blind. Instead they follow cycles, oscillating between booms and busts. Future regulatory and supervisory frameworks must build on this "changed economic paradigm" instead of continuing to ignore it!

But there is more to the current crisis than the extraordinary melt down of financial capitalism gone mad due to a lack of structures. The deadly spiral of the US housing bubble fed by an illusionary faith in ever increasing real-estate prices, and a criminal distribution of credit, is only the symptom of a more complex phenomenon. This phenomenon is a short-sighted abuse of the factors that are at the heart of globalisation: communication and transport innovations. These innovations have led to joint ventures with Western companies where goods are produced at low prices and low environmental standards; they are then shipped back and sold on the domestic markets.

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This massive movement of outsourcing has transformed China into a global manufacturing workshop. It puts wages under pressure, especially in the US, where the device to keep the economy, -i.e. consumption, growing, was the development of credit and indebtedness. This has created dramatic global imbalances where the richest nation in the world, the US, lives on credit on the expense of one of the poorest nations in the world, namely China. As we can witness now, this situation was highly unsustainable.

Today the large stimulus packages launched by the new US administration are welcomed as a great relief by the rest of the world that relies greatly on American growth. It is true that in the short run, they will contribute to getting the economy started again and towards recovery, but one has to be aware that this kind of intervention, if it is not very carefully designed, will only reproduce the causes and mechanisms that have lead to the current crisis. We urgently need to find a sustainable exit strategy, because one thing is certain, a return to the status quo ante is not an option!

The lesson to be learned from this tectonic move we are experiencing today is that we need strong multilateral surveillance mechanisms, including monetary policies in all countries, if we are to avoid the development of such bubbles and global imbalances in future.

It is this clash between both mechanisms on the micro and the macroeconomic level that lead to the mess we are currently in. Our answer therefore cannot consist merely of stimulus packages to revive industries from the past, or in capital injections for banks in distress. It has to be more comprehensive and address the system as a whole.

Tomorrow's model, which I call "the second age of globalisation", will be marked by the return of inflation, whereas in the last ten years globalisation has on the contrary led to a decrease of inflation. This should lead to real adjustments, such as a radical change in US consumption patterns which challenges the distribution of wealth, the development of another growth model for China more focussed on its internal market, a rise in influence of the euro as a reserve currency and a return to regulation and supervision of the financial markets. But these developments won't take place without public intervention to direct and to shape them. No supranational entity is better prepared to play a leading role in this new age of rule-setting than the European Union.

Thoughts about regulation:

Today, the tools of normalisation and regulation have become major issues in the global competition. They can be used as a protective and sometimes even protectionist weapon. But the quality of regulation can also become an asset serving the strategy of a financial centre. This is a major field of competition between the EU and the US, and at present, international discussions are organised around the regulation drafted by these two regions.

One might wonder why and how alternative models to regulation, such as codes of conduct or self-regulation developed at all. For me, the explanation lies firstly in the complexity of technological developments and innovations. At some point, the legislator no longer had the necessary level of expertise required to impose rules on new developments and therefore gave way to professionals who necessarily had vested interests in the norms they produced. It is, to some extent, the credit rating agencies' conflict of interest, between an advisory function and a rating activity, transposed at a more global level. By giving up on his normative role in order to promote industry friendly regulation by private actors, the legislator also abandoned his role of promoter of the general interest; this led to an effective privatisation of regulation and a complacency vis-à-vis the development of tax havens.

A second set of explanations regarding the emergence of alternative means of regulation is that the public authority was lagging behind the economic actors' global development. This is strikingly true in the whole debate around supervision. We are faced with cross-border, multinational conglomerates that no longer fit into the traditional categories of national and sector regulation. Their activities don't fall within the remit of one single entity with the power and the means to monitor them. This raises a double set of questions: how to regulate and supervise such actors so that the totality of their activities is covered, and to what extent does this imply transfers of sovereignty? Are governments ready to give up some sovereignty for the sake of efficient supervision and regulation and what do they ask in return for this transfer of sovereignty?

In the turbulent times we are going through, some governments pretend to take action by resorting to protectionist tools. But these are an illusion because the crisis is global and because for one country's economy to start exporting again, its neighbour's internal market must also be in recovery. In a situation where the public opinion remains focused on domestic debates and politicians see the remit of their actions and of their careers only in the national arena, this kind of reflex can easily be understood. But it doesn't provide us with efficient and sustainable answers. It is up to us as socialists to take the risk of long term and global initiatives. After all, internationalism has always been one of our founding principles and therefore we should be the ones to gear our actions to this end, remembering at the same time that we can never give up the short-term issues on which people expect us to deliver.

In doing so, I believe that three aspects need to be taken into account in elaborating a new means of regulation:

The first element is that there ought to be a new balance between actors. All stake-holders have to be taken into account when rules are drafted. Rules can't rely on the expertise of the industry itself, but must reflect the concerns of consumers, users, employees alike. Taking the interests of all stakeholders into account is the only guarantee that a long-term dimension of action will be considered and that we put an end to short-term visions and behaviours.

Secondly, there needs to be a global, supranational authority in charge of the implementation of global financial regulation. It can't be that norms are negotiated in international forums and that afterwards only some of the participants apply them. This undermines the authority of the principles and standards that have been drafted. Upholding multi-speed regulations and regulatory loopholes creates an unlevel playing field and fragilizes the entire system.

Beyond the question of how to draw up regulations, it is crucial to ensure that they are implemented and respected.

The example of accounting standards:

The dilemmas and challenges posed by the attempts at global rule-setting are perfectly illustrated by the example of international accounting standards (IFRS). This topic is not known by the wider public because it wrongly seems to refer to a rather technical and complex topic. But in reality, accounting standards have the primary task of promoting transparency in financial reporting and the development and effective functioning of capital markets, the guarantee of avoiding pro-cyclicality and insuring financial market stability as well as preventing systemic risk.

Around the 70's, there was an awareness at the European level that companies active on the (not yet finalised) single market needed to present their accounts in a standard format. The difficulty of this task was two-fold: harmonising national practices and finding an answer to the lack of standards that would have the capacity to reflect the complexity of the operations that were involved. The existing national accounting standards were not able to address this issue. At the time, some argued in favour of taking over the British or even the American standards. But instead of copy-pasting them, Europe made a daring move and decided to overcome its internal diversity and contradictions by enabling the drafting of international accounting standards. This was very attractive at the time as it was already clear that the future horizon of activity would be global. To a certain extent, this can be seen as the precursor to globalisation. From the start the United States developed an interest in this strategy and took an active part in the setup of the institutional framework in charge of drafting those new standards, notably around the concept of fair value. Some of these institutions were even based in New York.

As financial reporting involves highly public decision-making powers that have a major impact on many other areas of financial and even tax law, democratic legitimacy must ensure that the interests of all those affected are suitably represented and balanced in a transparent procedure using fair rules.

On the European side however, the Commission appeared to lack the human resources and expertise to take the lead in this process and therefore left it up to sector professionals. This means that no public authority defined the European interest in the process to ensure that the concerns of all stakeholders were taken into consideration. Moreover, the budget of these private normative institutions was funded by the private sector, which even further deprives the public authorities of power, influence and control. This is the first example of self-regulation in global capitalism. Whereas in other areas the Commission did take the initiative of drafting the rules that the EU needed even at times exporting them to the rest of the world, here, in the specific case of accounting standards, this activity was outsourced to a private body. The EU decision to oblige publicly traded EU companies to use international accounting standards from 2005 onwards significantly changed the context for the IASCF/IASB, which became a quasi law-maker, at least for the EU, because on the other side of the Atlantic, the US authorities took the view that IFRS, even though actively co-drafted by them, are not compatible with their own norms, the US GAAP (Generally Agreed Accounting Principles) and therefore refused to apply them.

Two lessons can be drawn from this case study. The first one is a positive one, because it shows where the power of the EU lies today. Indeed, since the generalisation of IFRS, the industry has called for endorsement of the IFRS in the US.

The second lesson to be drawn is less positive and sheds light on how we can improve in future. The lack of involvement on the part of public authorities in this whole process of drafting international accounting standards explains the current debates about the governance and the accountability of the IASB (International Accounting Standards Board), their integration in the global framework of financial governance and how to organise the European representation in its realm. Progress is finally under way, as the European Commission, after many calls from the European Parliament, is now proposing to partly fund the international institutions that draft these standards which would increase its oversight over these institutions and their work. But this is only a first step and the whole issue of international accounting standards should be discussed on a political level in the framework of the G20 negotiations that will, hopefully, deliver profound changes in the international financial architecture.

A further example can be found in the case of credit rating agencies. Rating agencies perform a public role. Their task is to enlighten the markets. The ongoing financial turmoil has highlighted several concerns about rating agencies that the European Parliament has already voiced[7]: conflict of interest, governance, reliability of ratings and rating of complex financial products. Transparency and understanding of underlying risks, in particular of complex financial products, need to be considerably enhanced. These concerns have been known for a long time and to avoid an unwelcome intrusion from legislators, the industry agreed on the introduction of a voluntary code of conduct in December 2004 under the auspices of the International Organisation of Securities Commissions (IOSCO). But the crisis has proven this code of conduct to be as ineffective as past ones.

In the end, the European Commission, which had been rather reluctant to address the issues that the European Parliament pointed out five years ago, put a proposal on the table to address them[8]. The 3 big credit rating agencies that benefit from a quasi monopoly in their field deploy a lot of lobbying efforts to minimise the effects of this legislation and argue that a global activity like theirs can't be regulated locally. I strongly reject this argument and hope that the EU will put enough pressure on the G20 to deliver concrete results in terms of the regulation of credit rating agencies. It will be even more legitimate to do so if it manages to reach an agreement over the Commission's proposal beforehand. All this will take political voluntarism, a willingness to take action and a sense of responsibility that are mandated by the dramatic nature of the crisis. Moreover, the argument put forward by the industry, namely that ratings once issued are global by nature, only reinforces my strong conviction that such global goods or services have to be regulated very carefully.

The last point I wish to mention regarding credit rating agencies is the following one: beyond the huge responsibility they bear in the organisation and the functioning of markets, they also exert an abnormal influence on public authorities when rating sovereign debt. How can it be that private institutions that are sharing a market through a quasi monopoly and whose methodology and conflict of interests are largely questioned can put governments under pressure and influence structural reforms by threatening to downgrade the rating of their debt?

One solution to this problem that is largely debated today on the EU level is the common issuance of debt, so-called euro-bonds. This would be an interesting solution that I call for, but it doesn't solve the principle problem of private institutions exerting a lucrative activity that puts democratically elected governments under pressure.

In these times when anything is possible, we as progressives should be bold enough to say that this system can't be right and that it doesn't serve the general interest of the people. We should call for an overhaul of public debt ratings so that it is put in the hands of public authorities such as a national and/or the European Court of Auditors.

Because the market has set the wrong incentives, another area where socialists should take the lead and call for global or at least European regulation is in

[7] cp. Resolution on the role and methods of rating agencies, 10 Feb.2004 (2003/2081(INI))

[8] cp. speech by Charie McCreevy, 7 February 2008: "Crisis or no crisis - Lessons for financial markets and regulators"

the area of remunerations. I believe that market discipline and financial institutions' corporate governance and incentive models (compensation) need to be revamped. Their short-termism has been a strong fuel for the entire system. Financial institutions should disclose their remuneration policy, in particular the remuneration and compensation packages of directors. Furthermore, disclosure and transparency should be combined with a requirement for supervisors to look into the remuneration packages of financial institutions, and if necessary require the supervisors to act. In their assessment of risk management, prudent supervisors should take into account the influence of remuneration, bonus schemes and taxation to ensure that they contain balanced incentives and do not encourage extreme risk-taking. Today we are told that this is not possible because of competition concerns. I agree that setting such rules on company or even national levels would distort competition and push top-executives to look for better conditions in other companies or abroad. That's why I'm convinced that for this purpose guidelines should be designed at the European level. Here again, this should serve as a baseline for negotiation at the global level.

It is my strong belief that the crisis we are witnessing can't be solved by conventional tools. It is not a cyclical crisis, but a systemic one. A qualitative change is needed and I am convinced that we as socialists have the right grid of analysis and tools to offer. The principles guiding our actions are that public authorities need to take back the lead in global standard-setting, that Parliaments can ensure that the executive takes this role seriously, and that Europe can be a motor in this process.

iv. Finance, Crisis, and the Real Economy

***By Prabhat Patnaik* [9]**

The crisis that is currently afflicting the capitalist world economy is commonly seen as an aberration. This aberration, it is argued, became possible because of the lack of adequate regulatory mechanisms with regard to the financial sector. The crisis could have been avoided with impunity if only sufficient safeguards, such as supervision and regulation of the financial sector, had been put in place. It represents an avoidable "system failure".

My purpose here is to argue that the current financial crisis represents *not a failure of the system but the system itself*, that it is the result of the *modus operandi* of contemporary capitalism rather than being unrelated or extraneous to it. The view that such crises are part of the *modus operandi* of modern capitalism is not some idiosyncrasy on my part; on the contrary it was central to Keynes' analysis. And accordingly, those who argue that the crisis constitutes an aberration or a system failure, even though many of them advocate Keynesian remedies to get out of it in the present circumstances, are being at best "contingent Keynesians". There is nothing wrong with being a "contingent Keynesian". This fact should be noted; as should the fact that Keynes' deep insights into the capitalist system have not yet been fully utilized in order to comprehend the current crisis.

Having developed his short-period theory of employment, Keynes sought in *The General Theory* to insert it into a theory of the trade cycle, and in doing so he observed an important characteristic of the cycle. He wrote: "There is, however, another characteristic of what we call the Trade Cycle which our explanation must cover if it is to be adequate; namely, the phenomenon of the *crisis*- the substitution of a downward tendency in favour of an upward tendency is often sudden and violent, whereas there is, as a rule, no such sharp turning point when an upward tendency is substituted by a downward one" (1949, 314)[10]. He saw the crisis as being endemic to the system, not an aberration in its functioning; as one of its essential characteristics as opposed to a symptom of its failure. He attributed the crisis to a sudden collapse in the marginal efficiency of capital, which in turn was related to the phenomenon of speculation.

He defined "speculation" as distinct from "enterprise" as follows: "If I may appropriate the term *speculation* for the activity of forecasting the psychology of the market, and the term *enterprise* for the activity of forecasting the prospective yield of assets over their whole life, it is by no means always the case that speculation predominates over enterprise. As the organization of investment markets improves, the risk of the predominance of speculation does, however, increase" (1949, 158). Speculators in short are concerned, according to him, "not with what an investment is really worth to a man who buys it 'for keeps', but what the market will value it at, under the influence of mass psychology, three months or a year hence" (1949, 155).

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[10] All quotations from Keynes are taken from the 1949 edition of *The General Theory of Employment, Interest and Money*, Macmillan, London. The page numbers are given in brackets.

Now, monetarist writers, whose views have come to dominate the economics profession in the period of neo-liberalism, see speculation as price-stabilizing in asset markets, and hence as an altogether benign phenomenon. And, precisely because it is a benign phenomenon, it has little *analytical* significance for explaining booms and crises. Speculation according to Keynes however did not give rise to asset-market stabilization but to bouts of euphoria or “speculative excitement” as he called it. And he was right; speculation in real life is far from being asset-price-stabilizing.

This is obvious from two recent examples. Oil prices which rose to an incredible $140 per barrel in early 2008, had crashed to as low as $35 per barrel within less than a year. Likewise the stock markets in “Emerging Market Economies” have moved within the space of a few months in the most volatile manner. In India for example, the stock-exchange price index, the Sensex, which was escalating by almost a thousand points a week to reach 21000 just a few months ago, has now crashed to less than 9000. Neither the earlier escalation nor the current collapse can be explained by any non-speculative factors, i.e. by any hypothesis that holds speculation to be price-stabilizing. The same is true about the incredible rise and fall in oil prices.

Speculation generates bouts of euphoria or “speculative excitement” which have the effect of pushing up asset prices in a cumulative manner. An initial rise in some asset prices, no matter what the cause, gives rise to expectations of a further rise, and hence to an increase in the demand for the assets in question which actually contributes to raising their prices further; therefore, the process feeds upon itself and we have asset price “bubbles”. Such “bubbles” typically characterize financial assets, which have low carrying costs and hence are more prone to speculation; but they are not confined to financial assets alone (as the housing market “bubble” in the United States has demonstrated).

Such “bubbles” have an obvious impact on the real economy. The rise in asset prices fed by speculative euphoria improves, for the individuals who own these assets, the estimation of the position of their wealth, and hence causes an increase in their consumption expenditure, and as a consequence an increase in employment. Likewise such a rise in asset prices, where the assets in question are producible, causes an increase in investment expenditure on those assets, which leads to their larger production, and hence to more employment. In short, speculative euphoria in the asset markets leads to a situation where the boom of the real economy, stimulated by whatever had caused the initial rise in asset prices, becomes more pronounced/prolonged. Or, putting it differently, speculation acts as a “super multiplier” (to use a term coined by the English economist John Hicks) or “compound multiplier” (as Polish economist Oskar Lange put it) upon the real economy. *Speculation itself does not engender the boom*; but it contributes to a prolongation of the boom by the euphoria it generates.

However, if for some reason the asset price increase wanes or comes to a halt, speculators attempt to sell off the assets in question causing a crash in the asset prices. This causes a reduction in consumption expenditure (because of the wealth effect), a collapse in the inducement to invest (since the price of the capital asset falls below its cost of production); a collapse in the state of credit, as banks face insolvency; and even a possible collapse in the inclination of depositors for holding bank deposits, which was the case during the Great Depression. In short, there is no longer any confidence in holding claims upon others, and hence a corresponding increase in liquidity preference; i.e. there is a disinclination to hold any asset other than pure cash. Not all crises display this severity; but to a greater or lesser extent these features mark any crisis.

Speculation therefore has the effect of making the boom more pronounced and/or prolonged; but it also has the effect of precipitating a crisis as distinct from a mere cyclical downturn. In the absence of speculation the boom in the real economy will be a much more truncated and tame affair. But precisely, because it is not a tame affair it is followed by a *crisis.*

Two conclusions can be drawn from the above analysis based on Keynes. First, since speculation is endemic to modern "free market" capitalism, where financial markets play a major role, speculation-engendered euphoria and the consequent pronounced booms, together with crises, in the sense that Keynes had defined them, are also endemic to modern capitalism. "Bubbles" constitute in other words the *modus operandi* of the system. Secondly, if "Bubbles" must be eliminated and speculation curbed, then it is not enough to put in place some regulatory mechanisms; *an alternative instrument for generating pronounced booms in the real economy has to be found;* otherwise, the economy would remain more or less perennially sunk in stagnation and mass unemployment.

The contrast between Keynes and Dennis Robertson, a well-known Cambridge economist who was a younger contemporary of his, on this question is instructive. Robertson had argued that to eliminate the trade cycle, and hence by implication the rigors of the crisis, monetary policy should aim at increasing the rate of interest to truncate the boom deliberately; that is, whenever employment rose above the average level of the past decade or so, monetary policy should deliberately aim at preventing such an increase; and likewise whenever employment threatened to fall below this average level, monetary policy should be used to counter such a fall. Robertson thought that full employment was an "impractical ideal", but monetary policy of this sort, while stabilizing employment at some level less than full employment, might well do so at an average that was higher than what would actually be obtained on average if the trade cycle ran its full course. Keynes was sceptical about this last proposition, and indeed thought that the opposite was more likely. But, above all, he felt that such an outlook was "dangerously and unnecessarily defeatist. It recommends, or at least assumes, for permanent acceptance too much that is defective in our existing economic scheme" (1949, 327).

Instead, what he suggested was that government policy should aim to achieve full employment; his suggestion was that when "disillusion" came, and with it the "error of pessimism" that threatened a collapse of the boom, monetary policy should aim at lowering the rate of interest to keep the boom going. "Thus the remedy for the boom", he wrote, "is not a higher rate of interest but a lower rate of interest! For that may enable the so-called boom to last. The right remedy for the trade cycle is not to be found in abolishing booms and keeping us permanently in a semi-slump; but in abolishing slumps and thus keeping us permanently in a quasi-boom" (1949, 322). But, above all, taking the economy close to full employment and keeping it there was not a task exclusively of monetary policy; fiscal policy had to be used in addition, with the State playing a pro-active role in demand management. Keynes in short wanted the regime of "bubbles-led growth" such as characterized so-called "free market capitalism" in the era of finance to be replaced by a regime of State-led growth or fiscally-stimulated and fiscally-sustained growth[11].

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[11] In drawing this contrast I do not mean that the "bubbles" are not themselves fiscally-aided. The dotcom and the housing bubbles in the U.S. for instance were aided by significant tax concessions by the government. But there is a difference between fiscal aid for a "bubble" and fiscally-sustained growth, which typically involves the erection of a regime that tries to restrict the formation of bubbles through regulatory measures.

The fact that finance capital would oppose such State intervention in demand management, or what he called the "socialization of investment", was anticipated by Keynes, hence his remark about the need for the "euthanasia of the rentier". After all, when Lloyd George, who had been the British Prime Minister during the first world war, had put forward a proposal on Keynes' advice in 1929 for public works financed by government borrowing to mitigate unemployment, which was already quite high by then in Britain, the British Treasury, under the influence of the financial interests represented by the City of London, had come out in opposition to it. This "Treasury View", which upheld that any such borrowing-financed public works project would "crowd out" private investment, to use a contemporary phrase, had called forth, by way of intellectual rebuttal, an article by Keynes' pupil Richard Kahn in the *Economic Journal* in 1931, which can be considered the first salvo of the "Keynesian Revolution". Keynes was thus familiar with the opposition of the financial interests to his proposals.

Keynesian "demand management" managed to overcome this opposition and gain currency only in the post-war period, when there was a changed correlation of class forces all over the world, with finance capital in retreat and with working class movements, whether expressed through Communist or Social Democratic movements, in the ascendancy. This conjuncture however, even though it lasted for well over two decades, finally had to change. Finance capital, strengthened over time, even during the period of Keynesian demand management, by what Marx had called the process of "centralization of capital", eventually acquired the nature of *international finance capital*, through a process of "globalization of finance". As a consequence, the incompatibility between the caprices of finance capital and State intervention in demand management became insurmountable. With "globalization", the caprices of such *international finance capital* necessarily had to triumph over whatever autonomous predilections the *nation-State* had, otherwise, there would have been capital flight from the economy in question; and this led to the demise of Keynesianism.

But let us leave aside for a moment this changing historical conjuncture. The important analytical point that emerges from Keynes' writing is that in the absence of State intervention in demand management through the use of fiscal means, the process of growth under capitalism is bound up with the existence of "bubbles". Bouts of speculative excitement followed by "disillusion" and "errors of pessimism" are the hallmark of capitalist dynamics. *Hence periods in capitalism which are not characterized by Keynesian demand management, which means both the pre-war years and the post-"Keynesian" years of neo-liberal policies under "globalization", would necessarily be characterized by "bubbles-sustained growth", in which case "crises" cannot be seen as constituting "aberrations" or "system failure" but must be seen as the system itself.*

Not to do so amounts to analyzing the neo-liberal epoch as if it were still characterized by pro-active Keynesian State intervention; it is to miss the distinction between the "Keynesian" and "neo-liberal" periods of post-war capitalism. In the Keynesian period, a financial crisis of the current sort would indeed have been an aberration; and it is not surprising that the first major financial crisis to hit the capitalist world occurred only in 1973 (i.e. after the "Keynesian" era had ended, with the introduction *inter alia* of free financial inflows among major capitalist countries). But under the "neo-liberal" dispensation it is the rule, exactly as Keynes had argued.

It follows that in the United States in the recent past if "sub-prime" loans had not been given, or if financial "oversight" had led to brakes on lending, or if the rate of interest had not been lowered, then the boom would have come to an end much sooner than it did, and unemployment would have increased much earlier. True, the crisis would not have been as severe or sharp as it has turned out to be, but the price paid for a possibly less severe crisis would have been a less pronounced or sooner truncated boom. After all, Alan Greenspan was doing exactly what Keynes had suggested, namely to keep the boom going by lowering the interest rate, so that either the old "bubble" continued or some new "bubble" was generated that would take the place of the bursting old one. The fact that the "housing bubble" that was stimulated by the decline in the interest rate enforced by Greenspan kept the boom going even after the "dotcom bubble" had collapsed only vindicated Greenspan's position.

Of course any prolongation of the boom in this manner brings with it the danger of a more severe crisis attending its collapse, but then the real panacea for it is not the truncation of the boom but its sustenance through other means, in particular fiscal means. In short, it is not enough to say that "sub-prime lending should have been avoided" or that "the interest rate should not have been steadily lowered" or that "financial regulation should have been tighter". All these statements have to be accompanied by some alternative suggestions for prolonging the boom; and these would necessarily have to focus on fiscal effort, exactly the way that fiscal effort is being emphasized now as the way out of the crisis by the "contingent Keynesians". To what extent, and under what other concomitant conditions, the U.S. would have been able to substitute fiscal effort for financial laxity as the means of sustaining the boom, especially in view of the "leakage" abroad of the impact of any fiscal stimulus because of its large import propensity, is a matter that need not concern us here. But the point is that, since financial laxity played a role in sustaining the boom, merely debunking it as the cause of the crisis is inadequate[12].

Putting it differently, since the so-called "system failure" could not have been avoided with impunity; it is misleading to call it a "system failure". Rather it is the system itself which was at the root of the trouble. The "system" itself could of course have been replaced by an alternative "system", State-led as opposed to "bubbles"-led growth. But that would have meant going back to the era of Keynesian demand management, which the advanced capitalist countries, pursuing neo-liberal policies, including the policy of "sound finance"[13], under pressure from international finance capital, had already abandoned.

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[12] This should not be taken to mean that fiscally-sustained booms, which overcome the syndrome of bubbles and the bursting of bubbles, can for that reason last forever. They obviously cannot, but what constitutes the limit to such booms is a matter that need not detain us here. One possible limit is the emergence of supply constraints, especially when the possibility of obtaining primary commodities *gratis* from the colonies via what economic historians have called the "drain of surplus" through taxation is no longer available; such supply constraints can result in extremely high rates of inflation in the presence of speculation. The last section of this paper discusses such speculation-engendered inflation. To prevent such speculation a "Keynesian demand management regime" must ensure social control over the financial sector. In other words, "socialization of investment" requires as a necessary complement "social control over the financial sector". Even if this is assured, a fiscally-sustained boom will still not last for ever because of class reasons, such as class conflict over distributive shares, and the undermining of the discipline that capital imposes on labour. See M.Kalecki, "Some Political Aspects of Full Employment" in *Selected Essays on the Dynamics of the capitalist Economy*, Cambridge, 1971; R.E.Rowthorn, "Conflict, Inflation and Money", *Cambridge Journal of Economics*, 1970; and P.Patnaik, *Accumulation and Stability Under Capitalism*, Clarendon Press, Oxford, 1997.

[13] The U.S., being the leading capitalist power whose currency is still considered "as good as gold" by the world's wealth-holders, is not obliged to follow policies of "sound finance", since capital flight will scarcely occur from the U.S. Indeed the U.S. has often run up substantial fiscal deficits even when the other capitalist countries were being obliged to restrict their fiscal deficits. But even in the U.S. there is a perennial pressure for fiscal "prudence" in the contemporary period.

To argue the "system failure" or "aberration" thesis presupposes that the "aberration" did not contribute anything positive to the real economy; that in its absence the system would have performed almost equally well. In short, it amounts to saying that the system itself can perform adequately without these "aberrations" and hence also avoid crises, but these "aberrations" *gratuitously superimposed upon the system because of lack of "oversight" and lack of regulation*, even while not contributing anything positive to the functioning of the system, contribute towards a "system failure" and a resulting crisis. It also suggests that Keynesian measures are needed only because of this "system failure", since once the crisis has hit the system the normal monetary policy instruments cease to work; but in the absence of such "system failure" these normal monetary policy measures are quite adequate for the system.

Paul Krugman, currently a strong advocate of a Keynesian fiscal stimulus, is quite explicit on this. He argues for instance that the "Treasury View", which held that a fiscal deficit "crowded out" private investment and which Kahn had criticized in his famous1931 article, "makes good sense" in normal times. His argument is not of the *simpliste* kind which holds that the interest rate equilibrates the demand for and supply of "savings", or of "loanable funds" or some other flow variable, and that a fiscal deficit, by increasing the demand for such a flow variable, "crowds out" private investment. On the contrary he sees the interest rate as being determined by monetary policy. But he argues that even in the case of an accommodative monetary policy, i.e. even if the short-term rate of interest, which is fixed by the monetary authorities, is kept unchanged, the long-term interest rate will nonetheless rise in the event of larger government borrowing. This is because the long-term interest rate is determined by the expected average of short-term rates, and people *expect the short-term rate to be jacked up* in the wake of the fiscal deficit's increasing the level of activity.

Since this is supposed to happen in "normal" circumstances, let us now focus exclusively on "normal" circumstances. In such circumstances, people will expect the short-term interest rate to be raised only if *there is no full "crowding out"*, i.e. only if the level of activity increases in the wake of the fiscal deficit. But in such a case the total magnitude of profits, and hence the rate of profit, will also increase which will push the marginal efficiency of capital schedule outwards. If this happens then despite people expecting the short-term interest rate to rise in the future, there will be no reason why there will be any crowding out at all. In other words, if we assume full "crowding out" then there is no reason why the interest rate should at all be expected to rise and hence for any crowding out to occur at all, which invalidates our assumption; on the other hand, if we assume partial "crowding out" then the rate of profit must increase which implies that even if the rate of interest is expected to increase there need be no crowding out at all. Thus whichever way we look at it, the argument is flawed, and reflects the discomfort of contemporary economists, even radical ones, with Keynesianism. Krugman argues for a Keynesian fiscal stimulus in the current situation, because he contends that, the advanced capitalist economies are in a "liquidity trap" where there is no expectation of a rise in the interest rate in the foreseeable future, and hence no question of any "crowding out". But since private spending is not sufficiently forthcoming, a fiscal stimulus is essential.

This illustrates what I call "contingent Keynesianism", that in "normal" times we do not need Keynesian fiscal stimulus because the economy performs adequately without it. But only when an "aberration" occurs, of the sort we currently have, a Keynesian fiscal stimulus becomes necessary. But this distinction between "normal times" and periods of "crisis" resulting from "aberrations" is itself invalid. If in "normal" times fiscal stimuli are avoided because they supposedly "crowd out" private investment, then such "normal times" must be characterized by "bubbles-led growth", as Keynes had suggested, in which case the "crisis" must be seen as being embedded in such "normal times".

The "contingent Keynesian" argument restricts the application of Keynesianism to crisis periods alone (this is reminiscent of the Austrian economist Joseph Schumpeter's concession to Keynesianism that it could be legitimately considered only as the economics of the "depression" period) when "sound finance" has to be abandoned because monetary policy ceases to work as the economy is caught in a "liquidity trap".

A word on the concept of the "liquidity trap" may not be amiss here, since it is commonly misunderstood. The usual interpretation of the concept, namely that at a certain interest rate the demand for money becomes infinitely elastic because bond prices are so high that everyone becomes a "bear", is meaningless: if people still hold bonds at this interest rate, the question arises: why do they do so? And if they do not hold any bonds, i.e. all bonds are held by banks; in this case the idea of an infinitely elastic demand for money loses all meaning. The "liquidity trap" cannot be reflective of a state of equilibrium in wealth-holding decision, as the liquidity preference schedule is. Any point on this schedule shows the demand for money at a certain interest rate on the presumption that this demand is the aggregation of individual demands *if every individual reaches equilibrium with regard to the form in which he or she holds his wealth at this interest rate*. But this cannot be said of the "liquidity trap". The "liquidity trap" is not reflective of a situation where every individual is in equilibrium with regard to his or her form of wealth-holding at the corresponding interest rate. The "liquidity trap" therefore can never be considered a part of the liquidity preference schedule, as is usually depicted in textbook diagrams.

It can only be considered as a state of affairs arising in the context of a dynamic disequilibrium where, at the prevailing interest rate, people prefer holding money to holding bonds, but are content to hold their existing portfolios even if these are not optimal from their points of view. It is in other words a situation where the *ex ante* demand for money at the prevailing interest rate is higher than the *ex post* holding of money *for all economic agents, including banks,* but this fact does not alter the interest rate because agents are content to let this divergence persist.

This situation of "excessive" liquidity preference typically is supposed to be unrelated to the state of the marginal efficiency of capital schedule, and the "liquidity trap rate of interest" is simply supposed to generate, given the state of the marginal efficiency of capital schedule, an amount of private investment that is way below what full employment, or even an adequate level of employment, warrants. But this understanding is erroneous. Liquidity preference and the state of the marginal efficiency of capital schedule are themselves not unrelated, the desire to hold money being simply the obverse of the collapse of the marginal efficiency of capital schedule.

This fact is missed by many writers who hold the *existence of an independently given "liquidity trap" as the main reason why the self-equilibrating nature of the labour market may break down*, i.e. why a crisis of persisting unemployment may arise. (Here we are talking about general perspectives and not specific explanations of the particular crisis of the present). *The liquidity trap however, is not the cause of the crisis, in which case since the occurrence of such a weird phenomenon of excessive liquidity preference can be assumed to be rather rare, the crisis itself would be rather rare.* It is on the contrary a result of the crisis, or more accurately a reflection of the crisis which as we saw earlier is endemic to the system and is marked by a collapse of the marginal efficiency of capital.

Much of the monetarist critique of Keynesianism is based upon this misinterpretation of the "liquidity trap" as being the cause of the crisis, the "fly in the ointment" that alone can prevent the smooth self-adjustment of markets including the labour market. As long as the liquidity preference schedule is downward sloping and the interest rate can be pushed down with an increase in money supply in wage units (i.e. relative to the money wage), a money wage cut will always raise employment exactly as orthodox theory predicts. Only in a liquidity trap, however, things will be different. And if a liquidity trap represents such an extreme case that it is more curious than anything else, then all is well with orthodox theory.

But this interpretation both of the "liquidity trap" and of Keynesianism is wrong. Once we see Keynes' theory in the context of a cyclical process where the cycles are associated with the building up and bursting of speculative bubbles, then clearly "excessive" liquidity preference, characteristic of the crisis, or the bursting of the bubble, becomes a real life phenomenon. And when there is this excessive liquidity preference, captured in the concept of the "liquidity trap" neither monetary policy, nor any money wage cut can eliminate unemployment. The self-equilibrating market disappears into thin air.

To be fair, the "contingent Keynesian" position perhaps sees the situation of "excessive" liquidity preference in this manner; but it attributes its emergence to aberrations rather than the very functioning of the market system in the context of speculation. But precisely because it is "*contingent* Keynesianism" its belief that the "normal" functioning of the market is smooth, weakens its own case vis-à-vis the orthodoxy. The fact that the idea of a coordinated fiscal stimulus by a group of advanced countries, which was an idea put forward by Keynes during the Great Depression (the same idea had been put forward by many others including several German Trade Unionists) and which was revived recently during the G-20 meeting, has been pushed into the background of late, is the result of pressure from international finance capital, and has therefore to do with material interests rather than with intellectual reasons. But the intellectual diffidence of "contingent Keynesianism", which concedes to orthodoxy theory that its analysis is valid in "normal times", certainly does not help its cause.

So far, I have discussed only one aspect of speculation as it affects growth under contemporary capitalism. Let me now move on to another aspect. The boom creates inflationary pressures in critical primary commodities like oil. In the case of agricultural primary commodities, any inflationary pressures can be kept in check through the imposition of an "income deflation" on third world economies from which many of these agricultural primary commodities originate, and where there is much absorption of all such commodities[14]. But in the case of oil, where the major producers are organized into a cartel, the question of imposing such income deflation simply does not arise. In the case of oil, and hence of such other commodities whose prices move in a manner complementary to oil, such as food-grains in the recent period because of the diversion of grains towards bio-fuels, the capitalist boom is associated with inflationary pressures which are aggravated by speculation. Even in the case of agricultural commodities, whose prices are not directly linked to the price of oil, speculation may still lead to substantial increases in their prices, notwithstanding the income deflation imposed on third world countries through the "neo-liberal" policies associated with globalization.

In short, if in the boom speculation operates on prices of assets, especially financial assets which keep the boom going, it also operates on the prices of commodities, which threaten the boom and which in any case bring great hardships, even during the boom, to the ultimate users of such commodities. (The benefits of such

[14] For an explanation of the concept of "income deflation" and an elaboration of this argument, see P.Patnaik, "The Accumulation Process in the Period of Globalization", www.netwrokideas.org

speculative price rises of commodities scarcely accrue to the direct producers of such commodities, who, in general, are peasants and petty producers). It follows, that even if the world economy gets out of the current crisis of recession, that fact will only reopen the prospects of commodity price inflation. The recession caused by speculation is bad enough; but the inflation caused by speculation that follows in the wake of the world economy moving out of the recession will be scarcely better.

Speculation in the area of international finance capital in short pushes capitalism into a crisis of a profound sort, where the “crisis” as Keynes saw it is embedded within an even deeper crisis, whose hallmark consists in the fact that overcoming the crisis of recession will almost immediately, or within a fairly short period, push the economy into commodity price inflation, especially oil price-inflation, which will have serious consequences for food-grain prices hence for mass hunger. The system’s space for operation shrinks drastically because of speculation in contemporary capitalism

v. From Global Financial Crisis to World Economic Crisis

By Francisco Rodríguez Ortiz[15]

1. Introduction: from financial crisis to the risk of wage deflation

The 21st century started with favourable omens for developed capitalist countries. The organised labour movement was weakened and divided. Emerging economies were poised to take-off. The US was consolidating its financial, economic and military primacy. The European Union, lacking international political relevance, pursued its enlargement and culminated its path to integration with the introduction of a common currency, the Euro. Markets were in the midst of a strong drive for deregulation. Globalisation, increasingly driven by international finance, accorded the leading role to markets regulating themselves but only a secondary one to government intervention.

However, the financial factor, which had taken the lead in shaping up the new economic order, was to become the triggering factor for the biggest crisis to shake capitalism since the Thirties. Financial crises are nothing new, but they tend to be more frequent and severe since the economy has become increasingly virtual and finance took on a life of its own away from the real economy. The current process of accumulation is no longer reliant on modernising production processes and social institutions, such as was the case under the Ford system. The markets tend to behave anarchically in the grasp of international finance which has been moving away from the real economy as the value of the whole array of financial instruments exceeds by far that of the underlying real assets on which they are based.

Financial crises have become recurrent since the 90's. For instance, the Asian Crisis was a dark foreboding of how deep financial crisis can grow in a global system which is so little regulated and as opaque as the present one.

As remarked by Stiglitz[16], when short-term capital markets are liberalised prematurely, before the development of adequate supervisory bodies, they prompt banks to grant an exceedingly large amount of credit without due risk assessment, increasing the likelihood of financial crises and economic downturns. Financial crises have become inherent to the system. This situation should have paved the way for greater intervention by public authorities to help prevent and avert their spreading. Nowadays a financial crisis brought about by the excessive indebtedness or leveraging of credit institutions, companies and consumers, is coupled with a "classic" crisis which finds its roots in the necessary shedding of debt, the vanishing of the "wealth factor" linked to the plunge in the prices of movable and immovable assets, the retrenchment of investments, the deterioration of the labour market, tighter wage restrictions and morose consumption. These phenomena may only be partially offset by a drop in interest rates

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[16] Stiglitz, Joseph: "La reforma de la arquitectura económica mundial: lecciones derivadas de las últimas crisis", *Ekonomiaz*, number 48, Vitoria 2008. taken from *Journal of Finance*, Volume 55,p.1508-1521, 2000.

and bigger budget and fiscal stimuli. The real economy was bound to fall into the trap created by globalised finances and, with a fallback effect at play, the financial sector is now in turn stricken by the adverse effects of the economic downturn.

The current crisis shows another unique feature: not only is it global, having spread from the real estate to the credit sector and from there to all the economic sectors, but also because unlike the 1998 Asian crisis, its hard core is to be found in the leading capitalist countries, from where it radiates to the periphery. Contrary to the "decoupling" theory, emerging economies will be hard hit by an increasingly systemic crisis mirroring the cracks in the worldwide economic interdependency and the capital appreciation systems.

Global as the crisis may be, the macroeconomic actions undertaken by governments have been lacking in coordination, as shown by the various choices used to manage monetary policy. As for the Euro-zone, not only had it to contend with the adverse fallout from the international crisis, but it also had to absorb the results of a mismatched monetary policy devised for an altogether different reality, plus being hamstrung by the inconsistencies in the Growth and Stability Pact and having to comply with a competition policy which hampers the rebuilding and dynamization of the industrial fabric. Growth and stability are perceived[17] to be paramount "public goods" for the achievement of full employment, economic and social cohesion, environmental protection, etc.

Mistakes in macroeconomic policy and financial markets' regulation have triggered inadequate moves in the real estate and financial markets, all the more so since the risks stemming from a liquidity glut in the world had been underestimated. At a later stage, the various options to get out of the crisis might help in coalescing the forces most hostile to the legacy of the "European social model". In a context of mass unemployment, the alibi of improving competitiveness as the way out of this crisis may well engender a growing challenge to the social gains won by workers in the more developed countries.

As underlined by Aglietta[18], the new competition conditions shift the brunt of the necessary adjustments to the wage earners. These wage restrictions will be all the more acute in the short term and will be explained away as being a requisite for improving the bottom line of businesses, notwithstanding its negative effect on the spending capability of individuals. Our societies, plunged in a deep downturn, are less vocal about income redistribution and are showing a greater tolerance for inequality. And yet, underlying the present economic downturn and financial crisis, there lurk the abuses in the deregulation of labour markets, long taken to embody the very paragon of a rigid market. Developed countries seem to opt for a non- cooperative strategy of competitive wage deflation, although there is a danger that such restrictive wage policies end up fuelling the deflationary trends already underlying the new model of accumulation.

The current crisis challenges the very feasibility of a financial model which is becoming more and more speculative. Employment will shrink, while consumption and investments will dwindle. The credit crisis will buttress the retrenching effects. Housing demand will retract further, and there will be a sharp decline in both their prices and employment figures. All of this will rebound negatively on the financial sector itself.

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[17] Fitoussi, Jean Paul; Le Cacheux, Jacques: *L´état de l´Union européenne 2007,* Fayard/Presses de Sciences Po, Paris 2007.

[18] Aglietta, Michel: Berrebi, Laurent: *Désordres dans le capitalisme mondial,* Odile Jacob, Paris 2007, page 131.

2. *Factors which have triggered the international economic and financial crisis*

2.1. On Greenspan monetary policy and its economic effects
Between 2001 and June 2004 US economic growth was encouraged by the accommodating monetary policy applied by the Federal Reserve. The Federal Reserve deployed a defensive strategy focused around offsetting the impact from the drop in stock exchange earnings through a promotion of the real estate and bond markets. Monetary policy had to furnish the financial system an ample supply of liquidity, stimulate expenditure by individuals and bring down investment costs. The steep drop in interest rates, which became negative in real terms, led to an increase in real estate wealth, which allowed households to offset the drop in value of their financial assets from 2000 to 2002. This appreciation of real estate equity in conjunction with strong job creation encouraged individuals to raise more debt, and later use the rise in the value of their collateral to take on more credit. Financial institutions, too, became increasingly leveraged. The outlook of constant price increases in real estate equity prices heated the market, paving the way to the subprime situation. The strength of the whole structure was underpinned by the assumption that interest rates would not rise and the assets would keep on appreciating. The drop in interest rates led to indiscriminate granting of mortgages, which underwent securitisation, and to the issuing of corporate debt. In an environment with an oversupply of liquidity there was a swollen demand for assets endowed with a high credit rating. In addition to that, many countries were in the midst of budget consolidation processes and the amount of public debt was therefore bound to be scarce. To meet this growing financial demand would result in the creation of the most complex financial engineering. Debt types of various kinds were packaged and marketed. Many products were simply devoid of regulatory frameworks, and the maximisation of earnings led many institutions to take on an excessive amount of debt to be able to purchase those assets. Investment banks, not supervised by the Federal Reserve in their liquidity and solvency ratios, would drive their leverage ratios to unprecedented levels.

"Investment banks, being free of controls, can leverage at a much higher level than commercial banks, thus taking advantage of the high shadow price of financial regulation. In a market with negative interest rates and a two digit growth in real estate assets, the temptation to cobble together instruments which would make it possible to finance real estate credit, and to sell them to investors who were greedy to get high earnings, was huge." [19]

Should monetary policy change course and the real estate market crash, purchasers would default massively and the financial instruments of this market would skydive. Assets would turn illiquid and mistrust would spread through the interbank market. As the credit market shut down, financing problems in the housing market would be exacerbated, with a most deleterious effect in the creditworthiness of the financial market.

Even though the Federal Reserve tightened up monetary policy from June 2004, long rates did not absorb the rise in short rates (oversupply of world liquidity until 2007, credibility of the US financial system, demand for risk free certified long rates claims from loan and savings banks, etc.). This was in part due to the expectation that structural adjustments changes (increased competition in markets, technological

[19] Nadal Belda, Alberto: La crisis financiera de Estados Unidos", *Boletín Económico de ICE*, n. 2953, Madrid, November 2008, page 21.

breakthroughs and productivity gains, massive imports of manufactured products from low cost countries, wage restraint in the face of relocation threats, precariousness in the job market, salary levels no longer linked to inflation, etc.) would make it possible to curb long term inflation. So, it turned out that the new conditions shaping up accumulation made credit policy far more accommodating than what would otherwise have been the case if judged only from the Federal Reserve actions. Nevertheless, the matching of long and short rates continued to be a source of problems.

"The near match of long and short rates continues to pose serious problems. On the one hand, it weakens considerably the banks profit margin and their economic balance (they borrow short and lend long). On the other, it deprives monetary policy of any room for manoeuvre, making further increases extremely dangerous and nullifying its current effects on inflation." [20]

Financial globalisation and an international liquidity glut, due to the US over-indebtedness, made monetary policy transmission channels less effective. As noted by Vladimir Borgy: [21] "however, the most persuasive explanation is a process by which the US excessive indebtedness has led to excessive world liquidity, keeping interest rates at an abnormally low level and fuelling rises in assets prices, in such a way that ultimately it degrades the implementation of US monetary policy"

Greenspan's policy of cheap money and diversified risks would create a real estate bubble in the US which would spread to the world financial markets through the explosive emergence of financial products linked to real estate assets and a boom of the more speculative hedge funds.

2.2 On the companies' financial leverage

The low cost of financing and credit facilities have made it easier for companies to take on increasingly higher levels of debt. They have used debt on a massive scale to raise their profit margin and to distribute generous dividends. This has pushed up the stock quotations of companies which used their shares as collateral to raise new loans. In this way their financial leverage became extraordinarily high since the cost of the debt was below their profitability (ratio between operating results after tax and the sum of equity and debt). But should monetary policy change course, companies and investment funds holding debt at variable rates would be in dire straits. The debt burden would simply be too high in relation to the market value of their assets and the banks' balance sheets would consequently be weakened. As remarked by Michel Aglietta,[22] "creation of worth derives then from a rationale based on making imbalance a permanent goal" . Stock markets would turn upside down and companies would no longer be in a position to release the necessary financial flows to service their debt. Whereas earlier they were eager to pile debt upon themselves, now they wanted to get rid of it. They would then be facing a contradictory restriction in this adverse stage of the financial cycle: they would need to trim their investments and achieve high profit margins to boost equity and soften the blow of financial leveraging. From there would follow greater pressures to tighten up the labour market and bring down wages to be able to reduce unit labour costs.

2.3 Subprime crisis and crisis of the financial system

[20] Le Héron, Edwin: " Alan Greenspan, la stratégie de la confiance", *Alternatives Economiques ,L´Economie Politique,* number 29, Paris, first quarter of 2006, page 38.
[21] Borgy, Vladimir: "L´état de l´économie mondiale", in CEPII:*L´économie mondiale 2006,* La Découverte, 2006, Paris, page 11.
[22] Aglietta, Michel ; Berrebi, Laurent: *Désordres dans le capitalisme mondial*, Odile Jacob, Paris 2007, page 41

The primary core of the crisis is to be found not so much in the growth of mortgage defaults as in the financial edifice built upon real estate mortgages. More worrying than the defaulting of subprime mortgages was the exponential growth of losses for those who, through misuse of financial leveraging, had invested on paper linked to the payment of such mortgages. The system was heading for a fall off the cliff if, with debt-financed leverage levels which could be 50 fold (assets being up to fifty times bigger than capital), the assumption that housing prices could not plunge turned out to be wrong. The model had not taken on board those risks inherent to the primary market (housing). The subprime crisis would have remained in the real estate market had it not been for the generalised securitisation of loans by the banks. Banks spread these complex products among international investors using them to refinance and grant further loans.

The financial crisis dries up the interbank and credit markets. Banks can no longer resell their real estate linked assets. The mark to market value of such assets does not stop shrinking. The banks are in the eye of the storm for several reasons: they have traded directly in the US mortgage market, they have bought claims and have granted loans to customers to finance transactions in the securitisation market. They are being walloped by the problems and bankruptcies of the funds they loaned to, and they sustain losses derived from the explicit or implicit liabilities they had entered into with them. The number of players swept up in the process, through securitisation and leverage, is very high, even without having traded directly on the US mortgage market. The losses have eaten into the banks' capital, and they have responded by cutting back on their credit lines. The “guarantee” which came with an AAA rating turned out to be a deadly trap. Should the banks fail in transferring those loans to institutional investors, they would remain as assets in their balance sheet[23]. This would inhibit their credit capability, all the more so since their ability to grant loans was already curtailed because they had committed large amounts of equity to finance corporate transactions.[24]

José Carlos Diez mentions a “financial decelerator”. The decline in housing prices weakens the ability of households to raise debt. Companies encounter more problems to raise fresh financing, and the situation is compounded by the financial institutions' liquidity problems, leading to a further credit crunch. Impact on employment is devastating. Families, facing a restricted ability to take on new debt, seeing how the wealth factor vanishes, and being more and more anxious and restless about jobs and wages, choose to balance their finances and throttle back their spending. The crisis takes hold of the real economy.

2.4 Liquidity and creditworthiness crisis and the role of central banks

The leading central banks were forced to take massive action to guarantee liquidity in the interbank market: they expanded their open market transactions downgrading the quality of the collateral, and extending payback schedules.

But, whereas the Federal Reserve, having become the leading force in managing the crisis, decided to step up to the hilt the bailing out of investment banks, the ECB, in the

[23] The “investment structured carriers” were created by the banks outside their balance sheets to invest them in long-term assets without drawing them out of their statutory capital stocks. But as huge losses pile on the banks or they go into bankruptcy, their off -balance sheet commitments have bled their financial results and balance sheets because they were bound by contract to grant them hefty credits.

[24] Díez, José Carlos: ”El fin de la Edad Dorada de la economía mundial”, *Política Exterior*, n. 122,Madrid, April 2008

grasp of its inflation phobia and suffering from the effects of the so-called wage second round effects, has kept up far too long its steadfast line on the risks of a inflation spiral. The ECB Governor went on record when he addressed the European Parliament on January 23rd:

"In all circumstances, but even more particularly in demanding times of significant market corrections and turbulences, it is the responsibility of the Central Bank to solidly anchor inflation expectations to avoid additional volatility in already highly volatile markets."

He showed his preference for upholding interest rates and massive injections of liquidity. Even more so, scared by the peak in the HICP, he would make the mistake of raising the intervention rate to 4.25 percent in July 2008, even though he eventually caved in to merciless reality in October 2008. Indeed, the main central banks in the world had to step up interest rates' cuts at the beginning of September 2008. Eventually, the Federal Reserve would set them at 1 percent, and the ECB, departing from its notorious monetary orthodox practice, had to trim them down to 2.5 percent. Yet, it kept on insisting how important it was in such turbulent times to uphold the principle of sustainability of public finance. Such an attitude was tantamount to sarcasm when public authorities were compelled to raise massive amounts of debt to bail out private financial institutions. And, of course, he stressed the urgency of greater efforts to make labour markets more flexible.

Recession is causing a steep decline in the price of raw materials, pushing the major economies of the world to the threshold of deflation, in itself a bigger risk. In view of this, central banks, and especially the Federal Reserve, have chosen to increase their money supply. Having learned the lessons from the Great Depression, they have bailed out the banks, participated in their recapitalisation and guaranteed deposits to avert a money supply crunch which would turn recession into depression. Only in this way might some measure of normality be brought back to the interbank and credit systems.

However, it is doubtful that easing the money supply can help in stimulating spending in a context of unemployment, strong wage restraint, readjustment of former excessive indebtedness and a credit crunch. Interest rates, for all the power they may wield, are hardly the magic wand to all the problems bedevilling today's economy. Investment and expenditure will not pick up unless families, banks and companies have got rid of and written off the excesses they previously indulged in and cut down their debt, and until the situation in the labour and interbank markets is brought back to normal, consumption and investment will not bounce back. It is likely that cutting prime rates will not re-establish the interbank financing flows. If the interest rate cut is not passed on to consumers and businessmen and is used instead to improve banks' balance sheets, the monetary policies will need to be shored up with a budget stimulus package. The central banks' strategy for economic recovery is showing its shortcomings. As remarked by Keynes, "You can lead a horse to water but you cannot make it drink".

3. A systemic crisis and the search for a financial and economic New **Deal**

This global crisis has shown the dangers of over-indebtedness, the instabilities created by distancing financial engineering from productive logic and the shortcomings in the regulation, supervision and risk evaluation. It represents the final outcome of the excesses incurred since the eighties by the liberalisation and deregulation of the markets.

Faced with the enormity of the crisis, the political and monetary authorities had to adopt a package of heterodox measures that would have been unthinkable just a few months earlier. First came the Paulson Plan, whose first draft entailed the creation of a federal agency to buy the credit institutions' “toxic” assets so the polluted loans would disappear from the banks' balance sheets. It was rejected by Congress. Following the announcement of several plans by EU Member States, the chosen option was the direct buying of preferential shares to reinforce private banks' equity and boost credit flow to companies and consumers. As in Europe, the Federal Government would underwrite new rights' issues by banks. But the most heterodox move would fall on the Federal Reserve who, after having agreed to the direct buying of companies' IOUs to palliate credit limitations, would not hesitate to engage a higher gear at the end of 2008: it did earmark 800 billion dollars for the financial markets and for loans to consumers and companies. It increased its monetary supply to buy mortgage assets tainted by toxic debts, a role previously assumed by the Treasury[25].

This measure, primus inter pares in the heterodox measures, preceded as it was by taking direct control of the major U.S. investment banks in the United States and the mortgage or commercial banks in Europe, could only be understood within the scope of an economy sliding into deflation and the gradual running out of room for manoeuvre for managing monetary policy from the interest-rate side. While the Paulson Plan leaned ultimately on the taxpayer and led to a slow and uncertain recapitalisation, the Federal Reserve made use of what euphemistically is referred to as "quantitative expansion" of the monetary base. Financial assets would no longer be bought by issuing debt as in Spain, but through direct monetary expansion. It does not seem the ECB is willing to go that far.

In parallel, the U.S. and European authorities seemed willing to increase significantly their deficit and debt levels in order to buy assets of varying levels of toxicity and to activate, through fiscal measures and government expenditure, the components of aggregated demand.

As an example, the U.S. Treasury Secretary proposed to raise the indebtedness ceiling from 10,6 to 11,3 billion dollars. In the most favourable hypothesis, the indebtness to GNP ratio, that was low at around 30 percent, would exceed 70 percent in 2009. The European deficits will be higher than 3 percent in 2009 and public indebtedness will again grow substantially. The economic crisis and the massive State aids it has induced have reopened the debate on the European goal of reaching zero deficits by 2010. The time has come for unqualified support for the aggregate demand components, with special attention to household consumption. Growth is still the best antidote against chronic government deficits. Nothing would be more destructive for government finance than the world economies entering into depression. The budgetary effort, needed from all countries, should be headed by those with current account surpluses. These schemes for boosting aggregate demand would then have to be coordinated internationally to prevent them from benefitting those countries with a more conservative agenda. The government deficit of some would become the surplus of others.

From October 2008, governments were compelled to launch massive rescue plans of their financial systems. Banks needed recapitalisation after having their

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25 100 billion dollars to buy the debt issued by government sponsored mortgage lenders Fanny Mae, Freddie Mac and the Federal Home Loan Banks. Another 500 billions to buy more dubious mortgage claims from Fannie Mae, Freddie Mac and Ginnie Mae. And an additional 200 billion dollars for a new credit tool guaranteed by securitising recent high quality (AAA) loans to consumers and small and medium sized companies. The Treasury would support this fund with 20 billion dollars from the initial Paulson's rescue plan to shield the Federal Reserve from eventual losses.

resources destroyed by the real estate and securitisation crisis, the depreciation of financial assets and the defaults on loans by consumers and companies. All this increased the need to expand their reserves.

Not being able to call on the markets made firm Government action necessary. It took the form of purchasing preferential shares (surprisingly forsaking the right to vote in exchange for a dividend; once the government agrees to support the banks the logical consequence would be to take part in their management) - purchases of damaged and illiquid assets (estimating their value is difficult), providing government guarantees, exchange of mortgage claims for bonds which can be easily converted into cash etc. Leaving aside national variations, governments have introduced guarantees on interbank markets loans. The banks need to be sure they will recover their equity in the case of default by the borrower. But monetary policy is not enough to pull the economy out of recession. This is the reason for several budgetary action plans implemented since October 2008. The forthcoming U.S. administration will enlarge them. It has stated its intention to boost government expenditure.

The nature of liberal capitalism, in vogue since the eighties, will be substantially altered. With the crumbling of the economy breaking the gospel of the intrinsic efficiency of the markets, interventionism is seen as the lesser evil. It appears that government funds will have to be mobilised to bail out an increasing number of activities and sectors. But priority is being given to the financial system. Should it collapse it would ravage the world economy given the significance of the brokerage activities of banks. Out of this deep crisis, so close to a credit crunch, should emerge a new regulation of the world's financial system, addressed to curtail and supervise the unlimited capacity of risk- taking enjoyed by financial institutions working outside any supervision. Thus, on 15 November 2008, the G20 put up the idea of tightening the regulation of the almost totally unhindered freedom enjoyed by the derivatives markets, though the U.S. did not want to bind them too tightly, to prevent charges of restricting market freedom.

The economic role of governments will have to be redefined. A new mix between government and market is needed. Even if many people, among them the EU Commissioner of Economic and Monetary Affairs, would increase the regulatory component of the financial system and reduce it for the non financial sectors to enhance their flexibility (the labour market?).

For the time being Europe is only coming up with fragmented initiatives from its Member States. While trying to come to Washington with a coordinated response strategy to the crisis, in fact the apparent agreement did not overcome national quirks. The European nations seem unable to present a concerted answer seemingly preferring the uncooperative and counterproductive Merkel's "first one out" tactics. Nevertheless, faced with the scope of the crisis, the European authorities have been forced to better coordinate their actions. The Eurogroup, with the participation of the UK, produced a plan in October 2008 focused on three central measures: to keep providing liquidity to the more damaged banks by buying their 'healthy' assets; recapitalise creditworthy institutions injecting equity into them by buying their shares; and to underwrite new debt to banks up to 31 December 2009 to facilitate loans to business and families. The authorities agreed to provide a guarantee for interbank transactions. It was thought that by ridding this market of lack of confidence among partners the main cause of tensions would disappear. The funds engaged by the EU Member States exceeded those of the Paulson Plan (Emergency Economic Stabilisation Act), which points to the intensity of the crisis in Europe. The intention was to give an EU character, actually a cosmetic touch, to what had only been a series of national initiatives that made the European institutions look like the great absentees in this unprecedented global crisis. The

Member States have concocted national plans: for infrastructures and aid/loans to small and medium-sized companies (Germany) or to strategic companies (France); reducing VAT to 15 percent to boost consumption (United Kingdom); reducing social security costs (Germany); 400€ income tax rebates (Spain), but there is no common strategy. Up until now national governments have been responding on a case-by-case basis to the evolution of a crisis that is getting the better of them. While Sarkozy advocated common action with a longer reach than the mere flexible collaboration of the 27 national plans, the German Chancellor refused any initiative that would put more money in the EU coffers. As their main net contributor, Germany privileged national stimuli over common action.

The Commission's scheme, for which opening the 'government faucet' "has a stronger positive impact on short-term demand than fiscal rebates", has three pillars: coordinating the national plans so they do not mutually interfere; increasing the resources of the European Investment Bank; and modifying the Structural and Cohesion Funds' regulations to speed up the payments to Member States. There is no agreement to encourage both consumption and investment by coordinating a tax (VAT) cut. The plan proposed a reduction in national company income tax to stimulate investment in a context of growing unemployment. I would put forward a selective tax cut (unlike the 400€ cut per taxpayer) so households can spend and save more.

In all, contributions to the EU budget included, Member States could commit common actions of up to 200 billion euros (1.5 percent of EU's GNP), the upper limit imposed by Germany that stated the EU "should not launch itself on a millionaire's race for who approves the biggest bail out plan". The amount is a modest one, lower than the 2 percent recommended by the IMF after the Washington summit, though higher than the EU budget itself.

The situation repeated itself; the Commission had not had a plan for the financial crisis and would not have one for the economic downturn. Each State would draw up and promote its specific plan.

This crisis has highlighted the need for firm government intervention and revealed the need for renewed international architecture of the financial and monetary systems in a globalised economy. Its global character calls for a regulation and supervision frame that is also global. This leads us to a redefinition of the IMF role, the great absentee. There is not an international lender of last resort acting as guarantor to lower the cost of indebtedness. The current IMF, with its limited resources, is designed to impose budget and fiscal discipline to developing countries and "solve" their problems in financing external debt. While Europe advocates strengthening the Financial Stability Fund, set up to "promote international financial stability, improve the operation of financial markets and prevent financial perturbations having cross-border effects", as well as coordinating national regulations, the U.S. has veto power in this Fund and does not want to hear of a global supervisor. They will not go further than reinforcing the coordination mechanisms. The G20 has remained at the rhetorical level and been incapable of starting the reorganisation of world capitalism. It is indeed disappointing that hedge funds, having contributed so much to financial leveraging, are still outside government supervision. And there is not even a mention of fiscal paradises. Banning them and imposing boundaries on speculative financial products seem more efficient than dusting off the Tobin Tax. A residual tax on speculative capital operations, difficult as they are to define, appears today less interesting than laying down rules to regulate the derivatives market and to stimulate cash-based products.

The depth of the financial crisis and its contagion of the real economy have brought back to life the paradigms of the Keynesian countercyclical interventions.

Governments, even those operating within the liberal dogma of market freedom, have had to step in to stabilise the economy. Jaime Requeijo, analysing the late 20th century "modern" crisis, wrote: "While it is possible Keynesianism is on the retreat in academic circles, it is still very much alive in economic policies and, much more so, in the devolution of the crisis management to governments”[26] . Faced with the evidence that monetary policy alone cannot overcome the crisis and could even lead into the liquidity trap if the deflationary trends are confirmed, hopes are now pinned on budgetary policy, notwithstanding deficit and indebtedness risks.

Conclusion: the master beams of anti-crisis actions

We are facing a complex crisis and the solutions being suggested are out of step and lagging behind the pace set by this downturn. The authorities, lacking the necessary information, underestimated its depth and the effects on the real economy.

Central banks will need to keep on providing the liquidity required to prevent the financial sector meltdown, as well as directly injecting capital and discounting commercial paper. They will also need to provide the economy with mechanisms for ensuring the existence of payment and credit tools. It is the only way to arrest the multiplication of company bankruptcies. But capitalisation by the governments will need to go hand in hand with the direct management of the bailed out institutions. It cannot be limited to a mere cover up of the bad speculative practices of some.

Even if the continuous and aggressive interest rates cuts are reducing the leeway of monetary policy, central banks need to show the willingness to set them at zero if needed. Monetary policy is losing multiplier efficiency and could even fall into the "liquidity trap", with the subsequent deterioration of economic activity as soon as interest rates are bereft of leeway. The consequences would be more unemployment, new falls in consumption, new investments retrenchment, etc.

Added to this, consumers, who previously tended to over-indebtedness, have withdrawn their consumption of durable goods at a time when the wealth effect has turned negative and the job market expectations look gloomy. They seem more prone to save, depressing even more the demand for goods and services, although the fall in inflation is slightly reactivating households' disposable income. It is also likely that real interest rates will remain high to allow states to keep on financing themselves, thus preventing monetary policy from boosting more consumption and investment.

A parallel requirement is to hike the banks' minimum capital requirements, to get rid of excessive financial leveraging and fine-tune the regulation and supervision of all financial entities by a central authority. “Without a swift recapitalisation bank deleveraging would continue and the amount of loans allowed to the real economy would keep falling”[27] . As companies undergo more difficulties and need to reduce their debt they could feel tempted to cut salaries to be passed on to prices so as not to lose market share. The results would lead to a generalised deflation and a subsequent deterioration of real debt and of the stimulating effect of the budget.

Another consequence is the need for use of fiscal and budget stimulus policies to dynamize the various components of aggregate demand. But as the Japanese crisis showed, higher transfers to households might well stimulate their propensity to save at a time when prices decelerate very quickly. Then, government expenditure, beyond and without forgetting ordinary headings, should prioritise social, economic and technological

[26] Requeijo, Jaime: *Anatomía de las crisis financieras,* Mc Graw Hill, Madrid, 2006, page 23.
[27] Nadal Belda, Alberto: ”La crisis financiera de Estados Unidos”, *Boletín Económico ICE,* Madrid, number 2953, november 2008, page 28.

infrastructures, the environment, and research, development and innovation expenses; in short, sectors that can have a positive long-term effect on workforce productivity. These are unavoidable measures to counter job destruction.

The government deficit will deteriorate due not only to the automatic stabilisers but also to the discretionary actions of governments, which need to act forcefully. They would need to increase government expenditure further than they seem ready to go: 7 percent the U.S. and 4 percent the EU in 2009. This poses in no uncertain terms the question of how to finance it, and even more so as liquidity is getting scarce. But it is a minor problem in an emergency situation like the current one. A "crowding-out" effect propelling debt rates' increase does not look likely in a context of moroseness of the private components of aggregate demand. Currently, the main economic and social problems are not those linked to the short-term sustainability of government finances, however important their long-term sustainability may be.

The European countries' economic and financial interdependencies are so high that none of them can aspire to overcome the paralysis without a deepening of the European integration process. Nevertheless, and here lies the major contradiction of the integration process, the room for manoeuvre of EU Member States has been curtailed while alongside it macroeconomic regulation at European level has not emerged.

As Fitoussi [28] mentioned, if the EU, bereft of a unitarian political perspective, refuses to see itself as a "great" economic country, it should come as no surprise that European nations see themselves individually as a "small" country in a playing field that is no longer just Europe but the world. This renders impossible a common response to a systemic global crisis.

[28] Fitoussi, Jean Paul; Le Cacheux, Jacques: *L´état de l¨Union e uropéenne 2007,* Fayard/Presses de Sciences Po, Paris 2007.

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