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## GLOBALIZED FINANCE

### *The Challenge to the Euro*

**T**HE EUROPEAN PROJECT is widely seen to be floundering, politically and economically, in the face of US global dominance.<sup>1</sup> While the long depreciation of the euro—from its initial \$1.16 in January 1999 to a record low of 82 cents in October 2000—may now have been checked, the underlying market scepticism about European economic prospects that accompanied its fall has not disappeared. The euro's decline was not, after all, a commercial phenomenon—Euroland was posting big current account surpluses at the start of EMU—but a financial one, the consequence of big capital outflows. Since December 2000, the euro has benefited to a certain extent from investors fleeing the troubled American economy; but whether this rising tide can float such a leaky ship remains to be seen.

The present conjuncture has highlighted two key weaknesses in the design of Europe's monetary institutions. There is, firstly, the weakness of their external policy: the Council of Ministers has some responsibility but no real power in this sphere. Given the present imbalances in the world economy, this carries the risk that a serious slowdown in the US will not be compensated for by a decisive relaxation of Euroland's macro stance. Secondly, there is the problem of the 'policy-mix'—the balance between the monetary and budgetary components of the macroeconomic stance.<sup>2</sup> Fiscal policy is both fragmented and uncoordinated. In a situation (undervalued currency, sluggish internal economy) where (now standard) Mundell-Fleming theory would call for a less restrictive fiscal stance, there is no clear mechanism for effective

budgetary coordination; nor is it clear how such a relaxation could avoid destabilizing long-run interest rates in the weaker countries.

In this context, the European Central Bank's sole response to the falling euro—repeatedly raising interest rates towards US levels, while the contradictory statements of Bank officials, EU Commissioners and national political leaders betrayed their growing anxiety—risked being both damaging and self-defeating: damaging, because unemployment is still very high in the core Euroland economies and the recovery fragile; self-defeating, because a slowdown in Western Europe might provoke further capital outflows towards other more rapidly developing economies. The weakness of the euro does not result from inflation—lower in Euroland than in the US—nor is it a mere function of interest-rate differentials, since much of the capital outflow is through FDI and not simply placements in the US banking system.<sup>3</sup> Rather, it was fast economic development in the US that gave rise to (real or perceived) investment opportunities, and thus attracted European financial resources.

It might be said that Europe is producing plenty of exports but not enough assets: its capital markets are fragmented and illiquid, compared to their US counterparts. And though Europe's security markets are now starting to expand and integrate, this involves a long, conflictual move away from its traditional financial institutions, based on various forms of 'relational' banking within specific countries and regions. Thus to address the weakness of the euro by simple monetary restriction runs the risk of exacerbating Europe's financial

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<sup>1</sup> This article draws heavily on discussions with two colleagues at the University of North London Business School, Stuart Archbold (now at the University of Kingston) and Photis Lysandrou.

<sup>2</sup> For a full analysis, see Robert Boyer, *Le Gouvernement économique de la zone euro*, CGP, Documentation Française, 1999.

<sup>3</sup> Martin Feldman observes: 'In the past year . . . [v]irtually all of the net equity capital that came to the United States was in the form of FDI, including mergers and acquisitions as well as new investments and outright purchases of existing businesses' ('Aspects of Global Economic Integration', NBER working paper 7899, September 2000). The point is important because it suggests that euro weakness is the result of the extent to which European companies, both industrial and financial, were participating in the US expansion. This participation was itself facilitated by the sophistication of US financial mechanisms—both as regards securities (portfolio capital) and mergers and acquisitions (FDI).

weaknesses—the underdevelopment of its financial markets, and the survival of obsolete financial structures—which, together, subordinate the European economy to US practices and priorities.

There is still a great deal of scepticism about the extent and the implications of globalized finance for European economic development. A strong statement would be:

So long as governments continue to target their current accounts, retain some sovereignty within their borders (so that at least the threat of government intervention in cross-border capital movements remains) and differentially regulate their financial systems, investors cannot think about domestic and foreign assets in the same way. Different national financial systems are made up of different institutions and arrangements, with different conceptions of the future and assessments of past experience, and thus operate with different modalities of calculation. All these features factor into a continued diversity of expectations and outlooks which cannot all be reduced to a single global marketplace or logic.<sup>4</sup>

Two arguments, in particular, are advanced to back the sceptics' case. Firstly, it is often suggested that today's high levels of financial interaction are not unprecedented—that something very comparable can be found in *la belle époque*, with the monetary nationalism that broke up the mechanisms of the Atlantic economy and the gold standard being seen as inseparably linked to the revolt of the masses and the assertion of democratic controls over the free market.<sup>5</sup> The second objection rests on the prevalence of self-finance: any account of globalized finance as a dominant force in today's economic life must confront the fact that the majority of investment is financed domestically.

A standard way of representing this is to show that, across countries, the ratio of savings to output is highly correlated with the ratio of investment to output. Countries finance nearly all their investment from their own savings—investment processes do not generally draw on external sources of capital. Why do they self-finance? Part of the answer must be that virtually all agents in capitalist economies rely heavily on this form.

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<sup>4</sup> Paul Hirst and Grahame Thompson, *Globalization in Question*, Cambridge 1999.

<sup>5</sup> Of course, the classic account of this process is that of Karl Polanyi, *The Great Transformation*, Boston 1957 (1st edition 1944).

Corporations, to take the most important case for the present argument, draw predominantly on internal funds when they undertake investment (see Fig. 1).

FIGURE 1 *Sources of corporate finance (percentages)*

	Retained Earnings		Equities		Debt		Bank Credit	
	1975–80	1991–95	1975–80	1991–95	1975–80	1991–95	1975–80	1991–95
US	63.5	81.1	4.4	1.1	13.2	10.4	6.6	-1.3
Japan	35.2	54.5	4.9	4.6	2.3	4.3	33.6	39.8
Germany	58.8	64.7	2.2	2.0	-0.1	0.7	25.3	23.2
France	42.6	71.5	4.0	18.3	0.0	0.2	12.6	12.2

Source: Jörg Huffschild, *Die politische Ökonomie der Finanzmärkte*, Hamburg 1999.<sup>6</sup>

Note the following characteristics: self-finance predominates; it is becoming more, not less, important in a quantitative sense; US corporations make more, not less, use of self-finance than those of Japan or Western Europe; the latter rely significantly more on bank credit and less on marketable credit instruments (commercial paper/corporate bonds); in general, equity makes a nugatory net contribution to business investment. This kind of evidence has been used to suggest that Japanese or German financial mechanisms—privileging ‘insiders’, such as house-banks—outperform those of the US—based on ‘outsider’ finance traded by anonymous creditors on organized capital markets; and that, in any case, accumulation processes must be relatively independent. These conclusions may be obsolete.

There are many detailed hypotheses about national self-finance. But it would follow from the use of self-finance by most corporations and

<sup>6</sup> For an English language review, see John Grahl, ‘Among the Vultures’, *International Review of Applied Economics*, vol. 14, no. 3, 2000, pp. 403–7. An examination of current account figures, it must be noted, reveals a single exception to the rule that countries self-finance: the US. Since this country is usually seen as lying at the centre of global financial networks, the exception is extremely important.

other economic agents that international capital flows would be small relative to the total of global investment activity. If we want to argue that globalized finance is important—is dominant—then we have to assert that the tail of external finance can wag the dog of internally generated funds. In what follows, there is an attempt to suggest that this is indeed the case.

### *Information asymmetries and the problem of agency*

The standard account of debtor–creditor relations draws on ideas of a structural information asymmetry between borrower and lender, first developed in the context of the used-car market.<sup>7</sup> The seller may have a better idea than the buyer about the quality of the car on offer, while the buyer may not be able to distinguish a good car from a ‘lemon’. The problem is that markets can break down in such circumstances: if the buyer simply lowers the price to take into account the existence of ‘lemons’ on the supply-side, the owners of the best cars may withdraw (known as ‘adverse selection’). The same considerations apply to credit. Borrowers differ with respect to their reliability and efficiency, yet it is the borrower who has the most concrete idea of how borrowed funds will be deployed. A simple increase in interest rates may not be an effective way of dealing with this problem: borrowers with sound investment projects may be deterred, leaving the credit market to those with risky prospects, or even those who simply intend to default. The widespread phenomenon of credit-rationing (limiting credit supply without raising interest rates) flows from this.

The ‘principal–agent’ problem has a very similar structure. In this case, information asymmetries obstruct relations between an employer and an employee or—more directly relevant here—between the proprietor of an enterprise and its management: bad prospects will be represented as good. Thus both equity and debt finance are sources of potential conflict and market breakdown. Hence the key slogan of *transparency*: creditors and shareholders want the procedures and motives of company managements to be visible to them. We do not have to take such (essentially neoclassical) models too literally. What is important is that they testify to the inherent difficulties in debtor–creditor relations, a

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<sup>7</sup> George Akerlof, ‘The Market for Lemons’, *Quarterly Journal of Economics*, 89, 1970.

key explanation for the prevalence of self-finance throughout capitalist systems. With self-finance the difference between principal and agent vanishes, as does the information asymmetry between creditor and debtor. The problem is that the capital market disappears at the same time: in a world of universal self-finance, there are no mechanisms for the reallocation of investible resources. And not only the capital market: since virtually all monetary exchange results in surpluses on the one hand and deficits on the other, a world without finance would be a world without markets as such.<sup>8</sup> It is the recycling of monetary resources—that is to say, finance—which permits the continuity of market relations by accommodating debtors; at the same time, the financial pressure to which debtors are subjected is a central component in bringing about market adjustment. Dimensions of the latter—intervals between assessments, thresholds triggering policy change, required speed of adjustment, balance between rationalization and expansion—all obviously have a financial aspect.<sup>9</sup>

### *Voice versus exit*

Now, if the inadequacy of generalized self-finance is recognized, then there are a variety of institutions which might structure debtor–creditor relations and thus make it possible for accumulation to be compatible with economy-wide restructuring and with the reallocation of capital. In extremely stylized terms two types of institution can be envisaged: following Hirschman’s classic text, we can distinguish between the voice-based and the exit-based approach.<sup>10</sup> The former establishes close, long-term relations between particular counterparties who will gain, over time, specific and accurate knowledge of each other’s motives and capacities. They may even come to develop ‘loyalty’—a certain identification of their interests, so that the coalition concerned actually works to mitigate the initial conflicts between them. This is closely connected to the notion of a ‘stakeholding’ enterprise, knitted to its creditors, its employees, its suppliers and customers, to the local community and so on. As this happens, interactions within the coalition

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<sup>8</sup> See the work of Jean Cartelier, for instance *La Monnaie*, Paris 1996.

<sup>9</sup> The view that finance is a kind of *superstructure* on the base of ‘production’ or ‘industry’ is responsible for many errors in critical political economy.

<sup>10</sup> Albert Hirschman, *Exit, Voice, and Loyalty: responses to decline in firms, organizations and states*, Cambridge, MA 1970.

become smoother and less costly. Frequently, this kind of structure will be socially embedded, in Granovetter's sense—economic relations will coincide with social relationships, based on kinship or other affinities.<sup>11</sup> In the case of credit-relations, lenders are reassured by their close, individual knowledge of borrowers.

Voice-based structures depart in two key ways from the logic of competitive credit markets. Firstly, they are particularist—they privilege insiders, those interests belonging to the coalition, against outsiders; secondly—and as a consequence—they may be extremely opaque to outside scrutiny. Comparativists, of course, will insist that voice-based systems are different in different places: the German use of house-banks and interlocking directorships is not the same as the Japanese *keiretsu*, while the Korean *chaebol* are different again; systems vary across continental Europe, and so on. This variation is nevertheless a *general* feature of voice-based financial systems: they are all particularist structures, often embedded in specific social relations. Being different is what makes them the same.

The exit-based approach, on the other hand, controls economic relations by the threat of departure—which depends on the existence of alternatives provided by the market. In the case of credit relations, exit means that one can sell one's claim on a debtor. Thus, exit-based structures want to make competitive markets more efficient, to impose sharper and more immediate sanctions on poorly performing debtors, to render the activities of corporate borrowers more transparent and to reform incentive systems in ways that align agents with the interests of principals. And because exit, in this case, depends on the ability to sell one's holding or credit instrument, it becomes easier as the corresponding asset-markets become deeper and more liquid.

All this is extremely stylized: few, if any, relations between creditors and debtors are pure representations of either approach. Even within the most highly organized competitive asset-markets, one will always find networks of dealers linked by voice, even exhibiting loyalty. Similarly, there are no completely closed stakeholding structures—however particularist these may be, the conditions of outside credit markets will

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<sup>11</sup> Mark Granovetter, 'Economic Action and Social Structures: The Problem of Embeddedness', *American Journal of Sociology*, vol. 91, no. 3, 1985.

always impact on their decisions. Nevertheless, it seems legitimate to interpret some of the most important current financial developments as a transition from voice-based to exit-based disciplines. The shift is historical: everywhere corporate managements are more subject to financial market pressures. It is also hegemonic: the actual process of financial restructuring has taken the form of the deregulation and internationalization of dollar finance.

It seems to be the case that, for all their fluidity and sophistication, voice-based structures have one fatal flaw—their particularism. However crude the market-based mechanisms of dollar-based global finance, they have the decisive advantage of being reproducible. These techniques, taught in business schools all over the world, can be generalized through the extension of US financial markets and practices. The financial regimes to which they give rise can expand without limit to obtain a truly staggering scale. This, in turn, is based on the imposition of universal standards. However efficient, on a local basis, the voice-based structures of Germany (or in the days of *encadrement de crédit*, those of France) may have been, they remain imprisoned in their specific social environments and are unable to extend their operations to the international level. While aspects of Japanese industrial practice—lean production, total quality, flat hierarchies and so on—have been enthusiastically adopted by Western corporations, these have been completely divorced from the ethic and sense of community which may, arguably, have given them a certain social value; lifetime employment, of course, stayed at home. What could not be exported (as is now clear from the debacle in East Asia) was Japan's opaque, 'relational' system of corporate finance.

A key battleground for this confrontation between voice and exit has been corporate governance. It seems to this writer that the battle is already lost and won. The precise ways in which flows of external finance—still the smaller part of investment—can profoundly reshape corporate behaviour will be examined through the workings of three, more or less fully globalized structures: foreign exchange markets, government bonds and independent central banks.

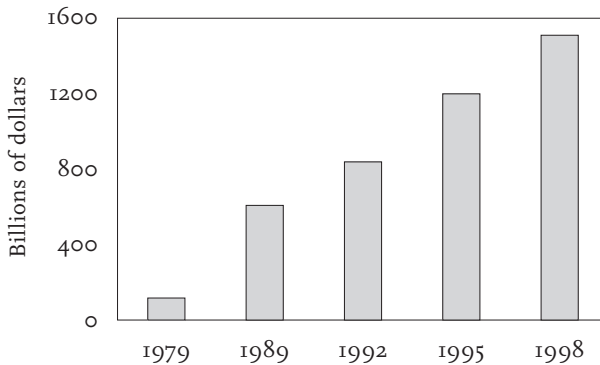
### *Foreign exchange*

The astonishing growth of foreign exchange transactions over the last two decades (see Fig. 2) has often been noted, but its interpretation



has sometimes been misconceived. Because there is clearly no relationship between foreign-exchange trading and either international trade or international investment-flow, these transactions are sometimes characterized as dysfunctional or purely speculative. If, however, we adopt a global rather than an international perspective, what we observe is simply the imbrication of national banking systems, almost the emergence of a unified payments system. The vast bulk of foreign-exchange transactions are completely analogous to displacements of liquidity within national payments systems—they simply recycle monetary resources, only now on a global basis. Fluctuations in exchange rates are not the occasion of this recycling but, on the contrary, an obstacle to it: when they are eliminated, the volume of cross-border monetary flows increases. (This can be seen in the rapid growth of cross-border payments within the EU's TARGET system. Although the total volume and value of inter-bank payments recorded by TARGET are stagnant, cross-border payments are expanding rapidly at the expense of domestic ones, as monetary and banking integration within Euroland proceed.)<sup>12</sup>

FIGURE 2 *Daily Foreign Exchange Transactions*



Source: BIS, cited by Huffschmid

<sup>12</sup> ECB data shows that total daily payments through TARGET were 1,042 bn euros in January 1999 and 1,035 bn in October 2000; within this total, cross-border payments, that is, new flows induced by integration, rose from 355 bn to 429 bn.

Money doesn't actually cost anything. There are, nevertheless, good reasons why it should be scarce. In a market economy, the allocation of these artificial symbols of wealth must be subject to the same logic as that of 'real' resources, otherwise the equivalence of money and commodities would be impossible. In every industrialized country the creation of money today is strictly limited. The reverse side of this is the astonishing acceleration of monetary transfers—an integral part of the emergence of global capital markets. Large banks draw short-term credit from any other point in the world system and, similarly, place any surpluses where they please. In consequence, one of the basic conditions of bank functioning—the ability of a bank to finance imbalances in its position—is determined not by national but by global circumstances, and on terms which are increasingly homogeneous. This can hardly fail to have repercussions on the strategies of any commercial bank embedded in these circuits. At the very least, any agent seeking short-term accommodation from such a bank must match the terms which prevail on the (global) inter-bank market. And longer-term credit is affected by short-run terms, since the two are always to some extent substitutes.

In the previously vaunted stakeholder systems of Germany and Japan, it should be remembered, 'relational' banking played a pivotal role. What has been said here by no means implies that banks will immediately abandon their long-term, stakeholding relationships with important corporate clients. But such relationships are being reassessed in a quite different context, and by quite different criteria.

### *Government bonds*

Deposits with large banks are not very risky placements: this transparency and liquidity is what permits the rapid penetration of globalized relations in this sector. The same applies to the liabilities issued by the stable governments of wealthy countries. Bonds are backed, as the American expression has it, by the 'full faith and credit' of the national government, and default would imply an immense disruption of political life. That is to say, agency and information problems are minimal. It is clear that, with regard to the bond market, the standardization of terms and prices does not always require immense cross-border flows. This is still, nevertheless, a unified market. It would be crudely empiricist to insist on actual phenomena as a measure of globalization; virtual

movements are equally important—the *possibility* of a switch out of one government's debt and a flight to 'quality' in that of another, held to be more reliable, or more respectful of the rules of the game.

Governments cannot be expected to trumpet the loss of their sovereignty. There are, however, two closely related reasons why they will do a lot to maintain the presence of their liabilities within globalized markets. Firstly, the relegation of their bonds to secondary status would impose immense costs in terms of the risk premium that would have to be paid to their creditors. To put things the other way round: the Italian government faces greatly relaxed budget constraints—to the tune of 3.5 per cent of GDP—now that the Maastricht agenda and EMU have promoted its bonds to international class. Secondly, government bonds occupy a key position in national financial systems. Since they are, conventionally, risk-free (perhaps, more accurately, minimum-risk) instruments—which would fail to perform only after a massive upheaval had already called other obligations into question—they act as benchmarks for the issue of debt by all other agents in the economy, according to relatively well-defined (and globally scrutinized) trade-offs between risk and yield.<sup>13</sup> Public credit remains the basis of private credit. Even non-standardized, non-classified junk bonds are marketable only according to a comparison with the more reliable forms of debt. Equity finance is also—although in a somewhat looser way—tied to bond yields: any dramatic rise in the latter is highly likely to knock the equity market for six. On the other hand, even a major stock-market collapse may be managed into a 'soft landing' if the bond market holds firm, as this will avoid any complete break in the flow of monetary resources to the largest borrowers.

Thus the relegation of a country's government debt from a globally enforced standard to the status of a high-risk instrument threatens the economy as a whole with financial disruption. People do what they have to do—even in free countries. The Maastricht process explicitly made the convergence of bond yields a condition of participation in EMU. The standard rationale for this is that bond yields embody expectations of inflation—which is completely true, but the expectations, the judgement, involved are *external*, as is the sanction. The Maastricht

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<sup>13</sup> The increasingly globalized role of US credit-rating agencies is of importance in this regard.

convergence process did immense damage to European employment and to the European social models. But if one wants to assert that the policy choices made in this context were the wrong ones, one must also recognize the pressures bearing on these choices.

If the world status of its bonds is an important consideration for any government, it is also true that the globalized bond-market is a sword of Damocles suspended over domestic policy-makers' heads. If any domestic development—monetary or fiscal, political or industrial—is read as threatening the solidity of a country's financial structure, globalized markets will exercise an immediate sanction. The demotion of a country's bonds, the emergence of a significant risk premium vis-à-vis the obligations of other states, will result in an immediate deflation of the economy concerned as bond yields rise, and with them the required rate of return on all medium-to-long-term credit instruments. Thus the monetary authorities of advanced capitalist states are not, as in the past, choosing between more or less expansionary or contractionary policy stances. Frequently, they are trying to *forestall* a spontaneous, market-led deflation of the domestic economy through a bond sell-off. This leads us into the new role of the central bank.

### *Independent central banks*

A question:

Let me now raise a curmudgeonly thought. When you think deeply about the reasons for removing monetary-policy decisions from the 'political thicket', you realise that the reasons apply just as well to many other aspects of economic policy—and indeed to non-economic policy as well. Consider tax policy for example . . . Yet, while many democratic societies have independent central banks, every one leaves tax policy in the hands of elected politicians. Why?<sup>14</sup>

And an answer:

The independence of central banks is the institutional form of a monetary legitimacy which transcends the national framework.<sup>15</sup>

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<sup>14</sup> Alan Blinder, *Central Banking in Theory and Practice*, Cambridge, MA 1998, p. 59.

<sup>15</sup> Michel Aglietta and Jean Cartelier, 'Ordre monétaire des économies de marché' in Aglietta and André Orléan, eds, *La Monnaie Souveraine*, Paris 1998.

A transformation of monetary policy has taken place—on a truly global scale—over the last ten years. This cannot be examined in detail here. But one can offer, as a token of an argument to be developed at greater length on another occasion, a brief characterization of the situation of national monetary authorities in industrial countries.

One can read through virtually the entire literature on central bank independence without coming across a single reference to external economic relations. There are plenty of international comparisons—on the one hand good, independent, credible central banks and on the other weak, politically vulnerable, inflation-prone central banks—but these are simply contestants in a beauty competition, not elements in a single system. Why then do we observe a huge wave of reform in nearly all industrial countries, always in the same direction? There is, of course, the pervasive influence of ideology; independent central banks emerge as a tribute to such eminent economists as Lucas, Barro and Grossman, Rogoff. No objections will be made here to the logic of their accounts (although some objections are certainly possible). Rather it can simply be pointed out that these accounts are abstract because, in portraying monetary policy as a game between politicians, central bank and private sector, they neglect the possibly important distinction between external and domestic agents. For example, the concern with inflation: domestic players might be worried by inflation as such—by the rise in consumer prices, for instance; external agents are more likely to be preoccupied by the risk of currency depreciation. In the most abstract accounts of market systems the distinction does not matter because the two variables—the internal and the external value of a particular currency—move in parallel. In practice, things are a little more complex. Exchange rates do reflect price differentials, but they do not do so immediately or exactly: in this context, the price of assets is as important as that of consumer goods.

The situation of the central bank places it between the globalized markets for money and for bonds. As regards the first, central bankers can still—just—control the price of monetary accommodation in the currencies they issue, but they do so in a world where the terms of accommodation, and the elasticity of its supply, are set on the foreign-exchange market. The sterilization exercises that once divorced these two constraints seem to have become a thing of the past, at least for small countries—and possibly even for the ECB itself. (Standard theory

suggests that sterilization becomes less feasible as the degree of international capital mobility increases.) The price of money is thus set by a trade-off between short-term interest rates and foreign-exchange rates, to which central banks respond—but which, in itself, is beyond the authorities' control.

The globalization of bond markets constrains every deliberation of the Bank of England's Monetary Policy Committee or of the ECB Council. It is no longer a question of making a judgement between an expansionary or contractionary stance: as we have seen, a sell-off of government bonds is a permanent contractionary threat which central banks *must* attempt to forestall. An effective monetary policy is increasingly seen as one without major implications for bond yields; the central bank thus operates not on the cost of capital as such, but on the term structure of interest rates, trying to accelerate or decelerate immediate expenditures without compromising the value of financial assets or the investment programmes linked to them. To assess the actions of the central bank as if this were not the case—as if comprehensive control over domestic credit conditions were still possible—is only another example of the anachronism that can be seen in many current debates.<sup>16</sup>

### *Effects on corporate finance*

Thus far, we have seen three key components of the credit system in a global context. Banks draw and place funds within an essentially globalized payments system, and the terms on which they do so are externally determined. Central banks certainly have some influence on the day-to-day price of these funds, but this influence is tightly constrained and has to be exercised in a way that does not threaten the stability of bond yields. Bonds are not only globally traded but also glo-

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<sup>16</sup> The position of the US central bank is exceptional in that the global dominance of dollar-based finance reduces the impact of external constraints on its policies. The constitution and functioning of the Fed are relatively unaffected by the monetary reforms of the last two decades; specifically, the Fed's broad mandate allows it to give considerable weight to the stabilization of output and employment as against the suppression of inflation. A growth-oriented macroeconomic stance can thus remain a key component of the US social contract. People have to live and die in the marketplace but they do at least insist that markets function, and the electorate still sanctions governments that accept lengthy recessions.

bally priced, and bond yields establish a key reference point, for all marketed credit instruments. Where does this leave the corporation?

It was pointed out at the start that external finance still provides only a relatively small fraction of corporate investment resources. Can the tail wag the dog? This depends on whether external finance is merely a residual element of an essentially internal process, or whether the terms on which it is available have started to define opportunity costs for both lenders and borrowers. Once industrial borrowers begin to take the external cost of capital as the key hurdle for investment projects, and their customary creditors start to regard yields on organized asset markets as a base-line rate of return, then market terms and costs will inevitably start to be internalized—even if insider finance continues to prevail in a quantitative sense. Increasingly, to the extent that external finance is determined on the market, these terms and costs will be a matter of global forces.<sup>17</sup>

It seems that market-determined finance does have decisive advantages over the voice-based mechanisms of relatively closed industrial groups. Firstly, it is able to diversify risks over a vast number of companies and investment projects. Secondly, market-based disciplines can reduce agency and information costs, by no means completely but, on aggregate, more effectively than the more precise but isolated inspection and monitoring procedures used in stakeholding models. The globalization of equity markets has therefore tended to reduce the cost of capital to borrowers in ways which raise returns to lenders.<sup>18</sup> Much of the evidence adduced to the contrary ignores the costs of cross-subsidy within stakeholder models: the weaker firms in a Japanese ‘convoy’ certainly have access to cheap finance but only at the expense of the stronger firms, or of the ‘relational’ banker. Nor are microeconomic data conclu-

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<sup>17</sup> To put the same point in more general terms: in the global market, the volume of trade in *financial* commodities (claims on income streams) now predominates over the volume of trade in *real* commodities (goods and services). See Photis Lysandrou, ‘Globalization as Commodification’, University of North London Business School Discussion Paper, forthcoming.

<sup>18</sup> René M. Stulz, ‘Globalization of Equity Markets and the Costs of Capital’, NBER Working Paper 7021, March 1999. Stulz finds a significant reduction of capital costs, but not as great as he expected; he may have underestimated the efficacy of the voice-based mechanisms being displaced.

sive here: a German enterprise may be better managed, physically more productive, committed to higher standards of design and so on than its US counterpart; but if the enterprise as such represents a misdirection of capital resources, then it becomes a weakness in the competition between national economies.

### *Shareholder value*

Beyond these pressures, there is now a drive in equity markets towards challenging, at the limit even eliminating, the very notion of a distinction between external and internal finance, through the demands of shareholder value. Legally, the shareholders of an enterprise are not its creditors but its owners. By the logic of financial markets, however, the main sanction they possess is not a proprietorial but a purely market act—to sell; to exit. Companies care about their share price: it determines the cost they pay for risk-bearing capital. Managements may also fear that too low a share-price will lead to their own dismissal. In this context, the fact that stock markets do not provide significant net amounts of industrial finance is irrelevant.<sup>19</sup> The role of equity is not simply to supply finance for companies, but to exercise control over the totality of corporate finance—including the use that is made of retained earnings.

It is not necessary to idealize here the so-called ‘market in corporate control’—in fact, there is every reason to question this supposedly efficient Darwinian mechanism for the natural selection of managements. Takeovers and mergers may as often be an expression of agency problems as their solution, reflecting the opportunism and empire-building of acquiring managements. The point is that this does not, in general, absolve the management of the *acquired* enterprise of the sanction of a devalued share price.<sup>20</sup> Then there is the capacity of relatively powerful shareholders, such as fund-managers, to intervene in corporate governance. Beyond the consequences that flow simply from flotation on the largest stock markets—accounting procedures and reporting conventions—shareholders may seek to impose incentive systems on

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<sup>19</sup> Gross flows, which include funds extracted *from* quoted companies, are a different matter.

<sup>20</sup> Stuart Archbold, ‘An Examination of Managerial Strategies and Motives in UK Mergers and Acquisitions’, British Academy of Management Conference, 2000.



management, tying them into maximization of profits and share appreciation through equity or stock options.

To summarize the shareholder-value agenda, one can look at matters from the point of view of the capital market itself—that is, in terms of the reallocation of capital resources. This market would see, on the one hand, over-capitalized enterprises situated in slow-growth sectors, perhaps with high earnings streams but with relatively limited possibilities of accumulation. To the extent that they escape pressure from shareholders as principals, these ‘cash-cows’ may have acquired complex networks of insider coalition partners, representing stakeholder interests. To such a company, the shareholder-value agenda is all too familiar: pressures for productive reorganization will involve downsizing, disposal of peripheral or under-performing divisions, stripping out of cushioned, managerial layers and so forth. Financial reorganization will include higher distribution ratios, equity buy-backs and increased gearing through the bond finance of assets that provide adequate collateral. In effect, the shareholders are saying: ‘There is no such thing as internal resources; everything is ours.’ Companies on which this programme has been imposed will provide higher returns on a possibly diminished equity base. This will correspond to higher risks for equity holders, but today’s fund managers are confident that they can diversify those risks. They certainly do not want the companies themselves undertaking asset diversification if this lowers their rate of return. On the other hand, shareholders would look for undercapitalized, high-growth enterprises. Capital liberated from the cash-cows will be poured into a wide range of start-up, innovative, hi-tech projects. The realization of profits in this case may lie far in an uncertain future, but the potential gains are immediately capitalized into equity prices.<sup>21</sup>

Aspects of the shareholder-value agenda are common to both growing and established enterprises. Operational decisions are not supervised; instead, there is an imposition of standardized reporting and accounting procedures (compare the capitulation of Metallgesellschaft to the

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<sup>21</sup> Thus it is by no means accurate to identify the advantages of US financial mechanisms only with phases of rationalization and disinvestment; they display a clear superiority in growth sectors such as biotech, where the capitalization of US enterprises at \$320 bn is some ten times greater than that of their EU counterparts. *Financial Times*, 27 September 2000, p. 29.

requirements of the NYSE); incentive structures are introduced to eliminate, in principle, any conflict of interests between shareholders and management.<sup>22</sup> The premise of this kind of development is an enhanced capacity (real or perceived) on the part of proprietors to diversify risks across wide portfolios—a development closely associated with the increasing weight of collective fund managers among equity-holders.

Of course, the idea that this pattern of accumulation is moving us towards a world free from agent–principal conflicts is absurd. Managements threatened with this kind of colonization are fighting back every day—by diversifying, for example, perhaps in blatant contradiction of shareholder logic, into the promised land of the new hi-tech paradigm, or by anticipating the called-for restructurings, or by loading themselves with so much debt that even the most gung ho acquirers will think twice before launching a bid. But many of these defensive moves simply accelerate the reordering of productive relations and investment programmes promoted by the shareholder-value drive. The high degree of instability inherent in such developments goes without saying: the press is full of dire warnings about a coming decline in the yield of equity capital, a decline which in itself must imply big falls in equity prices. Most of what these Cassandras predict must be right; but part of the needed correction has already happened, and even a big stock-market decline could be absorbed by the US corporate sector, provided that other channels of finance—bonds, above all—can be kept open.

It remains the case that shareholder-value is not—or not only—an ideology, but a real consequence of financial globalization. It represents a

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<sup>22</sup> Standard measures of financial flows neglect this pattern. Thus the data cited from Huffs Schmid above suggest that German corporations have more access to outside funds than do their US counterparts. This neglects, firstly, the extent to which US corporations have been made to finance each other through such stock-market mechanisms as equity buy-backs and, secondly, the fact that the German and Japanese flows often represent what are in fact internal resources—internal, that is, to an industrial-financial grouping—and not funds drawn from the capital market. Nor are simple comparisons of investment volumes always pertinent: it is important to know how effectively these investment resources are deployed. Michel Aglietta presents data indicating that the productivity of corporate investment in the US (that is, the ability of this investment to raise output) has increased by 40 per cent over the period 1982–97. The corresponding figure for Germany is 12.7 per cent, for France, 6.8 per cent ('Shareholder Value and Corporate Governance: some tricky questions', *Economy and Society*, vol. 29, no. 1, February 2000).

new balance of forces between proprietors and managers, very much in favour of the former. And it is driven not only by the as yet very limited cross-border market in equities, but also by the global transformation of currency and debt markets in ways which universalize these pressures, even in economies where equity itself is traded predominantly among domestic agents. The visible effect is to reinforce, in the most powerful way, the familiar drive towards more complete and immediate market disciplines in other areas, in labour and output markets. Trade liberalization or labour market 'flexibilization' alone would only sharpen pressures on *some* product markets, some categories of labour and so on. The shareholder-value drive, in contrast, tends to eliminate the notion of a sheltered sector by imposing the same norms of cost, price and profit as prevail elsewhere.

### *Defensive measures*

What are the implications of this for voice-based systems? From the point of view of the competitive capital market, stakeholder systems are not a solution to the problem of agency but rather the same problem writ large. Not only has a management established some autonomy from proprietorial interests; that management is embedded in a distributional coalition where a host of other interests can enforce their own priorities. For market-oriented shareholders in general (though not necessarily for privileged groups of insiders), opacity reigns. Particular, non-standard relations govern all transactions. In a confrontation between the two types of arrangement, general considerations would suggest that voice-based systems have three possible lines of defence. All of them are visibly failing in the context of an ongoing financial revolution.

The first line of defence might be to erect regulatory or other barriers, rendering exit options difficult, costly or even impossible, with the voice-based structures of 'Rhenish capitalism' or classical European social democracy being an imposed alternative to free capital markets. But the increasing interdependence of economies (in general) and financial liberalization (in particular) have been eliminating these restrictions for a generation. As early as the 1960s, to give one significant example, big German companies realized that they had an escape from the possibly irksome discipline of housebanks as suppliers of credit: they could simply go to the Eurocurrency markets. Exit options have never ceased

to multiply in the intervening years (although to different extents, of course, for different agents). If voice-based systems are to prevail, it must, increasingly, be through successful competition with the market-oriented forms.

A second line of defence might be to outperform the market-oriented approach, by reduced transactions costs, longer time-horizons, lower levels of conflict and so on. The efficiency of the particular, voice-based arrangements may overcome the general conditions of the market. This is always to some extent the case: no economic interactions will ever be purely contractual. But for the viability of a given voice-based system this efficiency condition (itself increasingly difficult to meet as market alternatives expand and develop) is necessary without being sufficient. There is also a *distributional* condition: the efficiency premium must make every member of a given coalition better off. Otherwise, that party may defect, and return to the market. The history of West European economies over the last two decades is littered with such defections at every level: skilled workers opting for individualized contracts with their employers; the severance of customary ties between suppliers and purchasers; giant enterprises delocalizing vast productive systems or abandoning their customary sources of finance for quotation on international stock markets. The pressure on all agents to do likewise goes on increasing.

Thirdly, as Hirschman argues, a voice-based system may mobilize the loyalty of its agents: an allegiance that rejects purely individual perceptions of interest. Of course this is an invaluable resource, and only the deep-rootedness of such loyalties can account for the resistance so far of many European social structures. But it is hardly necessary to point out the pressures. 'Those who deplore the cynicism of the men and women of our time', writes Pierre Bourdieu, 'should not omit to relate it to the economic and social conditions which favour or demand it and which reward it.'<sup>23</sup>

### *New developments*

The question of efficiency, however, is not a neutral criterion in judging between the two systems. As financial market disciplines become

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<sup>23</sup> *Acts of Resistance: Against the New Myths of our Time*, Cambridge 1998, p. 84.

more intense, different metrics are applied to company performance. The scope of such an assessment, moreover, is a function of the approach adopted—individual enterprises are more likely to fail under a shareholder-value regime, but the economy as a whole may produce higher returns. The outcome of the competition between the two approaches may also depend on the type of economic development that is taking place. Colin Mayer, formerly an influential proponent of ‘insider’ finance, now writes:

Outsider systems may . . . be particularly well placed to respond to the commercial opportunities created by the emergence of new technologies and new international markets. These require rapid adaptation which may be impeded by the complex webs of inter-relations between firms and other stakeholders which exist in insider systems.<sup>24</sup>

Finally, one has to take into account the sheer scale of the financial resources now being deployed to crack open the insider systems of Germany or Japan, made possible by the (practically) integrated world-payments system. The pace of this change varies: fast in France; slow, until very recently, in Germany. But this is a wheel that only turns one way: already the complex, interlocking shareholder patterns of Federal Germany are being dissolved as the big universal banks transform their equity holdings, from supports for reciprocal relations with industrial companies into asset-managing funds *à l'américaine*. In every sphere of European finance, agents are transforming markets, procedures and mechanisms to bring them into line with US practice. Only a few years ago, many transactions with derivatives ran foul of German gambling laws; today the German *Terminbörs* is a leading European market for derivatives. Whatever the balance of factors in the rivalry, the established European systems are losing. The cause is their financial weakness: their inability to mobilize and deploy capital resources rapidly, efficiently

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<sup>24</sup> ‘Corporate Governance, Competition and Performance’, in Simon Deakin and Alan Hughes, eds, *Enterprise and Community: new directions in corporate governance*, Oxford 1997, p. 171. See also Colin Mayer, ‘The City and Corporate Performance: condemned or exonerated?’, *Cambridge Journal of Economics*, vol. 21, no. 2, 1997. Mayer fails, in particular, to find evidence that insider systems lower the cost of capital: ‘it is difficult to believe that the international integration of the past two decades has not brought costs of capital closely into line, at least for large companies which are able to raise funds in markets around the world.’ He now argues only for a permissive policy: firms should be permitted to have concentrated, insider, ownership if they wish.

and on a large scale. It is a weakness which may yet begin to compromise the EMU project itself.

### *Models of resistance?*

The argument so far has been that globalized finance, based on the deregulation and internationalization of the US financial system, is neither a myth nor even an alarming tendency, but a reality. A recent article by Ronald Dore calls into question the triumph of 'Anglo-Saxon' capitalism; most of the evidence Dore presents, however, is quite compatible with the position expressed above.<sup>25</sup> The stubborn resistance of Japanese society to the shareholder-value agenda is itself evidence of the immense external pressures on inherited patterns of economic organization. Dore, like many of those attracted to 'stakeholder' forms of enterprise, seems to regard finance as a superstructure—subject, in the last instance, to determination by the 'base' of Japan's industrial system. Yet his own account of the long Japanese stagnation through the 1990s shows how potent financial factors have been. The banking crisis, seen as a major cause of retardation, was 'more or less' resolved by 1996. Since that date, pressures on public finance are recognized as having played a negative role. Thus indebtedness, private and public, has put the recovery of Japanese industry into disarray for a full decade—this in the world's largest creditor country, awash with unmobilizable assets.<sup>26</sup>

If Dore downplays the impact of financial forces, he may, by the same token, exaggerate that of ideologies. He records elsewhere a conver-

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<sup>25</sup> 'Will Global Capitalism be Anglo-Saxon Capitalism?', NLR 6, November–December 2000. See also his *Stock Market Capitalism: Welfare Capitalism. Japan and Germany versus the Anglo-Saxons*, London 2000.

<sup>26</sup> Similarly, Taggart Murphy ('Japan's Economic Crisis', NLR 1, January–February 2000) gives a graphic account of the painstaking political negotiations that are slowly untangling the web of bad and dubious debts in the Japanese banking system—but Murphy writes as if this process were of little importance, a secondary phenomenon. Compare, to take a notorious counterexample, the rescue of LTCM, whose insolvency is widely seen as displaying the instability, even the irrationality, of trade in financial derivatives. Its recapitalization (strictly, a 'bail-in' rather than a bail-out since the resources came from its own creditors, not from the Fed) was complete within days. For a more developed version of this point see Photis Lysandrou, 'Globalization and the Euro: lessons and policy implications of the Asian crisis', University of North London Business School Discussion Paper 28, October 2000.

sation with a Japanese manager who thought that ‘a global company should have global ownership’, as though to imply a surrender to the fashionable managerial nostrums of the hour.<sup>27</sup> But banking insolvency, a narrow, illiquid securities market, the opacity of interlocking industrial groups where one cannot be sure who owns or owes what, have become quite tangible constraints on the reorientation of Japanese production, and the manager’s viewpoint—one more decision to exit—may be more logical than he would like. As for the German stakeholder model, Dore’s pessimistic assessment hardly differs from the view presented here. Over decades, large companies and banks have built up huge cross-holdings in each other’s equity, supporting dense networks of reciprocity and cooperation, both financial and industrial. A key component of last summer’s tax reform was the removal of fiscal barriers to the dissolution of this structure. With capital gains tax on the disposal of these holdings simply eliminated, they can be transferred painlessly to fund-holding institutions (often yesterday’s ‘relational’ bankers) who will henceforth manage them not as the supports of insider finance, but as so many items in their portfolios. The consequence, accepted by both borrowers and lenders in Germany, if not yet by the European Parliament, is to put a trillion dollars of corporate assets into play.<sup>28</sup> Only a few years ago it was generally taken for granted that one could not buy a German company. That was then.

### *A crash will make no difference*

There are many commentators who assert that the dollar-based financial system is riding for a fall. They have some telling arguments on their side. Even on the most optimistic assumptions of ‘new paradigm’ economics, it is hard to envisage a surge of profits that could justify

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<sup>27</sup> ‘Asian Crisis and the Future of the Japanese Model’, *Cambridge Journal of Economics*, vol. 22, no. 6, November 1998.

<sup>28</sup> Peter Gowan has suggested that this transformation of German finance was a *quid pro quo* for the participation of German companies in the US economy (personal communication). This is surely correct, but the desire to attract US FDI into Germany was also an important motive. More generally, Gowan’s insistence on the political force used to extend what he calls the ‘Wall Street-dollar system’ across the globe can be accepted without denying that the resulting economic structure has an intrinsic logic of development or believing that the economic changes involved are reversible. See Peter Gowan, *The Global Gamble: Washington’s Faustian Bid for World Dominance*, London 1999.

current equity prices, if equities are to maintain anything like their historic yields. If, on the other hand, these yields are due to be lower in future—itsself an implication of the financial revolution—then prices are already too high.<sup>29</sup> It is clear that this concern is shared by the guardians of the dollar-financial system itself, including Greenspan. Other major disequilibria characterize the present situation: the huge commercial deficit of the US and the related shortage of savings, with American consumers relying heavily on asset-market appreciation to maintain their wealth. We already have bitter experience of the instability of asset-based growth in the outcome of the worldwide property boom of 1987–90.

The writer shares the *Schadenfreude* which accompanies every disruption of the dominant, dollar-based financial mechanism. But the days are gone when any real reversal of present trends could be expected from conjunctural developments. As an examination of the pattern of cyclical development over the past thirty years will show, globalized finance is driven forward not by any particular phase but by the cyclical mechanism itself (see Fig. 3). Crises, buffered and absorbed in the huge dollarized economy essentially through adjustments of US macro-policy instruments, have provoked massive regime shifts in Western Europe.<sup>30</sup> Of course, one key factor in this has been the lack of unity among the European states—their inability to define a common response. But, in this respect, are things really very different today?

A slowdown in the US would involve the immediate devalorization of US assets held in other countries; a turn-round of US current account and deterioration of European/Japanese competitiveness; pressure on Europe to expand by the most inappropriate means—big tax cuts, the sacrifice of financial stability; and, to the extent that the US bond market was implicated, equal pressure on long interest rates in Europe.

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<sup>29</sup> For an attempt to calibrate the overvaluation of US equities, see Sushil Wadhvani, 'The US Stock Market and the Global Economic Crisis', *National Institute Economic Review*, 167, January 1999, pp. 86–105. Also, Robert Shiller, *Irrational Exuberance*, Princeton 2000 (reviewed by Andrew Glyn in NLR 5, September–October 2000).

<sup>30</sup> Robert Brenner ('The Boom and the Bubble', NLR 6, November–December 2000) may overstate the ability of the US to manage a stock market crash, with its threat of a 'hard landing'. He considers the constraints on monetary policy but does not discuss the vigorous fiscal expansion which will certainly meet any significant downturn. US public finance is healthy enough to permit this response, which would work to limit dollar depreciation.



FIGURE 3

*Some crises*

	Crisis	US response	Consequence
1971-73	US balance of payments	Dollar devaluation, break-up of Bretton Woods	Monetary policy becomes key macro instrument in European countries
1979-82	US inflation	Volcker shock: drastic rise in US interest rates	Huge and persistent rise in unemployment in European countries; fiscal crisis of the welfare state
1987-90	US stock market crash, recession	Turn to monetary expansion in US in climate of capital liberalization	Worldwide property boom and bust; tensions in EMS; end of full employment in Sweden

The weakness and subordinate status of the EMU project can be read in the increasingly alarmed and disunited statements of the ECB leadership. They seem to feel less and less able to deploy the classic US response to such difficulties: ‘benign neglect.’ There are serious dangers here. Specifically, to defend the euro or the price of euro bonds, monetary conditions might be tightened, and this in a context where the forced march of member-state governments towards fiscal balance continues, or even accelerates. Here, then, there exists the possibility of a vicious cycle, with stagnation and weak profitability further undermining the strength and organization of euro finance, exposing all the European systems to continued external pressure. The institutional mechanisms which could block such a process are weak: the concertation of national budgetary policies—to the extent that it exists—remains focused on the goals of the Stability Pact, and there is no fiscal policy of overall macroeconomic significance at Union level. The truth is that Europe is not generating enough assets, either ‘real’ or ‘financial’. The deep-rooted preoccupation with *les grands équilibres* has held back development for twenty years (relative to a perpetually disequilibrated US economy). What is needed, on both economic and social grounds, is a relaunch of economic development, supported by a huge financial mechanism; but one which functions with different standards to those of globalized US finance.