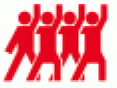

European Trade Union Confederation (ETUC)
Confédération européenne des syndicats (CES)

**EXECUTIVE COMMITTEE**
**Brussels, 15-16 October 2008**
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## Item 5 on the agenda

# THE FINANCIAL CRISIS AND THE ECONOMIC RECESSION: A TURNING POINT FOR CASINO CAPITALISM

**ETUC position paper**

The Executive Committee is asked:

- To take note of this document

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**THE FINANCIAL CRISIS AND THE ECONOMIC RECESSION: A TURNING POINT FOR CASINO CAPITALISM**

## I. Denouncing casino capitalism, the ETUC's London declaration

## Introduction

1. At the time of writing this resolution (October 7), all is confusion and disarray on world financial markets. A number of bank rescues have not worked first time (Fortis, Hypo, perhaps Dexia); a number of countries have taken action to guarantee all bank deposits causing problems for banks in countries where there are no much guarantees; European leaders met in Paris on October 5 and agreed to co-ordinate actions but within 24 hours, Germany was forced to act unilaterally to save Hypo; Iceland is in desperate difficulties; and stock markets have plunged world wide. The crisis has arrived in Europe.

2. The ETUC, with the London declaration, denounced the dominant model of financial capitalism: "Liberated" financial markets, no longer constrained by adequate oversight and effective regulation, are seeking to obtain excessive profits over the shortest run possible. They are doing so by developing 'innovative' but highly risky financial techniques, resulting in extremely high levels of leverage, excessive indebtedness, structural mismatches between assets and liabilities and pure and simple speculation. At the same time, this model of 'borrow and speculate' has distributed wealth and richness to the benefit of the few in a spectacular way, while wages and working conditions of workers have been put under pressure.

3. Now financial capitalism threatens the real economy. Confidence which is key to investing is undermined and credit is being squeezed. Recession looms and workers and governments are – once again -left behind to clean up the mess after the 'boom' has died and the bubble of irrationality has burst.

4. The ETUC's key message is that this must be a turning point. Governments cannot simply bail out the financial markets without public influence to make sure such a thing does not happen. There needs to be a policy response to stop the irrationality and greed of financial markets, to end their dominance over the real economy and to promote fair and decent wages instead of pursuing maximum stakeholder value.

## II. What has been happening and the policy response thus far.

5. Since the London declaration, a storm has raged throughout European financial markets. Major banks in Belgium, the Netherlands, Ireland, the UK and Germany have come into trouble and the governments of these countries were obliged to step in by extending emergency credit lines, buying bank shares and guaranteeing deposits of the public. Distrust amongst bankers has intensified further and bankers no longer want to lend to each other, with three months' euro interest rates reaching more than 5% and banks who do still possess liquidity are putting this liquidity into more than 100 billion euros in overnight deposits with the ECB. All of this has also had a major negative impact on stock exchanges worldwide.

6. On the other side of the Atlantic, the US government has been proposing to Congress to create a 700 billion dollar fund (called TARP) to buy up 'toxic assets', thereby hoping to clean up banks' balance sheets and restore confidence in banks. This proposal however has met with much popular resistance, with public opinion refusing a tax payer funded bail-out of banks and their overpaid CEOs. Nevertheless, the US congress finally did decide to give approval providing the depositor guarantee scheme would be raised from 100.000 to 250.000 dollar. This, together with previous bail outs of banks and insurance companies, brings the total cost of the financial crisis for the US government at 1.500 billion dollar.

7. The European Commission has presented, on the first of October, European legislation on banking activity and bank capital requirements :

    a. To oversee cross-border financial groups, multi-national high level boards grouping together the supervisors of different countries will be systematically created.
    b. To limit moral hazard and excessive risk taking, banks will be obliged to keep at least 5% of a securitised product. However, this implies that 95% of loans and the risk these carry can still passed on to other banks.
    c. Bank exposure to other banks will be limited to a maximum of 25% of the banks' capital or 150 million euro, whichever is the highest.
    d. It is to be noted that, compared to initial proposals, both rules have already been loosened on request of the banking sector.

8. Finance ministers are expected to adopt on the 7th of October a code of conduct on 'golden parachutes', advising member states to focus on systems aligning bonuses on long term profitability

9. On the eve of a special council convened by France with Germany, Italy and the UK, France floated the idea of a European fund to buy assets from troubled banks, but this idea was rejected by other governments. The key problem however of a mismatch between financial groups operating European wide on the one hand and national governments and supervisors focussing on the national economy on the other hand thereby remains.

10. The European Parliament has been approving two initiative reports on private equity and financial market regulation (see annexes for an overview of the Parliament's recommendations.

11. Meanwhile, the real economy is suffering as well. Economic activity has shrunk in the second quarter and, with indicators like the purchasing managers' index falling, prospects for the coming quarters do not bode well either. Unemployment has already started to rise in several countries. This downturn in the real economy is certainly related to the credit squeeze fall-out from the financial crisis. However, the economic slowdown is also rooted in the fact that central banks over the past years have switched to contractionary policies, in the excessive appreciation of the euro currency and in the bursting of the construction boom in countries like Spain and Ireland. In other words, even if there had been no financial turmoil, the real economy would still be suffering. Here, the president of the Commission, together with the Economic Policy Committee, identifies the financial and the economic crisis as an opportunity to lecture and force member states to implement more structural reforms and in that way make the labour market more 'resilient'. One wonders however how a labour market can be made resilient and what kind of jobs such a labour market would create in the absence of aggregate demand and well functioning financial markets.

## III. What to do next: Policy proposals from the ETUC

### *Saving the financial sector from the profiteers and the speculators*

12. The core of the problem is the massive de-leveraging that is taking place. Just like the process of leveraging and taking on more debt triggered an enormous and self- reinforcing boom, the process of unwinding excessive debt is now doing the opposite. Massive asset price depreciation, triggered by the sub prime crisis and high risk aversion against structured investment products, has wiped out an already too limited capital base. Since new equity investors no longer trust the balance sheets of banks, no new equity can be raised. Banks therefore have no other choice than to sell assets in order to bring equity and assets back into line. This however then creates more asset price depreciation. The vicious circle is complete.

13. In this system, only shock accelerators and not a single shock absorber exist. 'Mark-to-market' accountancy rules force banks to take the massive asset price depreciation into their books, even if the market is overly pessimistic and underlying assets and underlying income flows do not warrant such a massive write down.

14. Basel II capital requirement ratios force banks to raise new capital or, more likely, to sell assets to reduce capital consumption. In this way, and unlike in a normal market, falling asset prices depress asset demand further instead of reviving. Instead of restoring equilibrium between asset supply and asset demand, the downwards spiral continues. Meanwhile, banks are constraining credit for real investment and the real economy suffers, with further negative feedback effects on the financial sector.

***15.*** To break this cycle, some propose that government should not only act as a 'lender of last resort' but also as a 'buyer of last resort'. By taking over (bad) assets from the financial sector, government can stop this cycle which is choking the financial system. This is the essence of the US Paulson plan buying up 'toxic' assets. At the same time, such an approach also implies that (potential) losses are nationalised and that government is saving a sector from its own mismanagement. For this reason, another approach is to propose for governments to inject directly new equity into banks. This has several advantages. By acquiring shares, government also gets voting rights and the possibility to put things right back again inside the sector. Government can also choose to be more selective and support these banks worth saving while forcing others to merge with more efficient institutions. With government as share holder, exceptions can be made to going accountancy and capital requirements rules, thereby breaking the pro-cyclicality of these rules. In short, with public money should come public influence and this is especially true for a sector where management has proved to be so vulnerable to doubtful and short sighted practices.

16. Here as well, there exist compelling reasons to construct a policy response at the European level. With banks' balance sheets sometimes a multiple of national GDP and with spill over effects from national bail outs on other countries, an European level response is highly desirable compared to member states undertaking separate action. A European Recapitalisation Fund, providing new capital for banks would have several benefits. In return for these funds, the banking sector would need to accept an agenda of re –regulation (see following point). It would also be signal of confidence to the public that Europe is not divided and on top of the financial crisis. Furthermore, governments would no longer need to worry that the bail outs they are providing are bringing public finance in contradiction with the Maastricht criteria.

17. For the ETUC, the agenda of financial re-regulation needs to cover the following points:

a. Extend the scope and coverage of financial regulation. Finance institutions were allowed to construct a high leveraged parallel banking system with no or little regulation and supervision and in which loans and credits were based on short term roll over funding instead of deposits.

b. Impose much more robust standards for disclosure and transparency for hedge funds, investment banks, offshore vehicles,…

c. Prohibit off-the-books entities and transactions

d. Standards to impose a limit on the use of leverage.

e. Subject commodities trading to more extensive regulation

f. Change tax rules so that risky and excessive leverage is no longer rewarded by tax incentives.

g. Address executive and top level compensation. Change bonus and pay systems from promoting short term risky behaviour to promoting long term performance so that managers no longer have the incentive of participating in 'bubbles' and take on excessive risks. If the bubble burst, bonuses, being linked to long term performance will be wiped out and management will think twice before engaging in another outburst of speculation.

h. A financial consumer agenda to crack down on abusive lending practices

i. Organise public services providing basic and universal access to the banking system.

j. A European ratings agency.

k. Tackle private equity by outlaw 'short selling' of company shares, by limiting the use of voting rights to longer term shareholders, by redefining the transfer of an enterprise so that it includes a transfer of shares, forcing companies which have exited from the stock exchange to publish a minimum of information, defining capital adequacy norms for private equity and hedge funds.

18. In the light of the financial crisis, the ETUC wants to take a new look at several of the planned measures and directives which can be found in the European Action Plan on Financial services as well in the plan to modernise company law and corporate governance. The consequences of proposals such as the transfer of company headquarters, public take over bids, interdiction of 'golden' shares need to be closely scrutinised.

***Saving the real economy from misguided policy***

19. Saving the financial sector is highly necessary but it is also crucial to avoid a negative feedback effect from depressed economic activity

(rising defaults, falling asset prices) to the already stressed financial sector. Since the real economy is following monetary and financial developments with a time lag of around 9 months, this implies that the impact of the 2007-2008 credit tightening and interest rate hikes is still in the pipeline and will work to depress growth over 2009.

20. Moreover, this is not 'business as usual'. There now appear structural cracks in the model of growth which has been followed thus far. Over the past, growth in European member states has been driven, either by rising household debt financing current consumption and a housing construction boom (UK, Ireland, Spain), or by competitive wage moderation (Germany, Austria,…). Both models were in fact closely interlinked. Demand dynamics in the former countries provided the basis for the 'export-led' growth model of the latter countries. These drivers of growth ('bubble' led consumption and expanding export markets) have now disappeared. Household debt, together with housing prices, has become excessively high in the former countries and needs to be brought back down. These countries will therefore no longer function as a 'demander of last resort' for those European member states practising competitive wage policies, on the contrary.

21. There is a pronounced risk of European member states and policy making matters worse and transforming the slowdown into a long and protracted slump by implementing misguided policies:

    - Monetary policy will loosen but this may very well be 'too little and too late'.
    - Fiscal policy, as it remains driven by the objective of realising a zero deficit, threatens to amplify the initial slowdown, especially since the huge costs of bank bail outs will show up in public deficits and debts.
    - With a clear demand side policy reply lacking at the European level, member states will be tempted to do emergency structural reforms (wage cuts, flexibility, an overall downgrading of workers' rights) which otherwise would be rejected. However, trying to get out of the crisis at the expense of others is a bad idea in an economy as highly integrated as the European economy.
    - With monetary, fiscal and structural reform policy all working to deepen and prolong the downturn, negative growth expectations will become fully entrenched. This undermines confidence further and works as a self fulfilling prophecy, especially if the standard discourse of 'social Europe as a source of rigidities' is once again launched by the OECD, the ECB, the IMF and the Commission.

22. What policy needs to do instead is to make the management of demand a matter of common concern in Europe. Monetary policy

needs to take a forward looking approach and focus on the risks of depression to come and no longer on past inflation rates. The economy as well as the financial sector urgently needs deep interest rate cuts, to be implemented right now. Fiscal policy needs to put in place a temporary moratorium on contractionary policy, especially given the high costs government now has to carry when bailing out the banks.

23. However, to turn the business cycle around and restore economic confidence, more is needed. Here, the opportunity that the crisis and downfall of casino capitalism offers must be identified and taken. A serious inadequacy exists in today's global financial system. On the one hand, banks and businesses are in urgent need of new equity capital. On the other hand, global liquidity and savings are invested in short term assets carrying no or little risk. Financial investors are now mainly buying government bonds or moving into liquid bank deposits. This implies that the financial system will continue to restrain credits and investments because of a lack of equity capital. This deadlock situation can be overcome by creating a European level Investment Fund which aim is to invest in renewable energies, energy savings, innovation and European infrastructure networks, thereby replacing 'bubble' investment with 'green investment' as a new and sustainable driver for European demand growth. The European Fund, operated for example by the European investment bank, would issue AAA rated bonds, backed up by public sector guarantees. It would thereby mop up the excess demand for non-risk asset investments in today's global finance and provide cheap finance for these investments.

### *Saving wages from central bankers*

24. Despite significant upheaval on financial markets and widespread expectations of a coming slowdown, the ECB has kept interest rates unchanged at what have become relatively high levels since the outbreak of the subprime crisis in Summer 2007. When the ECB finally did move in June 2008 it was to hike interest rates even further, even though the economy at that time already found itself in the middle of a recession. In doing so, the ECB has not only been allowing recessionary forces and negative growth expectations to take a firm hold, as can now be seen from the steep falls in business and consumer confidence. It has also squandered precious time to start up the necessary process of recapitalisation of banks by way of a steeper yield curve restoring banking profits. (Lower short run interest rates compared to long run interest rates boost banks' margins).

25. To justify this pro-cyclical policy of tightening of monetary conditions in the face of intense turmoil in both the real as well as the financial economy, the ECB is trying to use wages as a scapegoat. The ECB is arguing that a billions and billions of euro's are redistributed to OPEC

countries and that workers should accept this, otherwise hyperinflation would revive in a permanent way. However, the point the ECB is overlooking is that workers have been transferring billions and billions of euro's from wages to profits over the recent years, as can be seen from the falling share of wages in GDP in many European countries. It is not reasonable to expect that workers would continue to transfer billions to profits while, on top of this, also paying for the oil bill. While the correct policy answer to higher oil prices is to invest in energy savings while protecting the purchasing power of those at the bottom, the correct policy answer to stop the share of profits of increasing indefinitely is to bring nominal wage growth back in line with trend productivity and trend inflation. The ECB however is resisting this process, both by condemning higher but justified wage demands in public as well as by keeping interest rates high so as to trigger a slowdown in order to weaken the bargaining position of workers and trade unions.

26. However, it is time the ECB comes to realise that robust wage formation and monetary stability do not oppose but complement each other. If the ECB wants to avoid 'bubble driven consumption', with asset price booms and households excessively indebting themselves in order to compensate for the lack of wage growth, then it needs to accept that real wages accelerate and at least start growing back in line with productivity. If the ECB wants to avoid a situation in which 'money is chasing investment' instead of the other way around, then the ECB also needs to become concerned about the distribution of income since it are excess savings, fuelled by rising income inequalities at the top of the income pyramid, which push financial markets to create new but risky financial techniques promising high returns for the excess savings of the super rich. If, at present, the ECB wants to prevent the financial crisis from turning into depression and deflation, it needs to stop with its crusade against wages. Policy makers in general should remember the fact that the Great Depression of the 1930's only took firm ground when employers started to cut wages so that the crisis jumped over from the financial market into the goods and services market.

***27.*** The ETUC therefore calls upon policy makers in general to support autonomous and strong collective bargaining practice on wages, independent of and not subordinated to law courts and judges. A return to 'beggar-thy-neighbour' policies with individual member states trying to get out of the crisis at the expense of others will only make matters worse. Freezing wages will undermine European wide internal demand and will turn the crisis of financial capitalism into a complete meltdown of both the financial side as well as the real side of the economy. This should be avoided. The ETUC therefore also calls upon its affiliates not to engage in this practice of European workers undercutting each other. Instead, they should orientate wage bargaining on the sum of trend productivity and trend inflation.

## ANNEX I Recommendations of the European Parliament

In its resolution on the future supervisory structure of financial markets, the Parliament is calling for:

a. A review of the European framework on capital requirements for the financial sector. Capital requirements should in particular function in a counter-cyclical way.
b. Adequate capital requirements for complex financial products and derivatives.
c. Publication of off shore activities and structured investment vehicles.
d. Avoiding that the market value of securitised assets would exceed the value of the underlying asset in an unfounded way.
e. Controlling unregulated markets ('over the counter market').
f. Force issuers of securitised debt to evaluate and monitor the risk.
g. Monitoring systemic risk at the level of the European Union.

In its resolution on private equity and hedge funds, the European Parliament repeats the conclusion from the IMF's global financial stability report saying that " there is a collective failure to appreciate the extent of leverage taken on by a wide range of institutions – banks, monocline insurers,hedge funds- and the associated risks of disorderly unwinding".

The European Parliament is calling for:

a. An extension of the regulatory coverage and capital requirements for all types of financial institutions.
b. Accounting techniques to counter the pro-cyclical effects of 'mark-to-market'.
c. Credit rating agencies to manage conflict of interest and separate their rating business from any other services. An EU review of Credit Rating Agencies.
d. Align reward packages with long term outcomes, reflecting losses as well as profits.
e. Make sure that the extent of leverage used by private equity is sustainable (adequate capital requirements according to risk).
f. Determine the legal status of private equity as employers so that the directives on consultation of workers and transfer of business also apply when private equity is involved.

## ANNEX II: Debt leverage of banks

## Ratio of total of the balance sheet and own capital

| Country | Banks | 2007 |
|---|---|---|
| France | Dexia<br>BNP<br>Société Génerale | 41,3<br>31,5<br>39,34 |
| Germany | Commerzbank<br>Deutsche Bank<br>Deutsche Postbank | 40<br>54<br>38 |
| Spain | Several banks | Between 17 and 24 |
| Italy | Several banks | Between 10 and 18 |
| US | Lehmann<br>Merill Lynch<br>Morgan Stanley<br>Goldman Sachs | 30<br>31<br>33<br>26 |
| UK | Barclays<br>Alliance and Leicester<br>RBS | 52<br>39<br>33 |

**Source: Natixis**

It is striking to observe the extent of leverage operated by US and UK banks but also by French and German banks. High leverage or limited own capital in relation to total assets implies high returns when asset prices rise and the cost of debt is low. However, when the cycle turns and asset prices start falling, high leverage works the other way around, it magnifies incurred losses and makes banks highly vulnerable to a bankruptcy.