

## INTRODUCTION

At the time of writing, the subprime mortgage crisis, despite the rescue plan of American and European governments, is still creating profound turbulence in the financial and real economic world. The extreme fluctuations on financial markets, solvency problems of banking institutions, lack of confidence of economic agents, who refuse to lend on a long-term basis are the new parameters to consider. The first victims are middle-class people and small and medium-sized enterprises, for which obtaining credit is becoming a nightmare. Confronted by these new elements, regulators, economists, nations and politicians face a very challenging situation. First, to stop the ongoing situation. Second, to solve the structural problem at its origin. To do so, the responsibilities of each actor have to be taken into consideration. Two parts will constitute this book: the first will focus on financial markets and specifically their role as regards financial stability in a global world; the second will give an insight into the banking sector with a special emphasis on Europe. The final objective is to give a hint of the actual situation as regards the integrity and/or transparency of the international financial system.

### Part 1: Globalization and Financial Markets: a Dialectic Dynamics

The financial part will essentially focus on the evolution of global finance and its efficiency as regards international context. A few months ago, the New York Stock Exchange faced the greatest collapse of its markets since 1929. The question of the salvage of banking institutions was at the core of debate. Two antonymic paradigms were discussed: should the government and the central banker intervene in order to restore the confidence on the financial markets? Would it be more efficient to let insolvent institutions to leave the markets? The adoption of the Paulson plan illustrates a situation where the Americans have chosen to inject liquidity into economic markets to avoid banking runs. On the other side of the Atlantic, Europeans have chosen to adopt the same attitudes. For the first time in our history, a common decision was taken to limit an international financial crisis. The following chapters intend to provide an insight on the global context, in which these facts have occurred. The analytic elements,

they propose, will help the reader to build up a critical analysis as regards the actual situation.

In the first chapter Michel Aglietta argues that shareholder value is the core principle of global finance. It is an intrinsically unbalanced principle for both financial stability and stake-holding on value creation in the corporate sector. It embodies a contradiction that has long been recognized: the separation between ownership and control. This contradiction has given rise to the 2002 crisis in corporate governance, which has struck pension funds and other institutional investors hard.

Because shareholder value cannot live up to its contention of being the one best way, it has given rise to competing models of corporate governance. In the last few years the structure of finance has developed to overcome the dilemma between ownership and control in implementing the concept of shareholder activism. Two competing models that have surged are positioned differently vis-à-vis the stock market. One is the model of hedge funds and private equity funds as dominant intermediaries between institutional investors and the corporate sector. The other is the model of institutional investors as universal owners, asserting their prominence on other financial intermediaries, including hedge funds and private equity funds. The paper analyses the capacity of both models to ensure financial stability and to fulfil the concern of corporate governance for social and environmental responsibility. Empirical evidence is brought about to show that the type of aggressive capitalism deployed by hedge funds and private equity funds entails very high hidden risks that will wreak havoc in more stringent monetary conditions. Furthermore private equity funds are serious threats for established social contracts and for the integrity of public services.

In the same line of ideas, Tristan Boyer and Elena Chane Alune argue that the securitization movement of the economy has a strong impact on corporate governance. In this context, the IASB has set a new framework for accounting and auditing. This framework has been designed to fit analysts' concern and shareholders' interests. As a consequence, this framework should induce analysts to lessen their need for other information than those provided by the accounting reports. Meanwhile, the IASB has launched a survey about adding a compulsory report of 'management commentaries' to existing financial statements. Some evidence show that the adoption of IFRS increases the need for non-financial information, they conclude that the securitization of accounting tends to broaden the analysts' perspective, and paradoxically to lessen the strict shareholder perspective they could have had.

Beside the question of standardization in accounting, ethical considerations could be important to understanding the place of financial centres in the globalization context. Though the case of Luxembourg financial centre, Jérôme Turkey aims to demonstrate that the ethical frontage of the self-regulated small

country is definitely cracked, which is a threat for the international finance and raises the question of a certification to ethics for financial centres.

Luxembourg is probably not the worst financial centre, but the size and the lack of responsibility of many actors allows identifying ethical weaknesses, and realizing the limits of current international assessments in business ethics.

Therefore an actual certification to ethics for financial centres should be implemented, to go beyond the existing assessments. Six criteria should be taken into account:

1. Credibility of the ethical statements
2. Means for detection of improper business conduct
3. Credibility of sanctions
4. Transparency on issues
5. Independence of auditors
6. Protection of the client

In a nutshell the experience of the Luxembourg financial centre demonstrates the need to reinforce ethics in financial institutions and markets and to go beyond the current assessments.

As discussed before, the global situation could give difficulties for enterprises. Nadine Levratto tries to explicit the rules to improve the management of firms. The evolution of bankruptcy law is designed to achieve a number of objectives: economic security, creation and expansion of firms in a capitalist economy, protection of the interests of the agents involved in transactions that goes far beyond creditors and debtors, and prolongation of the activity of viable firms. This contribution examines the French insolvency law and its transformations since the nineteenth century from a concrete, historical standpoint which makes it possible to view the modifications and the uses of the legal rules in an economic and institutional context. We show that far from being only one means of selection by which the market could be cleared of its failing agents, France's bankruptcy law opens up a non-commercial space for the resolution of failures of market which, by releasing the actors of their former constraints, authorizes them to re-enter the business world.

To complete the preceding analysis of the global world, some specific arguments will be given as regards the European context. Miia Parnaudeau will develop the role of credit market in the European context of the securitization movement with low enhanced inflation pressure. As a consequence, the inflation rate might no longer stand relevant to explain economic fluctuations. Economic agents are facing financial instability. Hence, an appropriate definition for their anticipations is needed.

In H. P. Minsky's analysis, individuals' investment decisions are generating financial instability. But the fact that commercial banks get to financial markets

in order to create more credit worsens the situation. Even if the Central Bank is limiting the credit offer, when commercial banks are using financial markets, they induce additional uncertainty for individuals. Consequently, individuals develop herding behaviours. In this chapter, these behaviours are illustrated by auto-realized anticipations on real assets' prices. Using a BIS database (treated by V. Arthur, C. Borio and P. Lowe) the evolution of real asset's prices in *Wicksellian* interest rate gaps is considered. On the basis of four countries (Germany, Spain, France and Italy), the results show that, according to K. Wicksell's intuition, a fall of the money market rate constitutes a leading signal for long term economic fluctuations. However, in our highly securitized European economies, long-term growth cycles are then better explained by auto-realized anticipations on real assets' prices. Anticipations on inflation no longer stand relevant. As a consequence, should European Central Bank target asset prices? Asset prices targeting could help to protect European economies from the financial instabilities that conduct long term fluctuations. But beyond European Central Bank's credibility to intervene (*ex ante* or *ex post*) on assets' prices, the results obtained in this paper suggest more to challenge monetary and prudential policies' efficiency.

## Part 2: Globalization and Banking Institutions: Evolution of Their Role and Institutional Aspects

The second part will emphasize the role of banking institutions in globalization. This question is crucial, especially as regards the actual financial context. Banks are closely linked to the production and exchange. The activities of banks in the real economy are listed below:

- Clear and settle payments to facilitate trade and commerce,
- Aggregate and disaggregate wealth and flows of funds so that both large-scale and small-scale projects can be financed,
- Transfer economic resources over time, space and industries,
- Accumulate, process, and disseminate information for decision-making purposes,
- Provide ways for managing uncertainty and controlling risk,
- Provide ways for dealing with incentive and asymmetric-information problems that arise in financial contracting.

Considered as the principal responsible actor of the current situation, they react by becoming extremely cautious as regards the level of risk, they accept to bear. Hence, lending and refinancing activities are becoming more and more complicated, both for individual agents and enterprises. However, their intermediary role to provide liquidity to the real sphere is essential to recreate the necessary

forces to stimulate growth. On this point, Europe and the United States face the same difficulties. The following chapters intend to analyse the delicate situations of banking institutions. The arguments proposed will lead the contributors to redefine their core business and incite most of them to replace the research of maximum profit with the concept of an optimum profit.

To begin with, let us consider the European case with its profound transformations. Kurt von Mettenheim reviews banking and public policy toward banking and finance in Continental Europe to reassess development strategies in Brazil and Latin America. Given the shift away from the Washington Consensus favoring privatization and liberalization, continental European experiences provide new perspective for developing countries. This chapter reviews the literature on several major Continental European countries, trends in public and non-profit banking sectors and the impact of bank-centred financial system on distribution of income and sustainable development. Special attention is given to government banking, development banks, savings banks and the financial dimensions of more socially ethical, coordinated market economies.

Caroline Vincensini will then explore the challenges facing the policy mix in Central Europe (Hungary, Poland and the Czech Republic) since the beginning of the 2000s. In a context of disinflation via direct inflation targeting and of preparation for EMU entry and struggle to catch up with the UE 15, clashes were observed between independent central banks and governments, leading to several conflicts on the policy mix and on the status of the central bank. How can these conflicts be explained? Are they related to insufficient credibility of the central banks, as was already suggested in the case of the conflicts opposing the ECB and the national governments in the first years of EMU? Or are other factors involved, such as lack of credibility of fiscal policies and imperfections of the institutional framework? The first two parts of the chapter outline the institutional and economic framework of monetary and fiscal policies in Central Europe, to identify the constraints weighing on them and to show their objectives often diverge. The third part exposes the policy mix conflicts observed in each country, identifying in each case the precise chronology, the sources and themes of the disagreements and whether the conflict mainly concerned the policy mix or attempts by the government to modify the central bank's legal status. The fourth part of the chapter explores whether these conflicts may be explained by a lack of central bank credibility, and suggests that the problem also lies with fiscal policies. The fifth part argues first that these conflicts are fuelled by diverging policy objectives, political factors and by the often excessive fiscal policies of the governments, then by the institutional framework. These conflicts will therefore probably not disappear mechanically upon entry into EMU. This result opens up an interesting normative debate on the improvement of the institutional framework, which can only take place at the European level.

Ingrid Größl will focus on the credit market. It has become a widespread practice among banking institutions to charge higher loan interest rates from households with lower incomes. In this chapter it is shown that the 'lower-income-higher-risk' argument which characterizes the economic perspective is flawed, and may lead to discrimination. Proceeding to the ethical perspective and in doing so, distinguishing between teleological and discourse ethics, it is shown that according to both positions, charging higher interest rates from lower income borrowers constitutes discrimination. However, both positions differ regarding their normative consequences for the behaviour of lending banks. Whereas teleological approaches shift responsibilities to the institutional environment, discourse ethics does not release banks from an ethical responsibility, irrespective of competitive pressures.

Elisabeth Paulet and Francesc Relano will hence give an insight on 'ethical' and 'alternative' banks. Their objective is to comply with these new demands of society. At the same time, 'traditional' banks have also tried to attract these new clients. They have thus stressed their commitment to sustainable development, for instance by signing the Equator principles or by issuing SRI products. Either way, at first sight it is not easy to tell the difference between the ethical/alternative banking born in the 1980s and the traditional banks recently committed to a more social/environmental approach. And yet, they are not at all the same. This chapter will show that beyond the threshold of ethical or sustainable banking, still compliant to some degree with refined 'greenwash', or the superficial moralization of the economy, there are some few institutions which act as real alternative banks. We shall illustrate this point through an analysis of the WIR Bank and its specific counter-cyclical behaviour within the Swiss banking system as regards the credit policy.

This book intends then to inform the reader about the amplitude, effects and consequences of this new international crisis. Far from answering all remaining questions, it intends to alert professionals and researchers about incautious attitudes of investors in financial sphere, which induces lasting turbulence for the real economy.