Opinion of the European Economic and Social Committee on ‘The economic and social consequences of financial market trends’

(2008/C 10/23)

On 17 January 2007, the European Economic and Social Committee decided, in accordance with Rule 29(2) of its Rules of Procedure, to draw up an opinion on The economic and social consequences of financial market trends.

The Section for Economic and Monetary Union and Economic and Social Cohesion, which was responsible for preparing the Committee’s work on the subject, adopted its opinion on 4 September 2007. The rapporteur was Mr Derruine.

At its 438th plenary session, held on 26 and 27 September (meeting of 26 September), the European Economic and Social Committee adopted the following opinion by 115 votes to 25 with 13 abstentions.

1. Recommendations

Information, transparency and protection of investors and consumers

1.1 It is important to develop statistical instruments that will give a better picture of the hedge funds and private equities industries and to develop indicators for corporate governance, all of which are subject to harmonisation, at least at European level.

1.2 In order to alleviate the increasing suspicions weighing on part of the financial industry, to limit the danger of undue risks (especially indebtedness) generating systemic shocks and to ensure respect for fair competition between the various types of investment, prudential standards should be applied to hedge funds and private equity funds (a ‘Basel III’).

1.3 ‘The EESC would urge the Commission to present, as soon as possible, its draft legislative provisions aimed at stepping up the information provided by institutional investors with regard to their policies in respect of investment and voting’ (1).

1.4 In order to enhance protection for investors placing their money in private equity funds, the UCITS directive (2) should be amended so that it also covers these players and obliges them to be more transparent. Although the promise of high returns may be a factor in attracting investment, the final investor may be unaware of the risks involved.

1.5 The Commission should encourage and pursue, together with the interested parties, (including banks, consumers' associations, the public authorities and service providers) initiatives aimed at raising the awareness of consumers of financial services, who generally do not possess the requisite financial background and knowledge and are therefore unaware of the risks involved (2).

1.6 Listed companies which have been bought out but whose turnover or number of employees exceeds a given threshold should always be required to publish a minimum amount of information when they are withdrawn from the Stock Exchange and are no longer subject to the inherent reporting requirements.

Risk management and diversification

1.7 It would be appropriate to think about the possibility of introducing an obligation to diversify the portfolio of the funds invested in, particularly in the case of save-as-you-earn schemes, using existing models as a basis (see also 1.2).

1.8 The American subprime crisis has spread to other sectors of the financial market and to the EU. In the event of a European banking crisis, it is likely that the costs incurred would be substantial because of the fragmentation of supervision, which would slow down any appropriate reaction. Under the subsidiarity principle, the major banks should be subject to supervision at European level. The Committee invites these banks, along with the Commission and the Committee of European Banking Supervisors (CEBS) to confer in order to spell out the conditions and define the criteria for identifying the banks concerned.

1.9 In the case of delegated management, which permits diversification of management risk, extending the length of management mandates would encourage a more long-term approach and limit speculation that goes beyond arbitrage, in order to limit the bias towards the short-term and the race for profits fuelled by the speculative attitudes of management service providers.


(1) As it emerged from the conference ‘Increasing financial capability’ organised by the European Commission in March 2007, the Sandler report presented to the UK Chancellor of the Exchequer, Gordon Brown, contains interesting avenues for reflection.
1.10 Financial rating agencies — which are both judge and defendant here, in the sense that they help investment banks to design, value and place derivatives — should be subject to greater transparency.

Reconciling the financial strategy and the European social model

1.11 The use of tax incentives might encourage pension funds, which adopt a more long-term strategy, to integrate quality and social responsibility (4) into their financial investment policies. Socially responsible investments currently represent only a limited proportion of the total (4).

1.12 The Commission and the Member States must ensure that corporate social responsibility applies to all stakeholders, including investment funds, which have an influence on the companies which they are involved with, and sometimes manage. In this connection, the EESC raises the issue of the implementation of the directive on information and consultation of workers to holding companies (4) and, if they are not covered by this directive, asks that it be reviewed.

1.13 To complement this, the Directive on Safeguarding employees’ rights in the event of transfers of undertakings (3) should be brought up to date to guarantee that transfers of undertakings resulting from operations to transfer these shares are also covered, thereby ensuring due respect for workers’ rights to information and consultation.

1.14 Statistics on wages (and perhaps incomes) should be broken down into at least quintiles, in order to gauge the impact of wage policy on price stability more clearly.

1.15 Services of general economic interest are an essential pillar of the European social model. They are also a prime target for private equity funds, which opt for leveraged buy-outs, as SGIs generate significant cash-flow, are in a position of (near-) monopoly, have low debts and high operating costs. In order to prevent problems for consumers and citizens or any damage being caused to cohesion, the EESC reiterates its call for the common basic principles to which all SGIs must adhere to be defined at Community level. These should be set out in a framework directive and, if necessary, in individual sector-specific directives. (3)

Equal tax treatment

1.16 As some countries have already done or are about to do (Denmark, Germany and the United Kingdom), consideration should be given — with due respect for the principle of subsidiarity — to rules restricting the tax deductibility of interest payments on debt in the event of a company buyout.

1.17 Further to the work already undertaken by the OECD and the moves to combat unfair competition from tax havens, consideration should be given to the possibility of changing the tax rules so that the place where the manager actually operates from determines the tax base for hedge funds, given that these places are usually major cities in the OECD countries. Accordingly, the applicable tax rate should be the rate for normal income rather than the rate for capital gain.

1.18 Since a great many very short-term investment decisions are taken in offshore tax havens, the Committee urges the Council, the Commission and the ECB to think about the possibility of action based on Article 59 of the Treaty (5).

1.19 The Committee highlights the importance of coordinating fiscal policy more closely, setting minimum requirements, especially for the various forms of capital taxation. This policy can be justified on the grounds of both fairness and economic efficiency.

2. Introduction

2.1 Over the past 25 years, the global economy has undergone profound and far-reaching changes. Although we are usually content to explain this phenomenon under the label of globalisation, we are not sufficiently aware of its financial dimension or the creation of a global financial market.

2.2 Accordingly, while both the media and policy-makers continue to focus on the indicator of GDP, a new approach is needed to take proper account of the actual reality. In 2002, global GDP represented 32 thousand trillion dollars. However, although this figure may appear astronomical, it is nothing in comparison with the total sum of financial transactions outside GDP (1 123 thousand trillion dollars) which are 35 times greater in value!

(3) See in particular the work carried out under the United Nations Environment Programme Finance Initiative (UNEPFI) including the report, ‘A legal framework for the integration of environmental, social and governance issues into institutional investment’ (2005).

(4) See in particular the work carried out under the United Nations Environment Programme Finance Initiative (UNEPFI), including the report, ‘A legal framework for the integration of environmental, social and governance issues into institutional investment’ (2005).


(9) Where, in exceptional circumstances, movements of capital to or from third countries cause, or threaten to cause, serious difficulties for the operation of economic and monetary union, the Council, acting by a qualified majority on a proposal from the Commission and after consulting the ECB, may take safeguard measures with regard to third countries for a period not exceeding six months if such measures are strictly necessary.
The global economic sphere (in trillions of US dollars, 2002)

<table>
<thead>
<tr>
<th></th>
<th>Derivatives transactions</th>
<th>Exchange transactions</th>
<th>Financial transactions</th>
<th>Goods and services transactions</th>
<th>Total (interbank transactions)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>699</td>
<td>384,4 (*)</td>
<td>39,3</td>
<td>32,3</td>
<td>1 155</td>
</tr>
<tr>
<td>Currency used for settlement</td>
<td>United States (dollars)</td>
<td>Euro system (euros)</td>
<td>Japan (yen)</td>
<td>Other monetary zones</td>
<td>Total (interbank settlements)</td>
</tr>
<tr>
<td></td>
<td>405,7</td>
<td>372,9</td>
<td>192,8</td>
<td>183,6</td>
<td>1 155,0</td>
</tr>
</tbody>
</table>

(*) Including 8 for international commercial transactions.


2.3 Institutional investors are spearheading financial globalisation. Their emergence has been accompanied by the spread of Anglo-Saxon corporate governance practices (such as protection of minority shareholders, obligations in relation to transparency, institutional activism at general meetings and changes in the relationship between shareholders, managers and workers) and the appearance of credit derivatives, new financial instruments which make it possible to disperse the risks previously seen as intrinsic to certain types of investments. These changes have either been made possible or accelerated by the new information and communication technologies.

2.4 At this stage, it should be stressed that the strategies implemented by institutional investors in the broad sense differ according to their investment horizons. Whilst some investors practise arbitrage, which tends to stabilise financial markets, others, such as pension funds, must act in response to very long-term commitments. The same name may also cover widely differing practices. For example, some private equity funds specialising in leveraged buy-outs invest in an enterprise for a period of three to five years, whilst others, operating as business angels, provide innovative SMEs with risk capital and may be committed for as many as fifteen years (10).

<table>
<thead>
<tr>
<th></th>
<th>Shares</th>
<th>bonds</th>
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<tbody>
<tr>
<td>Hedge funds</td>
<td>1 to 5 months</td>
<td>1 to 5 months</td>
</tr>
<tr>
<td>Other investment funds</td>
<td>9 months to 1 year</td>
<td>1 to 6 months</td>
</tr>
<tr>
<td>Insurance</td>
<td>1 and 2/3 years to 3 and 1/3 years</td>
<td>6 months to 2 1/2 years</td>
</tr>
<tr>
<td>Households</td>
<td>3 to 5 years</td>
<td>8 months to 4 years</td>
</tr>
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2.4.1. Having said this, these actors may also have close links with each other. For example, 24 % of the capital raised by private equity funds in 2005 came from the pension fund sector, 18 % from commercial and investment banks, and 11 % from insurance (11). One of the increasingly important functions of investment funds and other asset management companies is to provide management services to pension funds and insurers via management mandates.

(10) In simple terms, here are some characteristics which can help to distinguish more clearly between hedge funds and private equities. Hedge funds work on marketable assets; i.e. shares, but also raw materials, credit derivatives and so on. They use various kinds of strategy to reach their objective, which is absolute return. When they invest in a company, they are happy with a low percentage of shares, but are proactive in influencing the choices made by the company. The aim of private equities is to extract value, mainly through company acquisitions, using debt. The company in question is then no longer listed and therefore no longer bound by disclosure requirements. After totally restructuring the company over several years, the private equity then disinvests from the enterprise.

2.5 Institutional investors, who had already developed to a certain extent in the Anglo-Saxon countries twenty years ago, have become increasingly interested in the countries of continental Europe. Funds have also been created in the various Member States. However, at the current time, American investors still control half of all collectively managed assets.

2.6 The current estimate is that institutional investors account for 80% of stock market transactions. Accordingly, it would seem unrealistic to take investment positions opposed to those of the major investment bodies. They are also the main players when it comes to holding cross-border shares. A Eurobarometer poll (in August 2005) revealed that only 1% of households owned shares from a foreign company and that barely 3% would consider buying foreign shares! Moreover, very few of them take an active part in shareholders’ general assemblies whilst institutional investors have been playing an increasingly visible and active role in these for several years.

2.7 This opinion is concerned, primarily, with listed companies, since they are active on the stock markets. These tend to be very large companies. However, since they have a decisive influence on employment and the behaviour of other enterprises, the ‘changes’ they are subject to also affect the economy and society as a whole:

— these companies generate one in every three jobs in Europe and one in every two in the United States;

— they predominate in the extractive industries, transport and telecommunications and corporate services, in other words sectors that are key nerve centres;

— they also influence the way SMEs operate, through sub-contracting and financial involvement.

3. Convergence of corporate governance systems (12)

3.1 A distinction is usually drawn between two different corporate governance models, with different types of institutions and practices influencing the ways companies are directed, administered or controlled, different types of relations between stakeholders and different objectives assigned to companies.

— The Anglo-Saxon model is characterised by enterprises where ownership is extremely dispersed and institutional investors very present, even if they are not directly involved in the management of the company. Although each individual investor generally holds no more than 3% of the total shares, they exert their influence through actually selling or signalling their intent to sell their shares. This system is typical of countries with a high proportion of listed companies.

— In the model characteristic of continental Europe and most other countries, including Japan, shareholders tend to hold blocks of 10 to 20% of shares, which gives them effective control. Investors include the State, banks or other companies, and are directly involved in the management of the companies. Unlike the previous model, workers are also involved to a certain extent in the company’s affairs, the most extreme example being the German Mitbestimmung.

3.2 Over the past twenty years, the continental European model has converged towards the Anglo-Saxon model. The factors encouraging this process include: the Single European Act and the privatisation of State corporations, tax reforms in Germany, particularly on capital gains in the stock market, which have led banks to sell their shares in industry, the requirement for institutional investors to use their voting rights, introduced by the American Labour Department (1988 and 1994), the vitality of the US economy during the 1990s in comparison with the relative stagnation in continental Europe, the listing of major companies on several stock exchanges and the new international accounting standards.

3.3 Nevertheless, capitalism still assumes diverse national and regional forms, as a result of:

— the diversity of economic institutions at national level, in terms of law, politics, culture and resource base;

— the interdependence of capital and labour markets and between the legislation and standards regulating the ways companies operate;

— the cost of moving to another system, since changing just one of the elements mentioned above puts the coherence of the whole at risk.

4. Economic impact

4.1 The rapid rise of institutional investors has democratised access to financial markets and helped to diversify portfolio risks, by offering the expertise of a management team. By pooling household savings, more and more diverse funds are available, which reduces the risk borne by individual investors. UCITS offer access to potentially high capital yields for individual investors with modest financial means and little market expertise. For enterprises and public administrations, the concentration of capital in the hands of institutional investors reduces the costs of negotiation, by providing a single interlocutor.

(12) James Shinn. Private profit or public purpose? Shallow convergence on the shareholder model, Princeton University, 2001. Contains studies covering 14 countries: the United States, the United Kingdom; Belgium, France, Germany, Italy, the Netherlands, Spain; China, Japan, South Korea, Malaysia, Singapore and Taiwan Roger M. Baker, Insiders, outsiders, and change in European corporate governance, University of Oxford, 2006.
4.2 Institutional investors of all kinds (including hedge funds, pension funds, banks, insurers and private equities) manage the wealth of around 300 million households, mainly in the United States, Europe and Japan (16). Their aim is to maximise the returns on their principals’ savings, in line with the level of risk they are prepared to assume.

4.3 From the perspective of consumers and households, tautologically, the growing proportion of household wealth in investment fund shares implies an increase in the exposure of household wealth to market risk (17).

4.4 Apart from UCITS and insurers, pension funds are well known to the general public. They are presented as one of the ways of bringing down the costs of the demographic trend towards ageing of the population. They fall into two types: defined benefits schemes and defined contributions schemes. In the first instance, the risk is born by the sponsor, i.e. the employer, and in the second case, by the final saver. Although this second type of scheme is characterised by a riskier assets structure, they are becoming increasingly popular, since sponsors are seeking to minimise the risk generated by their long-term commitments and employees are increasingly drawn to saving schemes which can offer higher yields and rights that are more easily transferred from one employer to another (18).

4.5 Their assets are managed by the funds themselves, although management is very often delegated (either fully or partially) to mutual funds or other management companies. So, although the investment horizons are theoretically long, management performance is actually judged in the short term and on the basis of profits alone. This explains why the proportions of shares in total assets has risen sharply and has contributed to the rise in share prices.

4.6 The convergence of the two models of corporate governance, together with the development of ICTs, increased activism on the part of institutional investors and the latters’ profit yardstick have led large enterprises to focus exclusively on maximising the returns on their shares (dividends and capital gains). Issues relating to their capacity to generate future cash flow or the partnership approach highlighted in the European social model have been pushed into the background.

4.7 A new type of governance has therefore emerged. Its goal is to be proactive in changing to different strategies, to ensure that value is continually created for shareholders, rather than medium or long-term improvements in competitiveness, which may thereby be compromised. Such strategies include share buy-backs, where a company buys back its own shares in order to increase the indicator of its net return on equity (ROE), mergers and acquisitions (M&A), sometimes totally unrelated to the needs of industry, reduction of a company’s sphere of activity and integration of its tasks into the group’s activity to help diversify the investment portfolio, relocations, staff cuts and flexible work contracts to reduce fixed costs or convert them into variable costs (19).

4.8 Generally speaking, the requirement for a high return on equity in real terms, from 10 to 20 % depending on the sector, has destabilising macro-economic effects: such high returns imply that growth in profits is much higher than GDP. This has led, (along with other factors, such as migration, relocations, increased import penetration) to a rising proportion of wealth being held by those with capital. We are witnessing a new distribution of added value in Europe. According to data from the European Commission, the OECD and the BRI, the share of salaries in GDP (taking the average of the EU15) fell from 71.5 in the 1980s to 66.7 % in 2004. This shift in nearly 5 GDP points has been reflected in a symmetrical rise in capital returns (profits).

4.8.1 The macroeconomic impact of such a considerable change in the distribution of wealth is deflationary: it increases global savings but, since workers’ purchasing power has barely risen, their demand lacks dynamism and enterprises are not therefore encouraged to invest. On the other hand, a large proportion of their profits is redistributed to shareholders (in the form of dividends and share buybacks), which creates surplus liquidity and the phenomenon becomes self-sustaining.

4.8.2 Moreover, since the key OECD countries are competing against each other to attract direct foreign investment stimulated by surplus liquidity but held back by the slow growth of domestic markets, they have introduced tax reduction policies which could cripple public finances, unless public spending, apart from social expenditure (c.f. ageing populations), is reduced.

4.8.3 Indeed, since interest on debt is exempt from tax in many countries, leveraged buyouts are equivalent to a form of public authority subsidy for the operations of private equity funds. This places them in an advantageous position. Furthermore, apart from the question of unfair competition in relation to other economic actors which do not use this type of procedure, leveraged buyouts also have implications for public finances. A study conducted for the Danish Ministry of Taxation (20) predicts that, all other things being equal, in Denmark, these losses could represent 25 % of the total income from company taxation two years from now. A similar situation pertains in most other European countries and countries in the euro area, which are subject to the budget criteria of the Stability and Growth Pact.

4.8.4 With regard to the remuneration of fund managers, the 20 % carried interest they traditionally pay on returns in excess of certain thresholds is, as a rule, taxed at the lower rate, i.e. that applied to capital gains, and not at the higher rate of tax on normal income. There is no justification for this, since they themselves only contribute a marginal amount of the capital. This situation leads to a problem of unequal tax treatment between these individuals and other workers who are more heavily taxed.

4.9 It is not only companies’ nature and strategies which have evolved, but also the role of the chief executive. Ten years ago, the CEO’s job was all about ‘stewardship’ of the corporation’s assets for stakeholders; today, it’s all about the bottom line for investors. The rate of CEO dismissals and other forced departures on the grounds of poor shareholder returns reached its peak in 2005, when four times as many of the world’s top CEOs were forced out as ten years before. More than one in seven of the world’s largest companies made a change in leadership — compared with one in 11 only a decade earlier. Their tenure has also been reduced. This increasingly rapid turnover can lead to problems, since the changes that need to be made within enterprises usually take three or four years to implement.

4.9.1 As a result, since many management boards find themselves without candidates to succeed the dismissed CEO this recruitment strategy can cascade into further increases in CEO salaries — not only due to the additional compensation required to motivate a chief to change jobs, but also to the efforts of companies to retain their CEOs. Indeed, an overwhelming majority (90 %) of institutional investors are concerned about what is seen as excessively high pay for managers and the lack of any positive effect on company performance (78 %) (14).

4.9.2 Although companies appear to be distancing themselves from the stock options which have led to conflicts of interest and major scandals, the practice of giving ‘golden parachutes’ and other rewards to CEOs who have failed to improve company performance (in terms of competitiveness and jobs) is shocking in the eyes of the public.

5. Cohesion/social inequalities

5.1 On the one hand, although the high dividends paid to shareholders have been justified in the past by the risk involved in the operations in which they are investing their capital, the basis of this argument has been seriously undermined by the developments which have taken place in recent years.

5.1.1 In fact, their liability is limited to their own contributions, and the negotiability of their asset — which is linked to the growing liquidity of financial and stock markets resulting from their globalisation and the introduction of new technologies — considerably reduces the level of risk they bear, whilst also giving them unequalled exit and diversification capacity.

5.2 Moreover, economists have observed a seasonal pattern to redundancies, which peak in January and June, in other words, the time when companies’ annual budgets are determined and revised. The conclusion was that the redundancies were motivated by a desire to improve the bottom line, rather than to meet industry requirements (15).

5.2.1 In addition, there is a trend towards individualisation of work contracts and salaries and an explosion in the numbers of atypical contracts such as fixed-term and part-time contracts, intended to convert a proportion of the fixed costs linked with salaries into variable costs and, ultimately, to increase the profit and therefore the return on equity. In 1992, 25.4 % of employees were employed on fixed-term or part-time contracts. In 2005, the proportion had risen to 33 %. Except in 2005 itself, the growth in insecure contracts of this kind has far outpaced the growth in new jobs and, as far as fixed-term contracts are concerned, only led to a permanent contract in 33 % of cases (as against 22 % to cessation of employment and 39 % to another contract of the same type) (16).

5.2.2 This is resulting in new risks for both workers and enterprises:

— enterprises do not invest in these mobile workers, who in their turn do not invest their energy, since they have less feeling of belonging to the enterprise and fear that they will not draw any concrete benefits from training (17) (18);

— in the knowledge society, human capital is increasingly specific to particular enterprises and therefore not easily redeployed (i.e. it cannot actually be transposed from one firm to another) (19);

— workers’ representatives can no longer identify the interlocutors they need to approach in the context of social dialogue, since ‘their company director’ is actually a fluctuating and atomised group of faceless shareholders;

— workers are put in the position of competing against each other:

— at global level, due to the high mobility of productive and financial capital and the doubling in the number of workers participating in the economy following the collapse of the Soviet bloc and the entry of other countries, notably China and India on to the international scene;


17 Since human capital is increasingly singled out as a factor contributing to competitiveness in a knowledge economy, it is astonishing that it is not counted as an asset on companies’ balance sheets.


19 Cf. § 6.4 and following paragraphs.
— at national level, due to the unemployment rate and the proliferation of very low quality jobs, which drives up the value of good quality jobs, and to the paradox of training: on the one hand, it is now good form to highlight the need for training and the mismatch between jobs and skills, on the other, almost one in three workers feel that they are overqualified in relation to the requirements of their current jobs and the least qualified workers and interim workers are not offered sufficient training;

— the setting of worker against worker is exacerbated by the fact that worker mobility is relatively limited, because of the maintenance of transitional periods for legislation on economic migration, under which foreigners’ access to the labour market is made contingent on the existence of shortages in particular occupational categories (political restrictions) or the absence of any real progress in relation to transferability of pension rights or the overheating of the property market (socio-economic restrictions) or inadequate knowledge of languages (cultural restrictions).

5.2.3 A new balance must be found between shareholders and workers. Aside from the distortion in the division of GDP into ‘capital’ and ‘labour’ and the factors mentioned above, the imbalance is also reflected in the exponential development of financial and stock markets over the past few years, in contrast to the reverses in labour law, which no longer provides workers with sufficient protection (for example in terms of contracts or continuing training (24)). This reflects the fact that labour flexibility (and increasing insecurity) is now becoming an adjustment variable for businesses.

### Development by social model

<table>
<thead>
<tr>
<th></th>
<th>Market capitalisation/GDP</th>
<th>Worker protection</th>
</tr>
</thead>
<tbody>
<tr>
<td>Anglo-saxon model</td>
<td>UK, USA, CAN, AUS</td>
<td>54</td>
</tr>
<tr>
<td>Scandinavian model</td>
<td>FIN, DK, SV</td>
<td>28</td>
</tr>
<tr>
<td>Continental</td>
<td>FR, DE, AT, B, NL</td>
<td>30</td>
</tr>
<tr>
<td>Mediterranean model</td>
<td>IT, SP, EL</td>
<td>16</td>
</tr>
<tr>
<td>Japan</td>
<td></td>
<td>98</td>
</tr>
</tbody>
</table>

N.B.: There is no data available for the new Member States.

Labour protection is measured by the ‘EPL version 1’ indicator calculated (for the years 1990, 1998 and 2003) by the OECD. It covers regulations on the protection of regular and temporary employment. The closer the figure is to 0, the weaker the rules on labour protection (EPL version 2 also includes information on collective redundancies but does not go back as far as 1990).

5.3 It has now been several years since we entered into a phase of severe wage restraints (25) as a result of increasing international competition and profit yardsticks. However, not all socio-occupational categories are concerned by this phenomenon.

5.3.1 Therefore, as in the United States (26), the European Commission, Eurostat and the ECB should refine their statistics by breaking them down into (at least) quintiles (27) so as to identify more clearly which categories of workers (very high wage earners, very low wage earners and the groups in between) are actually spurring increases in the overall wage bill and in incomes more widely, so as to get a clearer picture of the risks to price stability, in the knowledge that people in the various different categories do not have the same propensity for consumption (28) (c.f. also 4.8.4).

5.4 Although employee shareholder schemes have developed, they cannot redress the balance since, in terms of their representativeness across the workforce, they are disproportionately weighted towards the highest waged employees (generally senior management).

5.5 Since economic systems are shaped by a particular history (see point 3.3) it is quite understandable that the convergence of corporate governance models (see points 3.1 and 3.2) has not had a particularly visible impact in continental Europe in terms of the fight against unemployment, even though the European social model is based on a social market economy which is premised on a partnership approach in the widest sense, transcending the interests of shareholders alone.

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5.5.2 Various recent studies have pointed in this direction, notably T. Piketty and E. Saez: ‘The evolution of top incomes: a historical and international perspective’. American Economic Review, 2006.

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(26) Cf. the three yearly ‘US Survey of Consumer Finances’.
(27) Distribution of wages ranked in ascending order and divided into five equal parts, containing the same number of observations.
6. R&D and innovation

6.1 As demonstrated by the 2000-2001 stock market crisis, in view of institutional investors’ propensity for mimicry when it comes to investment decisions, there is still a possibility that this may lead to over-investment in certain sectors and, simultaneously, under-investment in others.

6.2 The example of the Scandinavian countries shows that it is possible to combine high social and technological performance with a financial system that is based on banking rather than stockmarkets.

6.3 As for private equities, they bring the risk-capital which small enterprises need to launch new activities (start-up), an area which has been in decline for several years (in 2003, it accounted for less than 10 % of their investments) (**). On the other hand, private equities are increasingly focusing on buy-outs (which accounted for over 60 % of their activities in 2003) (see the chapter on ‘Leverage effects and systemic risk’). Moreover, this trend is unlikely to stimulate investment, since, in view of the risks involved in this activity, the priority for private equities will be to reimburse and pay out to shareholders rather than to invest for the long term.

6.4 Apart from R&D, so-called ‘tacit’ interactions (**) are an increasingly important factor for the competitiveness of all firms. Tacit interactions involve exchanging information, formulating opinions, coordinating and monitoring other activities and exchanges (of goods, services and information) with other workers, clients and suppliers and represent a combination of various different forms of knowledge. Employees with these kinds of skills now represent between 25 and 50 % of the total labour force.

6.4.1 If they wish to become more competitive, companies can no longer rely on standardising the work of their employees who use tacit interactions or replacing them with machines. On the contrary, they need to remove organisational barriers, create a climate of trust, not only between employees but also between employees and the firm itself, and enable them to take decisions and communicate rapidly and easily. Corporate strength therefore lies in the collective knowledge specific to each particular enterprise, which is built up over time.

6.4.2 Enterprises now have considerable room for manoeuvre when it comes to improving the productivity of workers involved in tacit interactions, more so than for other categories of employee. This is reflected in the wide disparity in performance in sectors with a high proportion of jobs of this kind. Sectoral social dialogue has a role to play here in creating opportunities for firms to share their experiences, for example in seminars and studies.

6.4.3 This emphasis on companies’ specific areas of competence raises questions in relation to flexibility, which envisages a generic form of training enabling individuals to find employment in another firm, possibly in a different sector from the one they are leaving.

7. Leverage effects and systemic risk

7.1 The buy-outs conducted by certain types of private equities are a speculative activity, based on indebtedness and a gamble on being able to use the profits generated by the target firm to reimburse borrowing and generate considerable gains within five years.

7.2 In the countries of continental Europe, these operations accounted for 0.6 % of GDP in 1995, and no less than 3 % in 2005. (**) (For the United Kingdom, the figures are 1 and 7 % respectively. Buy-outs now represent the key activity (70 %) for private equities, whilst the contribution of venture capital is declining (5 % in 2005).

7.2.1 In the second half of 2006, alarm signals from the central banks (ECB, Bank of England) and the rating agencies (Standard and Poor’s) multiplied in response to the ebullience of this sector (USD 500 billion) which, in 2005, raised 70 billion dollars more than the previous year. They noted a systemic risk resulting from the sharp increase in firms’ indebtedness together with a multiplication of junk bonds, which were reaching worrying levels.

7.2.2 This is a dilemma for the monetary authorities, since any rate increases aimed at slowing down this activity would also spell the end for firms currently surviving due to excess aggregate liquidity.

7.2.3 Buy-outs raise two other different but equally vital questions:

— When operations are conducted by creating a holding company, the directive on worker information and consultation does not apply. This results in lower worker participation for these employees, who number several hundred thousand in Europe.

— Through leveraged buy-outs (LBOs), investment funds are entitled to be represented, on behalf of the company they have acquired, on the management boards of major European groups active in crucial sectors, such as the aerospace industry. Given that some funds of US origin have particularly close links with the US government and intelligence services, the EU’s technological, military and political independence is at risk, in that a seat on the management board gives access to confidential information (***).


7.3 In general, there are a number of biases that artificially boost the average return shown by private equity funds. Since they are not bound by any reporting obligations, only the highest performing private equities actually report their results, and funds which disappear due to poor results are withdrawn from the databases. A study by Citygroup shows that once these factors are taken into account, the return calculated over a ten year period is lower than for a mid-cap basket of shares. The performance reported is even lower when management costs and the costs of investing in these illiquid assets are also taken into account (33).

7.4 Hedge funds are an industry worth over one and a half thousand trillion US dollars. These funds are not new, but their importance has grown over the past twenty years. This sector is facing pressure from investors, such as pension funds, to become more transparent. In response to this pressure, a system of credit rating and risk has been developed by various rating agencies.

7.4.1 In view of their colossal financial clout, hedge funds in their turn exert huge influence on financial, stock and money markets. This question merits in-depth examination:

— The American, UK and European regulators have recently reiterated their concern that investment banks might allow hedge funds to increase their borrowing capacity by using relatively illiquid collaterals, whose value might therefore fall rapidly in the event of a financial crisis. They are also posing questions in relation to the offshore vehicles which are speculating on the leverage effect and enabling American banks to extend credits to hedge funds beyond legal limits.

— Hedge funds are also active in the ‘carry trade’ sector, in other words in operations where investors borrow in low interest currencies (such as the yen or the Swiss franc) in order to invest in currencies which pay higher interest rates (Australian dollar). Increasing numbers of banks, including the Bank for International Settlements (BIS), and economists are convinced that these transactions, which are extremely profitable for the hedge funds, are one of the factors contributing to the weakness of the yen, which in January reached its lowest level in relation to the US dollar in four years. A sudden interest in the Japanese currency (following a recovery of the Japanese rate in response to the vigour of the Japanese economy) could degenerate into a financial crisis. Barclays Capital estimates that the essentially speculative carry trade is now at its highest level since the Russian crisis of 1998.

7.5 Derivatives enable banks to lay off exposure to risk by converting it into complex financial products that are the object of transactions. In so doing, the risk is dispersed but spread across the economy, to players who may not be subject to prudential rules.

7.5.1 Although the statistical probability of a major financial crisis with systemic repercussions has diminished over time, a crisis is still probable and the damage would be all the greater than in the past, particularly in view of the closer links between institutions and markets resulting from the financial innovations which have enabled better integration of markets and merger and acquisition operations in the banking and insurance sectors (34).

7.5.2 In view of a leverage effect which has increased over the past few years and which, by definition, does not appear on the balance sheet, it is impossible to estimate the amounts actually involved and the risk to which the economic system is exposed.

Brussels, 26 September 2007.

The President
of the European Economic and Social Committee
Dimitris DIMITRIADIS


Revised amendments

The following amendment, which received less than a quarter of the votes cast, was rejected during the discussion (Rule 54(3) of the Rules of Procedure):

Points 5.1 and 5.1.1

Replace points 5.1 and 5.1.1 with the following point 5.1:

5.1 On the one hand, although high dividends paid to shareholders have been justified in the past by the risk involved in the operations in which they are investing their capital, the basis of this argument has been seriously undermined by the developments which have taken place in recent years.

5.1.1 In fact, their liability is limited to their own contributions, and the negotiability of their asset—which is linked to the growing liquidity of financial and stock markets resulting from their globalization and the introduction of new technologies—considerably reduces the level of risk they bear, whilst also giving them unequalled exit and diversification capacity.

5.1 Dividends paid to shareholders should be in accordance with companies' performance.

Reason

Both points seem overly critical of the important role that shareholders play in the development of companies. Stating that ‘their liability is limited to their own contributions’ appears to play down the risk posed by investing in the financial and stock markets. Moreover, the recent crisis within these markets contradicts the statement that ‘the introduction of new technologies considerably reduces the level of risk they bear’. Limiting dividends paid to shareholders could have a negative impact on stock market trends.

Voting:

For: 65
Against: 70
Abstentions: 13