FOUNDATION FOR EUROPEAN PROGRESSIVE STUDIES
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**FEPS**

**Rue Montoyer 40 | 1000 Brussels (Belgium)**

# TOWARDS A SUSTAINABLE ECONOMY

## - Theoretical Approach and Policy Implications -

Paper drafted by Matthieu Méaulle, Economic Advisor, FEPS
Any further information can be obtained through the Secretary General of FEPS, Ernst Stetter
(ernst.stetter@feps-europe.eu)

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Keynes said in the *General Theory* (1936) that "*the difficulty is not to understand new ideas. It is to escape old ideas*". Indeed, it seems difficult for the socialist, social-democrat and labour movements in Europe to state that the development model experienced and recommended all around the world is totally flawed and based on an ideology which has never been supported by any piece of scientific demonstration, putting aside *ad-hoc* assumptions.

It is now common knowledge that the last twenty years have been marked by what has been labelled the revenge of Hayek over Keynes. In fact, Hayek, in his masterpiece *Prices and Production* (1931), tried to demonstrate that any external intervention in the economic system would bring the seeds of a future crisis. By intervening in the economic system, the state would in fact bias the relative price system in a way which does not reflect agents' desires. This would influence investments in the wrong sectors of production, sectors which should not develop if one was only considering agents' desires. This production would not be bought, and would induce chain losses considering their interactions with other sectors.
This argument could have been also brought upon if States would have intervened for social justice reasons. A rise in wages or an expansionary monetary or budgetary policy would, for the same reasons, deform the "natural" relative price system in a way which does not reflect agents' desires. For the supporters of such a vision, unemployment is either voluntary, given agents' preferences, or involuntary, with its roots lying in political intervention in the economic sphere.

This view has been challenged by a colleague of Keynes, Sraffa (1932), stating that monetary economic policy was not synonymous with future economic crisis. In this respect, Sraffa was also demonstrating, using Hayek's tools, that economic intervention was not systematically destabilising.

Finally, after the modern formalisation of the General Equilibrium framework by Arrow & Debreu (1954) trying to show that the economy, through the intermediation of the markets alone, could reach a state of rest satisfying individual desires, it has been demonstrated that this equilibrium was neither unique nor stable (Sonnenschein (1972, 1973); Mantel (1974); Debreu (1974)). As was stated by Kirman (1989), "the Emperor has no clothes":

> *"it is worth repeating that recent theoretical work has shown how little the Walrasian model has to say about aggregate behaviour. Economists therefore should not continue to make strong assertions about this behaviour based on so-called general equilibrium models which are, in reality, no more than special examples with no basis in economic theory as it stands"*.

However, these models have remained the main tools for economic forecastings. Nonetheless, it also means that economic intervention is needed if one is interested in the stability of the economic system, more specifically, of the capital accumulation process.

As said earlier, supporters of such vision see involuntary unemployment as a special case, a case in which political intervention in the economic system prevents the establishment of full employment. The recommendations of such economists are straightforward, they both recommend to decrease labour costs, of which wages are a big component, and to prevent any public intervention which would distort relative prices and free competition, and would ultimately act against the establishment of an optimal allocation of capital in the economy.

However, this view has been challenged by Keynes, stating that involuntary unemployment was a feature of modern capitalism (under assumptions of perfect competition and price flexibility) and not just a special case. This result is the consequence of the fact that, for Keynes, the level of employment is not determined on the labour market, which, by definition, does not exist taking into account the absence of a labour supply curve. An employment policy is therefore not a labour market orientated policy, but more a policy directed towards what is considered to be the cause of involuntary unemployment, the lack of demand, resulting from a lack of investment and consumption.

All the logic is completely reversed. When free market ideologues advise the lowering of wages to raise profits for a decrease in unemployment, Keynesians recommend raising investment and consumption in order to raise employment and profits. When free market ideologues recommend increasing savings for future investments, Keynesians recommend an increase in investment for an increase in savings. When free market ideologues see the deep roots of unemployment on the supply side of the economic system, Keynesians see it on the demand side:

> "*the growth of wealth, so far from being dependent on the abstinence of the rich, as is commonly supposed, is more likely to be impeded by it. One of the chief social justifications of great inequality of wealth is, therefore, removed*" (Keynes (1936)).

This liberal logic, instead of having directed European and world economies on stable growth paths, in fact lead to major imbalances at regional and international levels. As stated by Stiglitz & Fitoussi (2009), the crisis has structural roots. The aggregate demand deficiency preceded the financial crisis and was due to structural changes in income distribution. Since 1980, in most advanced countries the median wage has stagnated and inequalities have surged in favour of high incomes. As the propensity to consume out of low incomes is generally larger, this long-term trend in income redistribution by itself would have had the macroeconomic effect of depressing aggregate demand. In the US the compression of low incomes was compensated by the reduction of household savings and by mounting indebtedness that allowed spending patterns to be kept virtually unchanged. At the same time, the limited safety nets forced the government to pursue active macroeconomic policies to fight unemployment, increasing government debt as well. Thus, growth was maintained at the price of increasing public and private indebtedness. Most European countries tread a different path. The redistribution to higher incomes resulted in an increase in national savings and depressed growth. The shift in distribution resulted in soft growth:

*"These two paths were mutually reinforcing because the savings from the EU zone contributed to the financing of US borrowing. Thus, the combination of structural disequilibria that goes by the name of global imbalances resulted in a fragile equilibrium that temporarily solved the aggregate demand problem on a global scale at the expense of future growth"*(Stiglitz & Fitoussi, 2009).

In this respect, the stimulus package that seems necessary does not have the sole purpose of relaunching the economy for a higher growth rate but also of recasting the patterns of European economic growth. It is a growth-and-twist movement. As such, the new tools for financial regulation under consideration on the European scene should be considered as complementary to the stimulus package for the real economy. This stimulus package should be orientated towards more social justice; not for "charity" or "humanitarian" reasons but because social justice is a prerequisite for capital accumulation. Moreover, environmental problems have become so evident that productive investments must be green orientated.
The recovery in the European Union and elsewhere will crucially depend on the capacity to sustain aggregate demand in the medium and long terms, preventing both artificial financial booms and permitting higher investments for better jobs and a better environment.

## Social justice for economic recovery:

One of the main characteristics of globalisation since the 1980's is the decrease in the share of GDP which go towards wages. Contrary to widely held opinion it is established by international institutions, such as the IMF and European Commission, that the underlying decrease in the share of wages in GDP is a structural phenomenon and not a conjectural one. The share of wages in GDP from 1982 to 2005 in Europe decreased from 63% to 58%[1]. In the Triade (with a rate of profit equal to 100 in 2000) it increased from 70 in the 1980's to 110 in 2006 (Husson, 2008). But it is also possible to show that this movement is not linked to an increase in the rates of investment and growth. On the contrary, the latter, in the same period for the same region, continued to fluctuate around 2% or 3%. In other words, the puncture on wages has not been used to invest more. The ongoing discrepancy between the

[1] Ameco Database. For international comparison, see also Horn, Dröge, Sturn, van Treeck, Zwiener (2009).

profits realised by enterprises and the share of the profits going to real investment is therefore a good indicator of the financialisation of the economic activity. If the rate of financialisation is defined as the non-invested share of profit as a percentage of GDP, which is the difference between enterprises' margin rates and their rates of investment, one can clearly see a strong link between the rate of financialisation and the rate of unemployment in Europe from the 1980's (*Ibid.*).

This clearly shows the limits of deregulated markets. The decrease in wages and the consecutive rise in profits did not lead to an increase in investment. Even more it led to an overinflated financial system, becoming a sector of production on its own while creating no wealth as such.

This means many things at the same time. It first means that a lowering of wages does not systematically increase employment. This calls for a strong integration of social and employment policies as part of economic policy. It also means that competition as the unique tool for stabilisation does not ensure that the economic system will move in the right direction (Nikaïdo, 1985; Méaulle, 2007) i.e. on a smooth growth path. This calls for a European industrial policy, given the intrinsic unstable character of the economic system. Finally, given the doubt one can have considering financial wealth creation, it means that some financial products, if they do not serve the needs of the real economy, should be banned. This calls for more regulation of financial systems and actors.

However, as stated by the last IMF World economic outlook (2009):

> "*Financial market conditions in the region*[2] *have improved, but the largely bank-based financial system will take time to fully resume its intermediating role. Tight credit conditions will limit private investment, and rising unemployment will weigh on consumption, even as public support will need to be gradually withdrawn*"

As suggested by the SAMAK group,

> "*Immediate measures focusing on unemployment require a targeted and sharp increase in public investments in construction, renovation, infrastructure, education and training*".

[2] i.e. Europe.

Their economic modelling suggests that tax reliefs in the current circumstances would have only a third of the effect of active public welfare investments. This result could be compared to those produced by the IMF (Freedman, Kumhof, Laxton, Lee, 2009):

> "*Using government expenditures as the fiscal stimulus results in very much larger effects on GDP than does lump-sum transfers*".

For a stimulus equal to 1% of the Euro area's GDP in the first period and 0.5% of GDP in the second period, GDP would grow by 1.6% in the first period and by 0.6% in the second period. The cumulative fiscal multiplier would be equal to 1.5 while for the same stimulus through lump-sum transfers or tax reliefs it would be inferior to 0.5. If monetary accommodations are allowed during the adjustment process (meaning that monetary authorities keep unchanged nominal interest rates even if the stimulus implied a decrease in real interest rates through an increase in inflation) the cumulative fiscal multiplier could reach 3.3 whereas it would still be inferior to 1 for lump-sum transfers or tax reliefs.

Moreover, a rise in wages, far from having a depressive effect, could represent an escape of the present crisis. A rise in wages raises consumption, given than workers have a higher propensity to consume than capitalists. This should induce, in the short run, a rise in the use of productive capacities by enterprises. Following the multiplier effect, production and employment rise. There is then a new rise in demand which in the medium and long terms will induce enterprises to invest in developing their production capacities leading to higher profits and higher profit rates (Hoang Ngoc, 2009; Lavoie, 2004).

The Globalization Fund could widen its scope of action at the European level by using it to implement a common unemployment insurance system, aimed, among other things at strengthening regional coherence. One could also stress the need for the adoption of a European minimum wage anchor.

It should not be necessary to say that each project should be evaluated with respect to its impact on social justice, on the environment[3] and on the stability of the economic growth path. This requires, however, that one is able to assess the degree of interconnectedness of

[3] Notably concerning the reform of the Common Agricultural Policy.

production sectors and to investigate the repercussions of any investment plan on the stability of the whole economic system.

All these recommendations should call for public intervention in the economic system. These interventions will have a cost which will have to be paid in the medium and long terms. However, one should be clear in stressing the need for sound public finances. The last twenty years have been dominated by supporters of free markets who consider taxes as an obstacle for capital accumulation. In this respect the last twenty years have been marked by decreasing public resources. It is therefore much less, as often suggested, a generational conflict than an income groups conflict. One should be clear in stating that a new paradigm for capital accumulation, giving priority to social justice, industrial policy and financial regulation, should go together with increasing tax regime for very high incomes. One should also consider that a growing economy, with different growth patterns than low wages and deregulated markets, should induce more public resources.

Moreover, one should state that the crisis enabled an escape from the arbitrary stability and growth pact, but questions our solidarity principles. One should think about an Active Solidarity Pact in case of national or regional bankruptcy. Such a tool would also foster European integration.

Finally, it should clear that the more these policies will be designed as part of an integrated and inclusive European programme, the more these policies will be successful.

## Financial markets: servants of the real economy:

Already in 1936, Keynes, quite ironically, stressed the irrationality of financial markets and the need to regulate them:

> "*Thus, apart from the necessity of central controls to bring about an adjustment between the propensity to consume and the inducement to invest, there is no more reason to socialise economic life than there was before*".

This comes from the fact that for him:

> "*professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view. It is not a case of choosing those which, to the best of one's judgment, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees*".

Moreover, Minsky (1980) pointed out that financial stability cannot be taken for granted by assumption as it is in the neo-classical synthesis. He said that:

> "*significant incoherence occurs because market processes do not assure that effective demand always will be sufficient to yield profit flows large enough to enable "bankers" and "businessmen" to fulfil their commitments on debts*...".

In fact for Minsky, "stability – or tranquillity is destabilising" and the fundamental instability is upward. A period of tranquillity (in which the financial system is robust and there are no relevant shocks, so that profits are systematically greater than debt commitments) increases the confidence of firms and financial intermediaries, thus reducing both the value placed upon liquidity and the borrowers' and lenders' risks. This means that the price of capital asset increases and that the desired safety margins decrease. According to Minsky, the result is an increase in investment financed by indebtedness. In this way the expansion turns into a boom financed by indebtedness. The risk of default increasing, this could lead to a crisis of the financial sector, and consequently of the whole economy.

However, one can also interpret the recent financial crisis as a bubble in what became a sector of production: finance. The production of financial products through financial innovations is very intensive in financial products, notably in the case of securitisation processes. Investors were not interested in investing in asset backed securities but in structured products of ABS, collateralised debt obligations of all types. Their production being rentable, capital transfers occurred in favour of the financial sector, raising at the very same the price of financial products needed for the securitisation procedure and therefore the profit rate of this sector. In other words, one can easily suspect that the rise in profitability in the financial sector was in fact self-fuelled without any regard for what happened in the real economy.

All these arguments call for strong and direct regulation of financial markets and institutions. Self-regulation and market discipline have proven to be flawed concepts in terms of systemic risk.

The need for regulating special investment vehicles is crucial. It is thanks to them that financial institutions were able to escape Basel II regulation. However, as stressed by Colander, Föllmer, Haas, Goldberg, Juselius, Kirman, Lux & Sloth (2009):

> "*The danger of systemic risk means that regulation has to be extended from individualistic (regulation of a single institution which of course, is still crucial) to system wide regulation. In the sort of system which is prone to systemic crisis, regulation also has to have a systemic perspective. Academic researchers and supervisory authorities thus have to look into connections within the financial sector and to investigate the repercussions of problem within one institute on other parts of the system (even across national borders). Certainly, before deciding about the bail-out of a large bank, this implies an understanding of the network. One should know whether this bankruptcy would lead to widespread domino effects or whether contagion would be limited. It seems to us that what regulators provide currently is far from a reliable assessment of such after effects*"

Therefore, one should consider carefully the need to implement a central clearing of derivatives, called Central Counterparty by Hrovatin, Levin, Nava, Planta and Ritter (2009), or one could go even further with a ban on such products (Dizard, 2008; Lordon, 2009).

However, it is noticeable that the last European Commission proposal for regulating alternative investment funds is very disappointing[4]. The first and major criticism one can address concerns the scope of the directive. As its title suggests, the European Commission only intends to regulate managers of Alternative investment funds and not the funds themselves. It does not mention tax issues, leverage, capital requirement and short selling of Hedge funds and Private equity and leaves out the question of employees rights.

In this regard, one should consider the need for a return to a separation between "utility banking" and "casino banking" of investment banks. This proposal could break the dangerous chains of counter-party relationships in the desintermediated financial system. If commercial banks had no access, or very limited access, to wholesale funding and the markets for securitised instruments, they would have had to source their funding from depositor base (Eatwell 2009).

In addition, one could consider the need for a generalised transaction tax. As demonstrated by Schulmeister, Schratzenstaller & Picek (2009), with a tax rate of 0.01%, tax revenues would amount to 1.49% of world GDP. In Europe, almost 99% of all spot and derivatives transactions on exchanges in the EU are carried out in Germany and England, implying that network externalities of well-established market places are the most important factor of their success, which

> "*in turn implies that an FTT of 0.05% or even 0.01% will not induce any considerable "emigration" of transactions*"

Finally, one cannot speak about financial regulation without addressing issues surrounding tax havens, with regard to taxation, macroeconomic and financial stability. In this respect one should consider banning any exchanges with off-shore places. They enable financial institutions to escape minimum self-regulating principles set out in the Basel II framework and bear an important responsibility for the poor development of some emerging economies, especially in Africa. Indeed, the fact that multinational enterprises do not have

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[4] For a detailed analysis of the shortcomings and loopholes of the directive on AIFM proposed by the European Commission
see http://www.feps-europe.eu/fileadmin/downloads/political_economy/0909_FEPS_HFPE_update.pdf
and http://www.feps-europe.eu/fileadmin/downloads/political_economy/091029_FEPS_AIFMSweden.pdf

to publish detailed results (country by country) enable them to transfer their profits in tax havens in which they will pay no taxes, through transfer pricing mechanisms. It has been estimated that illegal transfer pricing amounted to $ 1000 billion.

## Global matters:

Europe as a global economic actor, and its place within the global governance institutions, should be re-casted.

If, as said earlier, one sees the poor growth of the European economy in the last 10 years and the present financial burst as a consequence of rising inequalities, calling for more social justice in income distribution, through public investments (for reason of efficiency), one should not be afraid to speak of a new multilateralism based on principles other than competition and deregulated markets. In fact, Behrman, Birdsall & Szekely (2003) found that an index combining six indicators of liberalisation in Latin America (trade policy, financial policy, tax policy, external capital transactions policy, privatisation policy, and labour policy) is clearly associated with rising inequality. Moreover, they also showed that financial policy and tax policy were the factors driving the impact of liberalisation on inequality:

> "*Do our results suggest that policy liberalisation has been bad for equality concerns in Latin America – a "class act" favouring the relatively highly schooled upper classes because their net effect has been to exacerbate earning differentials? Our answer is a qualified yes*"

These policies were recommended for two reasons. They were viewed, notably in the 1985 World Development Report as an engine for development. The World Bank estimated that countries shifting to pro-market policies, "outward-looking" policies, grew about 2 percentage points faster than those with "inward-looking" policies. Second, there was a general view that free-trade policies would tend to be equalising rather than unequalising. Indeed, the Heckscher-Ohlin trade model suggested that opening labour abundant economies to trade should raise wages. Unfortunately, both of these expectations proved unfounded. This makes Krugman (2008) say:

*"But what can be done about rising inequality and, probably, declining real incomes at the bottom of the distribution process? At the risk of sounding trite, the answer is that if you want to help the poor, help the poor. Because income distribution is so unequal, modest programmes of aid to the poor, measured as share of GDP, can have large impacts on the quality of life for the poor. So although we may be chastened and somewhat dismayed at the failure of liberalising policies to deliver broad-based gains, the answer is deliberate policies to help the poor, and not a reversal to liberalisation"*

This, however, suggests a departure from the usual free-market ideology which holds that free competition necessarily leads to a convergence of emerging and developed economies. As stated by Stiglitz (2009), the framework for financial market liberalisation under the Financial Services Agreement of the General Agreement on Trade and services under the WTO and, even more, similar provisions in bilateral trade agreements may restrict the ability of governments to change the regulatory structure in ways which support financial stability and economic growth. This could also mean that a return to more stable exchange rates with clear-cut rules governing adjustments which need to be effected in the face of current account imbalances (Dullien, Herr & Kellerman (2009)). Managing global imbalances could be tackled through the issuance of IMF special drawing rights as a global reserve currency. However, as suggested by Stiglitz (2009), although large counter-cyclical issues of SDRs are the best mechanisms to finance world liquidity and official support to developing countries during the current crisis, this decision also illustrates the problems associated with tying SDR issuance to IMF quotas, as somewhat less than $100 billion of the proposed emission ($250 billion in SDR) would benefit developing countries, with even a much smaller amount (about $20 billion) going to low-income countries. This implies that this issue is closely tied to the ongoing debate about reform of IMF quotas.

Moreover, one should also think of financial architecture with a special emphasis on the role of public banking system. Indeed, all seem to agree that more and more efficient investment is needed for the recovery of our economies, both in the developed and developing world. Therefore a key role of the financial sector must be to channel savings to efficient and socially desirable investment. Analyses of market gaps (e.g. for long term financing very relevant for the funding of low carbon investment and of SMEs) highlights the need for a greater public role in the banking sector. In this respect, it seems urgent to analyse the role of public development banks at national, regional and international levels, notably, for example, in financing the prevention and the mitigation of climate change.

In addition, in different segments of the markets there is a need for more regional coordination and international cooperation. Pooling sovereignty could be a way of achieving greater financial stability as governments jointly regulate more global aspects, avoiding, among others things, regulatory arbitrage. In this respect, one could try to establish areas where benefits of pooling sovereignty (resulting in greater financial stability) clearly outweigh costs of giving up sovereignty. This should also lead to a reflection on a greater new role for transatlantic coordination between Europe and US in a new multi-polar environment. In this process, one should also analyze the impact of the new design of regional and international regulation on/in developing countries.

Finally, in the light of the crisis, and the emergence of the G20 as a central institution in the design of a new global financial and economic architecture, it seems important to assess the role of the United Nations both as representing the smaller and poorer countries, as well as in shaping alternative policies for a more inclusive framework. This should also represent the opportunity to assess and strengthen the links between the United Nations and the Bretton Woods institutions, the Bank for International Settlements and the Financial Stability Board, both at the institutional and substantive levels. One should explore relevant European Union precedents on regional coordination of national policies, (especially macro and financial, but also in other fields) that could offer interesting lessons for possible similar actions at the G20 level or at the level of more multilateral bodies, such as the UN, IMF, BIS, FSB, others.

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