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Paper Chase: Stock Markets, Financialization, and Pensions

Corporate finance: putting it all together

In earlier chapters, we described a simple process of business lending between a productive company and a bank. The bank creates credit. The productive company uses this purchasing power to invest in capital goods, hire workers, and expand production. This lending-and-investment process is essential to economic growth and job creation under capitalism.

In practice, however, companies have access to a wide range of financial resources to pay for their investments, not just bank loans. In fact, most established companies can usually pay for ongoing real investment needs internally (from profits on existing business), with no need for outside financing sources at all. Indeed, in recent years the business sector has generated far more profit than it needs to pay for new investments. As a result, a strange reversal of traditional financial channels has occurred: instead of turning to financial markets to finance new investment, companies now use financial institutions to recycle surplus cash.

Quickly-growing companies, however, do need help to finance new investments. Troubled or loss-making companies, too, need to borrow – often as they struggle to turn around their operations. And all companies need routine financial tools (like lines of credit) to pay their day-to-day bills, while minimizing the idle cash they keep on hand.

The various financial resources available to productive companies include:

- **Bank loans** These are the simplest form of finance, but usually the most expensive. Loans can be short term or long term, depending on how quickly the borrower must pay back the money (with interest, of course). Loans are usually backed up with some kind of real collateral from the borrowing company.

If the company stops paying interest, then the bank gets that property as compensation.

- **Corporate bonds** These allow companies to borrow directly from investors, cutting out the bank as the "middleman." Like loans, companies must pay interest on a bond. Riskier companies have to pay higher interest rates. Very risky companies issue "junk" bonds, which pay interest several percentage points higher than normal loans. Investors, in turn, can buy and re-sell corporate bonds on bond markets. Through this trading they can make extra profit (or reduce potential losses when a borrowing company is in financial trouble). Bond prices rise when interest rates go down, or when a company's financial stability improves.
- **Equities** Companies can also raise new funds by issuing small "pieces" of ownership, called equities, SHARES, or stocks. These assets do not normally pay interest, although special shares (called "preferred shares") may pay interest. And many companies pay cash dividends (usually every three months) to shareholders, which are similar to interest. But even if no interest is paid, issuing new equity is costly for a company. Administration costs (like brokerage fees) eat up a tenth or more of all new funds raised, and companies which issue shares must comply with complex government regulations regarding financial disclosure, accounting procedures, and internal management practices. If a company goes bankrupt, shareholders are the last to receive any compensation from selling the company's remaining assets: this is the risk they must take, by becoming part-owners of the company. Company shares are bought and re-sold on the STOCK MARKET. Professional analysts and investment brokers monitor stock market trends very carefully, hoping to profit from the ups and downs of share prices; they put incredible pressure on corporate executives to manage their companies with a strict focus on maximizing profitability and hence shareholder wealth.

Companies try to balance their financial needs across these different sources: loans, bonds, and equity. Interestingly, no corporate executive would ever claim (as conservative politicians do) that company debt should be eliminated altogether. Effectively used, debt allows

a company's owners to enhance their own profit. If the company's real investments generate a higher rate of profit than the interest that must be paid on its debt, then the company can "magnify" bottom-line profit by increasing its debt.

But big risks come with debt, too. In tough times, heavily-indebted companies face greater risk of outright bankruptcy (since they must continue to pay interest, whether they have any profits or not). With little internal equity to fall back on as a cushion, the company might be unable to pay its interest costs – in which case it collapses.

Speculation, financialization, and fragility

Unlike normal bank loans, bonds and equities can be bought and sold on "second-hand" markets (like the bond market and the stock market). In theory, these paper markets have a productive underlying purpose: they make it easier for companies to mobilize financial resources (from individual investors) to finance real investment projects. And the ability to sell their bonds or stocks when needed makes investors more willing to invest their money in a company in the first place.

Bubbles and Whirlpools

"Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done."

John Maynard Keynes, British Economist (1936).

However, once they've been issued, the useful "real" life of stocks and bonds is over. The borrowing company has received the initial finance, and (hopefully) done something productive with it. The subsequent secondary buying and selling of those assets has no direct impact on the company which issued them. And all that second-hand buying and selling is fundamentally divorced from the real production that real businesses undertake. Instead, the enormous paper chase

which occurs every trading day on financial markets is motivated by a very different goal.

Productive profit is generated by a company which purchases inputs (including labour), produces a good or service, and sells it for more than it cost to produce. The pursuit of productive profit has many unfortunate side-effects, but at least it results in production and employment.

Speculative profit, on the other hand, involves no production. It is motivated by the age-old adage: "Buy low, and sell high." No jobs are created (except for the brokers who handle the trading, pocketing a lucrative commission on each sale). Investors simply buy an asset, and then hope that its price rises, allowing them to sell it for more than they paid. SPECULATION is the act of buying something purely in hopes that its price will rise.

Any asset can be bought and sold for speculative purposes: including "real" things like real estate, fine art, and commodities (from oil to pork bellies). But today paper financial assets are the major tool of the speculative trade. And the dramatic expansion of financial trading under neoliberalism – both the variety of financial assets traded, and the amount of selling that takes place – means that financial speculation now plays a dominant, wasteful, and often destructive role in the economy.

To make matters worse, clever financial experts are constantly developing new kinds of financial assets, and new ways of trading them for profit. Some of these assets (called DERIVATIVES) depend, often in very complex ways, on the performance of *other* financial assets. Example of derivatives include futures, options, and swaps. Money itself can be traded for speculative reasons, especially on foreign exchange markets (where one country's money is converted into another country's money). And whether it's stocks, bonds, or derivatives, every trade generates a juicy commission (typically 2 or 3 percent) for the brokers who conduct it – giving them a massive interest in frenetic trading for its own sake.

The development of secondary financial markets has thus opened up a Pandora's Box of speculative financial activity. Investors become less concerned with companies' real businesses and more concerned with their paper assets. And the profits from innovative financial "engineering" – developing and selling new types of paper assets – can be immense. Individuals and investors can become far wealthier, far faster, by successfully playing the financial markets rather than

through the gradual, often boring process of building a successful productive business. Unfortunately, speculative bubbles – which occur when the price of a certain asset is driven quickly higher by exploding investor interest, creating fabulous (but surreal) wealth in the process – are always followed by speculative crashes.

A typical speculative cycle begins with the "discovery" of some new asset: perhaps a new product, a new technology, or even just some amazing new kind of financial derivative. In the 1600s, in one of capitalism's first speculative episodes, Dutch investors drove the price of new breeds of tulips to astronomical highs – peaking in 1635 at as much as several thousand Dutch florins for a single tulip bulb (equivalent to as much as US$75,000 today). Initial investor interest, concentrated among insiders, drives up the price of that asset. Other investors see rising prices (and the associated speculative profits), and pile in for a piece of the action. This in turn drives the price even higher.

No matter what the initial spark for the upward motion, it is soon overwhelmed by purely speculative pressure. Investors' hopes for quick trading profits become self-fulfilling, driving the price still higher … for a while, anyway. But eventually something shocks the confidence of investors. Insiders, smelling trouble, sell out first. That produces an initial price decline. Suddenly greed turns to fear, and other investors sell their assets en masse. Once again, the herd mentality of investors becomes self-fulfilling – but this time in a downward direction. The end result is a faster rise, and a deeper fall, than could be justified by any "real" economic factors. In the interim, the bubble produced an immense waste of resources, and untold losses for those who didn't reach the financial exits in time.

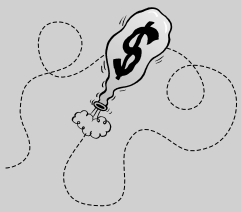
In many economies (especially those in the Anglo-Saxon world), this endless paper chase has come to dominate economic news and economic moods. It's assumed that if the stock market is rising, the economy must be healthy. Indeed, pompous executives commonly describe their efforts to boost the wealth of their shareholders as the "creation of value." And they can seemingly create billions of dollars of "value" overnight, if their company's shares catch a rising speculative tide. How utterly miraculous this must seem in contrast to the daily grind and drudge of average working people who toil to create smaller bits of genuine value every day. But in concrete economic terms, there's no value at all in the hyperactive and pointless flight of paper assets around the markets. Well over 95 percent of

trading on major stock markets simply represents the recycling of already-issued assets. Where's the value in that?

Today there's an incredible diversity and flexibility of financial assets, and those assets (and the specialized financial experts who create and manage them) play a larger role in the operations of real businesses. The shift to an increasingly finance-intensive mode of economic development is called FINANCIALIZATION. One simple way of measuring financialization is to compare the stock of financial assets in an economy, with the stock of real capital assets which underlies it. Figure 18.1 does this for the US economy – the largest and most financialized in the world. Until the late 1970s, there was roughly a dollar in real capital (buildings, property, equipment) for every dollar in financial wealth (stocks, bonds, or other paper assets). * One could have some confidence that each financial asset was backed by something tangible and lasting.

With neoliberalism, however, that ratio dramatically grew – due partly to the deliberate slowdown in the accumulation of real wealth and partly to the explosion of financial activity. Today there are over two dollars in financial assets for every dollar of tangible capital. This ratio peaked in 1999 (at the height of the dot-com stock market bubble), declined during the subsequent financial downturn, but has started to grow once again. Clearly the financial tail has come to wag the economic dog. And investors should quite rightly worry about what, if anything, underlies their financial wealth.

Panic in an Orderly Manner, Please



"A balloon that has been punctured does not deflate in an orderly way."

John Kenneth Galbraith, Canadian-American economist (1955).

* See the Economics for Everyone website for statistics, www.economicsforeveryone.com.

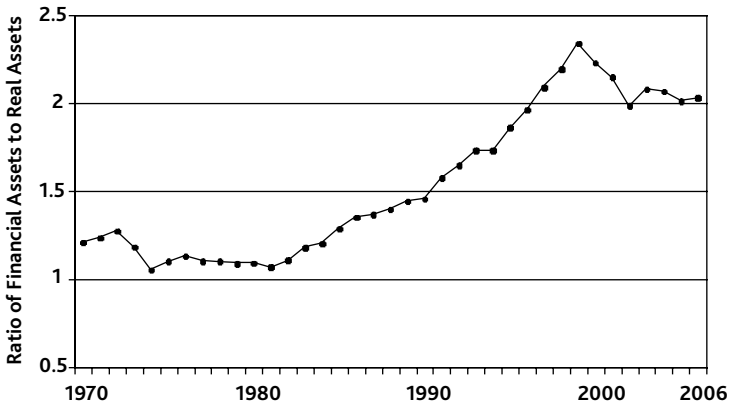


Figure 18.1 **Financialization in the US Economy 1970–2006**

Source: Author's calculations from US Ferderal Reserve Board of Governors data.

The complex layering of financial assets on top of each other, constant speculative trading in those assets, and the normal tendency of companies (including financial companies) to leverage their investments with debt, together gives rise to a deep-rooted financial fragility in modern capitalism. Financial assets have expanded much faster than real capital. Investors don't fully understand the diversity and complexity of new financial assets, and their unpredictable dependence on other economic trends. Yet they continue to take on more debt, so long as their bankers are willing to lend them the money.

The rupture of any link in the long financial chain of modern capitalism can set a crisis in motion. For example, when speculative investments are financed with borrowed money (as is often the case), sudden speculative losses can force the investor to default on those loans; this can cause trouble for the bank or other lender which made those loans, and the losses begin to cascade from one player to another. At the beginning, these losses may have little impact on the real economy. Eventually, however, a financial downturn can impact on real investment, production, and employment. This is especially ironic – since the rapid expansion of finance which created the fragile conditions in the first place had little positive impact on the real economy. But a quick and severe financial downturn can undermine real production, investment, and employment, for various reasons:

- Companies worry about their ability to sell additional output in the future, and hence postpone planned investments.
- Banks suddenly become very worried about default risk, and pull back the amount of new credit on offer (even for routine business and consumer purchases).
- Consumers may become infected by the negative headlines, and postpone their own purchases (especially major, discretionary ones, like homes or cars).

Any of these outcomes, if strong enough, could cause a recession in the real economy.

On the other hand, the fragility of modern finance should not be overestimated. For the most part, neither the ups nor the downs of the paper economy have much impact on the real economy. Proactive central banks generally respond to episodes of financial crisis and contracting credit with quick reductions in interest rates and injections of emergency funds; these help to restore spending power and confidence. It is unlikely, at least in the developed economies, that outright financial collapse could cause dramatic or long-lasting damage to the real economy. On a day-to-day basis, however, the waste and distortion arising from the excesses of financialization give plenty of reason to try to curtail the paper chase.

Pensions and stock markets

Most financial assets are owned by the small minority of very well-off households which composes the modern capitalist class. As discussed in Chapter 7, a clear majority of corporate wealth is owned by the very richest households in every leading capitalist economy. Financial wealth is especially concentrated at the top in the major Anglo-Saxon economies.

Some analysts have argued, however, that ordinary households are sharing in the benefits of capital ownership through pension funds. Large pension funds have been among the most active and sophisticated players in the paper markets, always with an eye on maximizing their own speculative profits. However, their importance should not be exaggerated, and it is not remotely true that capitalism is being gradually "socialized" through the expansion of pension

funds. As indicated in Table 18.1, collectively-managed pension plans account for a very small share of total stock market wealth, and that share is declining over time (mostly due to the shrinking share of workers who have workplace pension coverage in the first place).

Table 18.1 **People's Capitalism?**

	Pensions and Stock Markets, 2006	
Country	***Pension Fund* Equity Holdings as Share Total Equity Wealth***	***Change Since 1990***
US	6.7%	–3.2 points
UK	12.7%	–19.0 points
Canada	13.5%	–2.6 points

* Collectively managed trusteed pension plans.

Perversely, pension funds have helped to impose a tighter degree of financial discipline over real companies. That discipline typically involves more intense efforts to minimize operating costs – including labour costs, through wage cuts, downsizing, and resistance to unionization. Pension funds' efforts to maximize returns can thus badly undermine the immediate economic well-being of workers whose future security is entrusted to those same funds!

By allowing workers the opportunity to retire at a decent age and enjoy their last years in some comfort (free from the compulsion to work), pensions are a crucial underpinning to workers' quality of life. They reduce lifetime working hours and have helped reduce poverty among the elderly. The first pensions were negotiated by unions at the workplace level. These workplace-based pensions are called occupational pension plans.

Later, workers fought for and (in most countries) won public pension systems. These pensions are paid by governments or government agencies. In some programs, public pensions are universal, paid to all elderly citizens. In other programs, pensions are paid only to those who were employed for a sufficient number of years during their working lives. In most cases, workers are required to contribute to public pensions via deductions from their paycheques. In a few cases, public pensions are funded directly from the government's general tax revenues.

Pensions can be financed in two main ways. A PAY-AS-YOU-GO PENSION (or "paygo")* is financed directly from the plan sponsor's ongoing revenues. Most paygo systems are run by national governments. They allocate a share of current and future tax revenues (including targeted pension premiums) to pay for promised pension benefits. This is the simplest way to organize a pension, with very low administration costs. The stability of these plans, however, depends on the continuing economic viability of the sponsoring organization. This explains why they are used mostly by governments (since companies can't credibly promise that they'll stay in business forever, and hence be able to fund far-off pension benefits from future revenues). Most public pensions in developed countries are organized on a paygo basis.

In contrast, in a PRE-FUNDED PENSION the plan sponsor accumulates financial wealth over time to pay promised pension benefits in the future. Typically, premiums are collected from plan members and/or their employers. These premiums are invested in a range of financial assets (trying to maintain a balance between high rates of return and low risk). On the basis of complex and uncertain actuarial assumptions (regarding everything from wage rates to interest rates to life expectancy), the plan is supposed to have enough disposable funds on hand to pay promised pensions when the time comes. Most workplace pensions are organized on a pre-funded basis, as are public pensions in some countries.

The advantage of a pre-funded pension is the somewhat greater certainty that a fund will be able to live up to its promises (although even pre-funded pensions are never truly secure – since financial markets can perform badly, and actuarial assumptions can miss the mark). This is essential with private companies, which can go bankrupt at any time. And if a plan sponsor (especially a government) is committed to investing pension monies according to some criteria other than maximum profits, the pool of capital created by pre-funding can be a useful economic tool. The disadvantages of the pre-funding model include much higher administration costs (mostly for the well-paid professionals who manage the fund's investments), and the risk that the fund won't accumulate enough assets to pay out promised benefits.

* Examples of this pay-as-you-go system are the US Social Security system, the Canada Pension Plan, the Basic State Pension and Second State Pension in the UK, and South Africa's Social Pension.

Pre-funded pensions, in turn, come in two main forms. **Defined benefit** plans are group programs which specify the level of benefits to be paid, based on the number of years a retiree worked, their retirement age, and other factors. The onus then falls on the plan sponsor to ensure that sufficient funds are available to pay those benefits.

Defined contribution plans, on the other hand, simply deposit a specified annual premium (typically shared between a worker and their employer) into personalized accounts for each worker. These accounts are then used to "buy" individual pensions for each worker when they retire. The pension received by each worker depends totally on how much was deposited into their account, how much profit the account earned while it was invested, the level of interest rates prevailing at the time they retired, and other variables completely beyond the worker's control. There's little difference between a defined contribution pension and an employer-subsidized personal savings account.

The choice between these two kinds of pre-funding mostly hinges on who should bear the risks related to investment returns, life expectancy, and other key variables. In a defined benefit plan, the sponsor bears the risk; under defined contribution rules, that risk is transferred to the individual pensioner. No wonder, then, that employers have pushed hard in recent years to convert defined benefit pension plans into defined contribution schemes. Especially in the private sector, the overall importance of defined benefit plans is currently shrinking rapidly. The downside is that many pensioners will be left with inadequate pensions if their individual savings accounts should run out before they die.

Financial lobbyists argue strongly that pre-funded pensions are superior to paygo plans, even for public pensions. However, they have a huge vested interest in moving to a pre-funded system: namely, the massive trading commissions they earn for managing those funds, and investing them in various financial assets. Chile was one of the first countries to organize a pre-funded, defined contribution national pension system; while this model is endorsed by financial professionals and right-wing economists, it has been very ineffective in providing secure retirement incomes.

From a broader economic perspective, pre-funding offers no benefits and many risks. It contributes significantly to the financialization of the economy, with all its associated waste and instability. For public pensions in particular, paygo systems are preferable. Concerns

that these funds will be bankrupted by the ageing of the population have been deliberately exaggerated by the financial industry. In fact, while premium rates must be adjusted over time to reflect changing demographic factors, public paygo pension systems are clearly the most financially stable type of pensions in existence.