Foreword: Why Finance-Based Capitalism?

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Contemporary capitalism is driven by innovation and finance, but these two powerful factors have different outcomes. While innovation is always growth friendly, finance has mixed consequences: it may link savings and investments in a textbook fashion, and it may bring Schumpeterian gains as it is a condition of entrepreneurial innovation. But finance may also be associated with high-risk speculation, herd behaviour and financial crisis at the macroeconomic level, and it may lead to short-term behaviour on the part of business firms that undermines rather than promotes innovation. The essays in this book deal essentially with the benefits of innovation and the risks and distortions of high-powered finance in contemporary capitalism, with an emphasis on the latter. Yet, since 2002, growth rates in all capitalist countries have been higher than ever. Innovation or technological progress transformed into reality may always be an explanation, but how do we make it consistent with the instability and financial short-termism that characterizes business behaviour in post-industrial capitalism?

In this book, the authors discuss and offer answers to these questions, but do not resort to the old saying that 'we are entering the stage of financial capitalism'. Instead, Blandine Laperche and Dimitri Uzunidis in the Introduction, most appropriately speak of 'finance-based capitalism'. Events did not bear out the prediction flowing from Hilferding's analysis of German capitalism at the beginning of the twentieth century. Finance indeed became powerful, but not for the reasons that Hilferding put forward a century ago, namely, the fusion of banking capital with industrial capital at the behest of the former, and the rise of financial capital. Even in Germany this trend did not materialize. In ownership terms, finance and production remained reasonably separate although not disconnected. Classical capitalism did not become 'financial capitalism', but became 'global capitalism' if we take into account the integration of production and finance at the world level; or 'monopoly capitalism' if we bear in mind the continuous concentration of capital by means of mergers and acquisitions; or 'post-industrial capitalism' if we consider the enormous advance of services; or 'professionals' capitalism' if we acknowledge the rise of the professional class and its association with capitalists in running the economy and sharing income, prestige, power and privilege; or 'finance-based capitalism', not because banks control productive industries but because finance is more powerful than ever and controls an increasing share of world income and wealth. Why did capitalism become finance-based if the classical explanation does not hold?

Finance has always been powerful because banks create money, and, after all, money is the objective of all economic activity. Moreover, finance is or should be powerful due to the role that it plays in financing investment, consumption and international trade; but in this case theory was never consistent with practice given the major role played by self-finance, the reinvestment of retained earnings by business enterprises: the figures in this connection continue to be surprisingly high despite the development of financial markets. Indeed, these facts and arguments fail to elucidate the overwhelming significance that finance has acquired in economic affairs since the 1980s, because they are not new, and because some of them have had negative outcomes, as in the case of self-financing for investment.

One option is to resort to more general facts that have changed the world economy and finance. The most relevant of these facts is that since the end of the gold standard money has been purely fiduciary. This major change made banks and, more broadly, the financial system more unstable, and explains why central banks are so strategic: besides controlling investment and growth by managing interest rates and exchange rates, they regulate banks and limit their capacity to create money. In this volume, James Galbraith gives an account of the increased financial power that resulted from the financial upheaval of the 1980s, brought on by the Reagan–Volcker policies that pushed nominal interest rates above 20 per cent and caused a 60 per cent appreciation of the dollar. This change, along with financial globalization or the opening of financial markets worldwide, was certainly behind the new power of finance. The brutal increase in interest rates to fight inflation and protect the dollar was an extreme attempt to protect the American economy from the market failure of stagflation. The fact that it triggered a debt crisis in developing countries and threatened a world financial crisis by depreciating the credit of the major international banks was an unintended consequence which weakened rather than strengthened the financial institutions; but those institutions eventually came out of the crisis strengthened by an awareness of the key and momentous role they perform in the global economy. The end of the gold standard and the transformation of money into a mere fiduciary asset, financial globalization, and the astonishing size and speed of international financial flows are indeed three interconnected reasons for the increased power of finance.

A fourth reason why finance has become so central and influential in contemporary capitalism is the change in the concept of capital from ownership of the means of production, that is, the net worth of the firm published in its balance sheets, to the discounted value of business enterprises' cash flow (Bresser-Pereira, 2006). Until the mid-twentieth century, business firms' valuation depended on their net worth, on the assumption that their financial statements were correct. Capital was not simply a physical quantity – a stock of buildings, machines and inventories – but its ownership. Yet since the 1960s all this has changed, as the measure of flow, not of stock, has become the basis for valuation: the value of a firm or the capital of its stockholders corresponds to the cash flow that the firm produces, discounted at a reasonable interest rate. Capital has continued to be a form of ownership, but now it is ownership of a cash flow. The basis for financing is no longer a clear sum of products whose market prices are known and reasonably stable, but rather a fluid and contingent cash flow or money flow, which depends more on managerial capacity than on fixed assets.

Fifth, we have financial innovations and the new financial agents that are involved in them. Financial innovations are many but I single out two: hedging and leveraged buyouts. Leverage appears to reduce risks but it actually increases them by expanding financial capacity. In their turn, leveraged buyouts create substantial opportunities for profit on the part of their agents, while management of business enterprises is more risky as it is under permanent threat of hostile takeover. These two innovations increase risks but the new financial agents that take advantage of them (asset management, private equity and venture capital firms) enjoy greater influence. In the past these roles were essentially played by commercial banks, but in a limited way; in the 1980s, however, they began to be performed by independent and aggressive organizations run by professionals who originally had no capital but only technical or financial skill. The role of finance was thereby amplified. Consider, first, the asset management firms. Their multiplication and competent performance had the same effect on business enterprises as the threat of leveraged buyouts: while they increased the power of finance, they accentuated 'short-termism'. More relevant, however, are the private equity firms. They play a major role in the newly powerful world of finance, but they are also the source of major market distortions. Private equity firms are so called because they were created to arrange finance for closed or 'private' business enterprises whose stocks are not quoted on the stock exchanges. But today they also deal aggressively with 'public' corporations in so far as they are responsible for initiating leveraged buyouts. *The Economist* (2007: 11) recently summarized, though it did not accept, the arguments against the behaviour of private equity firms: 'Private equity is routinely charged with all sorts of iniquity. It strips companies of assets and flips them for a fat buck. It loads them up with dangerous amounts of debt, to suck out capital for its investors. It pays scant attention to employees and suppliers. Its greedy partners avoid the tax that others have to pay.' This is not the moment to assess such criticisms. They are certainly one-sided, because, as a trade-off, private equity firms are able to push business enterprises to perform better, more efficiently, and to show higher profits. It is more relevant to consider the enormous amount of finance that these firms deal with. The value of mergers and acquisitions in the first two quarters of 2007 reached $2.7 trillion, with 465 deals worth over $1 billion each. The total was buoyed by buyouts, including the largest on record: the purchase of BCE, a Canadian telecoms company. The average size of a merger and acquisition deal was $298 million, 58 per cent higher than in the first half of 2006, and the number of hostile bids (407) was almost four times greater. Of this total of mergers and acquisitions, private equity deals already account for 35 per cent of the value in the United States and for 25 per cent worldwide. Given their combined managerial and financial abilities, private equity firms generate large returns to the rentiers and the banks that provide finance for takeovers and restructuring. Thus, private equity firms contribute substantially to the new power of finance. Self-finance may remain dominant in financing investment, but mergers and acquisitions have grown strongly since the 1970s, and the increased share of private equity firms acting as intermediaries has given new influence to finance.

A sixth and major cause of the new weight of finance in the world economic system is the likely increased participation of rentiers in the total stock of capital. I say 'likely' because I have no data to confirm or refute the hypothesis, but the logic behind the idea is clear. Given that the total stock of capital existing in the world is owned either by active entrepreneurs or by inactive stockholders, one can expect that, as the wealth of nations grows, the share of inactive stockholders tends to increase. This is true for two reasons: because there is a secular tendency for the management and the control of business enterprises to become separated, transforming stockholders into mere financial agents, and because the ageing of the population in high- and middle-income countries tends to increase pension, insurance and mutual funds' control. Since such funds are also financial organizations headed by professional managers, it is easy to understand how this enormous mass of capital owned by inactive stockholders leads to finance-based capitalism.

Thus finance-based capitalism is also professionals' capitalism – it is a form of capitalism in which financial organizations – banks, funds, private equities, asset management firms – and the bright, salaried professionals who run them concentrate power and income in their hands at the expense of inactive capitalists – the stockholders. A sign of this change is the nonconformity of *The Economist* against this fact, and the warm welcome it gives to all episodes in which stockholders regain some power. It is also the successful book *The Battle for the Soul of American Capitalism* by John C. Bogle (2005: xix) whose main purpose is to re-establish the 'true' spirit of capitalism:

> over the past century, a gradual move from *owners' capitalism* – providing the lions' share of the rewards of investment to those who put up the money and risk their own capital – has culminated in an extreme version of *managers' capitalism* – providing vastly disproportionate rewards to those whom we have trusted to manage our enterprises in the interests of their owners.

Rewards that soon turn professionals into capitalists.

Bogle believes that 'managers' capitalism is a betrayal to owners' capitalism'. It is not; it is just a new stage of capitalism in which it is transforming into professionals' or knowledge capitalism in so far as the strategic factor of production changes from capital to managerial, technical and communication knowledge. In this new stage of capitalism development, income has been becoming concentrated everywhere and especially in the United States. As Godechot (2007: 6) observes, 'mounting inequality is caused mainly by the increase in the salaries of a small elite at the top of the salaried hierarchy'. In fact, in 1970 the salaries of the top 1 per cent of the best-paid professionals represented 5.12 per cent of the total salaried mass; in 2000 this figure had risen to 12.33 per cent (Piketty and Saez, 2004).

When we start to speak about increased inequality we are beginning to discuss the negative consequences of finance-based capitalism. Some such consequences, like income concentration, are in conflict with the objective of social justice that modern societies share. Others, like 'short-termism' – a managerial distortion that forces public business enterprises that should think and act according to the medium-term approach required by investment decisions to become concerned just with what will appear in their quarterly financial statements – are obstacles to another political objective of modern democracies, namely, economic growth. Short-termism is also in conflict with moral values. The temptation to fix financial statements increases; the Enron case was just an extreme example of a practice that tends to become normal. As James Sawyer underlines in this volume, 'often short-termism in the United States takes the form of financial manipulation, even predation'. It was no accident that business enterprise fraud was the subject of John Kenneth Galbraith's last book (2004). In the times of owners' or capitalists' capitalism we had the *robber barons* as the main business entrepreneurs, now we have *individualist professionals* acting as unethically as the former. On the other hand, the increased pressure on public business enterprises to achieve short-term outcomes did not contribute to strengthening the efficient market hypothesis, as the conventional orthodoxy holds; in fact, it only distorted management decisions and the overall process of entrepreneurial innovation. Not surprisingly, an expanding economic literature, springing generally from economic schools but also from the financial departments of business schools and from law schools, shows how financial agents' endeavour to make financial markets efficient actually stimulates fraud (Williams and Findlay, 2000; Langevoort, 2002; Goshen and Parchomovsky, 2006).

Many other distortions may arise from finance-based capitalism. Among them, an old one – financial instability – is central. Neoclassical economists tried to explain it with the fiscal populism argument, but the 1997 Asian crisis showed clearly that the central cause lay elsewhere. It was the acceptance by emerging countries of insistent advice emanating from Washington and New York since the early 1990s – advice to grow with foreign savings, that is, with current account deficits financed by bonds and foreign direct investment (Bresser-Pereira, 2004; Bresser-Pereira and Gala, 2007; Gonzales, 2007).

All these distortions are discussed in this book. They are market failures that go against business innovation and growth – the central theme of the book. Yet they are not sufficiently damaging to prevent capitalism from remaining dynamic; capitalism is unjust, unstable, and not as efficient as it could be, but it is always growing and changing. But, for that it needs to be regulated and re-regulated. Since the 1970s the mantra of the neo-liberal ideology has been deregulation; but if some deregulation was necessary, most of it just increased the influence of finance, making for finance-based capitalism and spurt economic instability. In order to avoid worse consequences, re-regulation is the only option. If all markets are socially built, they are institutions that involve and require regulation; if agents in financial markets are increasingly powerful and a source of distortions and instability, they require even more regulation. But regulation of financial markets is the subject for another book. The present volume is designed to show the power and the dangers involved in high-risk finance, and the challenges that innovation poses to business enterprises and nations; and it performs these tasks very well.

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