

SHARE VALUES AND ECONOMIC CRISIS

The theme of this paper is one which I first studied in 1974 (1) and which still seemed tendentious when I suggested the topic four or five months back. Now, however, it almost seems commonplace. Of course rapid changes in share values can help precipitate an economic crisis. That is what everybody is discussing. However, we still do not hear a very good discussion of why this situation should arise. There is a reason for this. Those who believe in free market economics find it difficult to develop their critical faculties in relation to that which they see as the foundation of their economic system. This is especially the case when the Stock Exchange is seen as a near perfect market with many buyers and sellers, unlimited access, provided you have the money, and a level of information available which is in itself an industry. To view such a market critically is well nigh impossible. Nevertheless, now the topic has forced itself on our attention, and despite the ideological blockage mentioned above, it needs some answer.

A Christian perspective on markets offers no such blockage. If markets are seen as communal transactions involving norms of service, fairness, stewardship and effectiveness, then it is possible to see markets as normatively defective, and in need of reform, without moving to the polar position of cursing all your Stock Exchanges. But in order to do this we need to consider carefully the underlying structure of this market in relation to the kind of services which it should perform. We need to retreat from the immediate analysis which begins from what is already given and consider ways in which the activity might be defective. We shall do this under the headings of Share Structure, Liquidity, Control, and Market Participation.

SHARE STRUCTURE.

We begin from the observation that while the equity value of a company may rise or fall by 50% within a year, it is evident that the underlying value of the assets does not change by a similar amount. For most large companies a 10% change would be inordinate. The knee-jerk response is to say that a company is far more than the value of its assets, and it is this far more that is represented in the share price. Yes, a COMPANY is far more than the value of the assets, but the question remains as to whether the shareholders should be getting returns on the company or the assets which they directly, or by proxy, have contributed to it. If it is the latter, then this normal response is defective and merely allows an important problem to be glossed over. For the reason why this incredible pattern of misvaluation occurs is because the paper does not faithfully and accurately represent the actual economic contribution which a shareholder makes to the company, but from the start overstates it.

In particular the fact that ordinary shares last for ever does not comport with the actual process of investment, where the equipment, technology or whatever the investment funds purchase may last only ten, five or one year. When depreciation is used as an index of this process, it suggests that time span over which capital is effective is extremely short. (2) What then is the effect of extending the paper life beyond the actual life of capital? One consequence is that weight is transferred from immediate income from the investment to variations in capital value. Recent price-earnings ratios in Japan meant that it would take something like a hundred and fifty years to get dividend income equal to the value of the share. Patently, the former is insignificant. Other effects include a slowing down of dynamism in the use of capital funds, in that they are much more slowly recycled to provide new investment funds. Rights Issues are a way of keeping a formal link between the shareholders and the raising of new capital, but they do not address the question of whether existing funds should stay permanently with the original company. This also raises the question of whether companies are able to grow and contract on an orderly way. Although companies can buy back shares and therefore shrink their capital, the expansion and contraction of this capital base is not seen as dynamically as it could be. There are other ways of structuring the package. Say, for example, that shares both capital

values and dividends were amortized over a relatively short period like ten years. The emphasis would be far less on capital variations and far more directly on the return to that investment.

The effect of everlasting shares on the raising of new capital is especially important. When there is a strong bull market the relative cost of raising capital through new issues is low and the issues float well. During a recession, however, new issues dry up, partly because the cost of raising funds rises and partly because underwriters are more exposed, as the British Telecom launch so beautifully demonstrated. Thus, because of the definition of capital as everlasting ordinaries there tends to be a marked cyclical fluctuation in primary investment. (3) This allows us to restate the problem of "Short-termism", identified especially by the CBI, but not seen yet as crucially important by them. (4) The problem is that market dealers in shares, whether private, institutional or those involved in mergers and acquisitions, undermine the long-term financial strategy which companies should be pursuing. Why this happens is not clearly analysed. It lies in the distinction between the primary and the so-called secondary investment markets. The latter is, of course, not an investment market. It merely turns over dead assets which represent historic claims. Funds which go into it do not issue in new investment of the kind that means machinery, larger stocks, new R and D. What in fact does happen to the funds which go into shares is very difficult to determine. For each buyer there is a seller, so the net influx of funds is probably registered as transaction costs pumping up the City, pension fund income, higher wealthy private expenditure (and house prices), an expansion of insurance business and higher expenditure by endowed institutions. Some funds also go to the government through Stamp Duty, Taxes and of course through the selling off of public sector companies. This diffuse transmission of funds through capital gains is thus almost wholly redistributive rather than being directly economically significant. How much of this money issues in new investment is an open question, but a guess would suggest less than a fifth. At the same time the savings, personal and otherwise, which find their way into this market directly or through institutions are clear potential new investment. Thus the overall effect is that the transmission of funds through the Stock Exchange structured as it presently is leads to a dilution of the new investment potential of a factor of something like 5. Of course other bits of the financial sector compensate for this peculiar structured arrangement - bank lending, internal finance provide funds on a more even basis and help redress the warped impact of the secondary investment market on the first.

LIQUIDITY.

Another aspect of the problem is liquidity. In one sense electronic transfer has made shares among the most liquid of financial assets in that they can be converted into money very quickly. Big Bang was rightly seen as a change in the structure of this market's transactions ability and costs. This is a world-wide phenomenon, and it has led to unprecedented purchases and sales of shares. This leads to the second great mismatch. Not only is the delineation of the share inappropriate to what it represents, but the potential liquidity of the share is inappropriate to the meaning of the asset. Funding investment or capital is a commitment. It is casting your bread upon the waters. In time the due returns will, or might, come to the commitment which has been made. But instant sale, reduced Stamp Duty and the breakdown of commitment by the asset holder have created a vast problem of overliquidity which has helped to create the crazy market reactions which have characterized the last year. People are able to move out of countries, companies and the market without any concern than immediate price trends. Indeed, market efficiency analysis expects the market to be seen precisely in these self-referential terms. (5) The conclusion which follows is that the increased liquidity which has followed from Big Bang rather than being a move forward is actually regressive on a situation which was already bad. A decrease in the liquidity of equities is needed if they are to more accurately reflect the economic function which they should fulfill.

Another way of stating this issue is in terms of the time horizons which exist in business and investment on the one hand and finance on the other. With increasingly capital- and research-intensive forms of investment the time horizons of industry have tended to grow longer and longer. Although at the same time more rapid obsolescence has also shortened the viable span of much investment. Especially with the kind of intense competition which occurs in many multinationals, the forward planning strategy is the key to the continued success and viability of the company. Thus, the time horizon for investment can overall be described as long, but pushed more into the future than it was a few decades back. This contrasts markedly with the shortened horizons which occur in finance. Market analysts, especially with their concentration on the Efficient Market Hypothesis, focus increasingly on immediate movements, and it is likely, in view of the large gains and losses involved, that institutions are moving away from the traditional long-term commitment to equities to a more instant pattern of market participation. The contrast between these two time horizons is very significant. Especially serious is the fact that in some sectors rapid financial changes can disastrously upset the plans which industry makes. Potentially, this disjunction is a serious source of instability, and changes are needed which reduce the level of liquidity which is found in capital markets.

This could be achieved in a number of ways. Increased Stamp Duty and an Excise Duty on all incoming capital would make the choice of moving into a company and nation a more sober one. (6) Why should the transfer of goods be subject to tariffs and that of capital not? A more radical plan would involve requiring say three or six months notice for the selling of shares which have to be sold within a month or be subject to various penalties. Or there could be a required minimum holding time for shares of a year or two with penalties for earlier sale. The ways of making the market less liquid vary and need arguing through, but the aim should be to allow investors to relate what they are doing to the companies whose assets they hold. This should lead to an increase in the level of stability of these markets, not necessarily through higher transaction costs

CONTROL

We are not concerned here with looking at the substantial issues of control, either public or private, or even at the way in which ownership allows control, but only at the perceptions of control which hang on to and even identify ownership of voting shares. The word "control" itself is very dated, ignoring the growth of management, diffuse responsibilities and company strategies which deny any such idea. Yet many shareholders and businessmen remain totally committed to the idea that share ownership should create the decisive control agency. This view is, however, changing. Industrialists can see that changes in exchange rates and in broad market movements can leave their companies exposed to take-overs without any concrete economic reason for it. And control can mean that they lose their jobs. There has long been criticism of control used for asset stripping. But more than this most shareholders know that their control function is residual and meaningless, and it is evident that the German pattern of joint shareholder-employee control has not had a cataclysmic on the position of shareholders in that country. Given this range of influences it is reactionary to view ownership and control in the old way, but at the same time the issue is not dead. With every major acquisition, the new boss powers in and shows the significance of a controlling interest.

Now, however, this issue is taking on a new dimension. Hitherto, international capitalism has largely been Western capital control in developing countries. Suddenly, however, we have the prospect of the United States and other major developed nations having a large proportion of their major firms owned and controlled from overseas. Especially in the context of the liquidity which we have already examined this is an alarming prospect. This is not for any chauvinistic reason, but because control can mean an arbitrary, fast and inhumane change of direction away from the contributions which workforce and shareholders had previously made. A production unit can be bought up to provide a shell assembly and sales focus for imported goods. Rivals can be taken over and

closed down. Moreover, we are now entering a period of economic imperialism, introduced especially by Japan, but also influenced by other countries with powerful multinationals, which can leave the host country with economic units which are treated as pawns in a bigger multinational design. The perceived rules of the capitalist game, dictated by the United States, have hitherto been unquestioned, but now the States faces a massive penetration of its domestic industry, especially as the dollar sinks further the question will be asked Should shareowning lead to the extent of control over companies which it presently does?

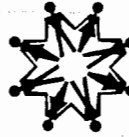
The answer to this question has to be no, as the Germans have realised, BECAUSE THE ACTUAL CONTRIBUTION OF SHARE CAPITAL DOES NOT ADD UP TO A CONTROL FUNCTION. The equation is a false one; the company embodies contributions from workers, shareholders and community and cannot be identified with share ownership as the only responsible executive power. The increasing prevalence of management buy-outs signals something like a groundswell recognition of this. The company as a historic community should not therefore be a pawn of those providing capital whose contribution, although important, does not have an absolute directing role. Again this is already recognized de facto in many companies, where the guiding managerial function firmly keeps the shareholders' role and responsibility in focus - ICI is an obvious example - but at the same time the arbitrary effects of financial control, often from overseas, are very evident, and will become starkly more so during the coming depression.

With the separation of ownership from total control, it seems that shareholders would be able to identify more proximately their financial concerns in an enterprise and we would avoid some of the more predatory aspects of acquisition which only seem to happen anyway on the basis of overvalued paper assets rather than sound economic arguments. The assumed identity of financial and economic health is now seen to be a myth, and it is time finance recognised its contributory rather than total role in business and industry.

MARKET PARTICIPATION.

Another aspect of the situation we are examining is the peculiar nature of this market. There are few markets where the buyers and sellers are almost identically the same group of people. Farmers sell milk and customers buy. Manufacturers sell lorries and hauliers buy. But here whoever buys, private citizen, pension fund or unit trust, also sells. This means that the normal equilibrium understanding of markets is defective when applied to this one. The opposition of interests and responses which is a normal, although badly understood part of market analysis, here does not apply because buyers and sellers are socio-economically the same group. Whatever factors influence the one group will automatically influence the other. Thus if the buyers are persuaded to buy at a higher price, the sellers will be convinced that they should sell at a higher price, in most cases. This is an extremely important characteristic, and it obviously adds to the volatility of prices and the potential instability of the market.

But there is another characteristic of this market which is far less pedestrian, and which owes much more to our attitude to it. The range of factors which impinge on market participants is widespread - exchange rates, market information, political moves, patterns of credit, company profits, weather and patterns of confidence. All participants respond to these and the daily prices are seen as the outcome of this vast informational edifice. The market has to be efficient. But notice the change in meaning of efficiency. It is no longer a question of efficient allocation, in this case the efficient allocation of capital, but of efficient response of the market to the information available. Efficiency is with respect to the market itself. But this is absurd. How can a market which is self-validating, not be efficient with respect to itself, except in the trivial sense of not carrying out transactions at the lowest possible margins? What we have reflected here in the literature of efficient markets is an ideology of economism where prices are seen as the validation of all transactions, and reflect the definitive judgement on all that goes on. Put more crudely, money is the measure of all things. Stated in another form the task



FAMILYBASE

of Reagan at present is to restore confidence to the Stock Markets of the world, because that process will ipso facto mean the resolution of our economic difficulties. This I hold to be idolatry, a process whereby the point of reference for economic life is not God whose stewardship we subminister, but Mammon, which is a law to itself.

This is reflected in the underlying idea of market participation: that of maximizing a financial rate of return. The purity of much market analysis consists in understanding how to make money out of money. As a result the imperatives for moving funds around have increasingly been given by the accounting concern of maximizing returns to the exclusion of a consideration of the economic contribution which those funds make in people's lives and an evaluation of whether the use is most helpful. Instead of money serving people, the idolatrous move has been made to make people serve money on the understanding that money gives the definitive answers as to what is the best investment or use to which it can be put. For a while this collective faith in rates of return and assets for their own sake inflates values and creates euphoria, especially when validated by the United States, British and other governments and powerful classes whose faith has been put precisely here. But beneath this pattern is the economic failure of speculation, concentration of funds in the so-called secondary investment market, the wasting of people's work, and the failure to reach where funds are really needed. The skyscraper is built on cardboard foundations and they can't take the weight of the edifice.

Our deepest need in this situation is a fundamental change of attitude which no longer subsumes the theory of value under that of price, and which asks radical questions about the purpose and norms of our capital markets. Then we shall see that there are reforms which can do something to change capital markets into our servants rather than our petty, wayward overlords. If the change does not happen consciously and thoughtfully, it will to a large extent happen willy-nilly and painfully as we lock ourselves blindly into a major economic crisis.

1. see Christian Party Manifesto 1974, A Christian Social Perspective (IVP, 1979) 363, International Reformed Bulletin, 1975, Transforming Economics (Third Way/SPCK, 1986) chs 6, 11.
2. This recognition that shares need not last for ever comes from Goyder The Future of Private Enterprise (OUP, 1951) and The Responsible Company (OUP, 1961), where Goyder relates it to the biblical Jubilee principle. I prefer to see the significance of Jubilee and the reason for limited share life in different terms, but still found Goyder's insight decisive.
3. This was the focus of the IRB1975 article. It has become less important than it was, because of the flexibility of fund-raising patterns, but it will still be significant in the coming downturn
4. CBI Short-Termism (CBI, 1987) and City/Industry Task Force Investing for Britain's Future (CBI, 1987)
5. S Keane Efficient Market Hypothesis (Philip Allen, Oxford, 1983), Stock Exchange Efficiency: Theory, Evidence and Implications (Philip Allen, Oxford, 1985)
6. J Tobin "A Proposal for International Monetary Reform" in Essays in Economics: Theory and Policy (MIT, 1982) ch20

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THE POLL TAX

A Christian Perspective and Proposals for Amendment

By Paul Mills and Michael Schluter

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