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Is the ERM a barbarous relic?

Mr. Gavyn Davies on the exchange rate and EMU

Keynes said fixing sterling exchange rate in terms of gold was a "barbarous relic"

In the early 1920s Keynes condemned the gold standard as a "barbarous relic". By the "gold standard" Keynes understood the system of fixing the external value of sterling in terms of gold and basing monetary policy on the resulting exchange rate. He thought it would be better - or, in his words, more modern and "scientific" - to base monetary policy on domestic objectives. Since then British economists have constantly debated the pros and cons of a fixed exchange rate. For most of the last 20 years the exchange rate has been floating and monetary policy has been determined, as Keynes would have favoured, by domestic considerations, including the growth of the money supply.

But fixed exchange rates still have supporters, notably Mr. Gavyn Davies with his recent advocacy of ERM membership

But a period of exchange rate targetting intervened between March 1987 and September 1992. (Mr. Lawson started "shadowing the deutschemark" in March 1987 and sterling was expelled from the exchange rate mechanism in September 1992.) This period is generally regarded as a disaster. In the late 1980s exchange rate pressures drove interest rates too low and the Lawson boom led to accelerating inflation; in the early 1990s exchange rate pressures kept interest rates too high and the economy suffered a severe recession. However, the Labour Party wants Britain to be friendlier with the European single currency project. The views of Mr. Gavyn Davies of Goldman Sachs, a Labour supporter who may have a senior economic advisory position if Mr. Blair becomes the next prime minister, are therefore important. In the current issue of the *New Statesman* he says that a "programme of integration" should be announced which ensures that Britain moves "inexorably" towards a single European currency. Further, "We should accept voluntarily the terms of the stability pact for EMU members, and rejoin the ERM at an early opportunity".

Mr. Davies' thinking on macroeconomic policy may well be dominant in the early period of a Labour administration. Here may lie part of the explanation for the recent surge in the pound. A number of well-informed financial institutions believe that Labour will win the general election, take the pound into the ERM and, ultimately, make Britain a full participant in European economic and monetary union (EMU). So they think sterling (plus short-term interest rates and gilts) may be about to enjoy a "convergence play", like the lira and the peseta in late 1995 and 1996. These institutions may be right in the short run, but have they - and Mr. Davies - thought through the implications of another period with a fixed exchange rate? Monetary growth appears to be accelerating, which makes the domestic case for higher interest rates already very convincing. It would be a tragedy if sterling's antics on the foreign exchanges interfere with sensible monetary policy in late 1997, as they have done so often in the 20th century.

Strong exchange rate hindering interest rate rise which is now overdue on domestic grounds

Professor Tim Congdon — 7th January, 1997

Summary of paper on

What is short-termism? Does Britain benefit from it?

Purpose of the paper

Criticism has been directed against British financial institutions for their alleged "short-termism". Mr. Will Hutton's best-seller *The State We're In* has given a definition of short-termism in terms of "a fetish for liquidity". It has also argued that this "fetish" increases to "insane" (i.e., excessive) levels the return on capital that British companies must deliver to shareholders. The research paper reviews these claims.

Main points

* **The core of Hutton's attack on the British financial system comes in chapter 6 of *The State of We're In*, which argues that financial institutions - including the banks - lack "commitment" to their investments. The consequent high liquidity of corporate equity is alleged to increase companies' required return on capital and to cause under-investment. (pp. 4 - 6)**

* ***Theoretical* answer to Hutton: "You have got the direction of causation the wrong way round. The higher the liquidity of a financial asset, the lower the return that investors will accept." (pp. 7 - 8)**

* ***Historical* answer to Hutton: "Economic development is, universally, associated with faster growth in liquid secondary financial markets than in national output as a whole." (pp. 8 - 9)**

* ***Empirical* answers to Hutton:**
  1. Rate of return on an equity portfolio is not the same as the rate of return on capital. (p. 10)
  2. Rate of return on capital in the UK has been exceptionally low by world standards in the last 30 years. (pp. 10 - 11)
  3. If dividend yield on equities falls (leading to *ex post* capital gains), the *ex ante* required return on capital declines. (p. 12)
  4. The increase in capital productivity in the UK has been higher since 1979 than in any other large significant industrial economy. (p. 13)

This paper was written by Professor Tim Congdon. It is to appear in a volume of essays on Hutton's *The State We're In*, to be published by the Institute of Economic Affairs' Health & Welfare Unit.

What is short-termism? Does Britain benefit from it?

A critical analysis of Hutton's *The State We're In*

Hutton's book condenses many widely-held prejudices,

Mr. Will Hutton's best-selling book, *The State We're In*, has brought together in a single volume many widely-held prejudices about modern Britain. Whatever the merits of these prejudices, his achievement is to have assembled them in the form of a book so that it can serve as a focus for debate. In particular, Hutton repeats and develops a number of popular criticisms of Britain's financial institutions. He may be the first author to present a sustained argument - in a piece longer than a newspaper article - that the British financial system suffers from "short-termism". The phrase has been used many times, but now at last someone has spelt out in detail what it means.

particularly about the financial system's lack of "commitment" to industry

According to Hutton, "The British economy is organised around a stock-market-based financial system and clearing banks averse to risk."(p. 21) As a result, the financial system is - in his view - "disengaged" from and "uncommitted" to industry, and is "uniquely bad at supporting investment and innovation". While these British weaknesses are said to have a long historical pedigree, Hutton alleges that the financial system has done particular harm since 1979. The Thatcher Government's programme of deregulation and privatisation is said to have enhanced the power of the financial system over the corporate sector. In Hutton's opinion, from 1980 onwards "[t]he economy was to be vandalised by the financial sector in the name of market freedom".(p. 66) Of course, "the City" - as the hub of the British financial system - is strongly attacked.

How serious is Hutton's indictment? Is he right to claim that the financial system has let Britain down and, if there has been damage to the economy, has it been greater since 1979 than before?

Much historical baggage,

The State We're In is attractively written. But the flow of phrases, and the extraordinary range and ambition of the book, make it difficult to pinpoint the main themes of Hutton's critique. For example, towards the end of chapter one Hutton remarks, "[t]o break out of this cycle of decline and to build cooperative institutions, Britain must complete the unfinished business of the seventeenth century".(p. 25) This proposition is paradoxical and astonishing, and a joy to debate. However, it suffers from a serious drawback: it cannot be subjected to a simple empirical test. Indeed, although at the first reading the opening five chapters are great fun and appear to "say something", on a second or third reading they dissolve. They say nothing that could be recognised as a refutable criticism of the City or the British financial system or, to be honest, of any feature of the British economy.

but it cannot be tested

This may seem too dismissive, but Hutton's problem is that most of the institutions that he regards as specific to Britain, and the source of its woes, are in fact common to all Western societies. These societies are uniform in their adherence to the rule of law, the dominance of market forces in price determination and a financial system based on private property. It is absurd for Hutton to single out Britain for its dependence on "gentlemen", "gentlemanly capitalists", "market forces", "the maximisation of shareholder value" and such like. Every Western society has them.

and precisely the opposite argument coud be made about Britain and its institutions

Hutton may be right that certain arrangements associated with a market economy came first in Britain; he may have a point when he suggests that these arrangements are deeply entrenched. But his interpretation of history could be turned on its head. It could be that Britain pioneered the industrial revolution and parliamentary democracy precisely because it was the first society to uphold personal freedom and individual responsibility, and to defend so consciously the related concepts of private property and market forces.(1) Further, it may be that other societies have been able to catch up with Britain economically over the last 125 years only because they have copied these hallmarks of its society.

If so, Britain's triumph was to demonstrate the superiority of a free-market economic system over the medieval structures of its European neighbours and pre-Meiji Japan, with their feudal stakeholder attributes. Capitalism could validly be associated with modernity, the open society and all those successful structures (market freedom, individualism and so on) to which Hutton is so hostile in a British context; cooperation and "the stakeholder economy" could be stigmatized as relics of medievalism and, at a further remove, of the tribal society.

Hutton's definition of and attack on short-termism:

Point 1 The critique of liquidity

Unfortunately, neither this sort of defence of Britain's past record nor Hutton's attack on it can be assessed by a simple and rigorous statistical test. As opinion, the first five chapters are interesting and amusing; from an analytical standpoint, they are irrelevant and can be discarded. If the historical baggage in the early chapters is dumped as impossible to analyse in a structured way, Hutton's substantive criticism of the British financial system must lie in the rest of the book. But chapters seven to nine say little about the organization of the financial system, chapter ten is mostly about foreign capitalisms and chapter 11 reviews 'The republican opportunity'. That leaves chapter six on 'Tomorrow's money today' and chapter 12 on 'Stakeholder capitalism' as containing the essence of Hutton's case. If he has something worthwhile to say, it must be in these two chapters. The rest of this paper concentrates on chapter six, because it introduces a new and possibly important topic in economic theory, and presents the core of the attack on short-termism.

Liquidity enables investors to quit when "the going gets tough"

The chapter starts with the claim that "The overriding property of the [British] system is its desire for liquidity - in other words, the ability to be able [sic] to reverse a lending or investment decision and return to the *status quo ante* of holding cash". While conceding that every financial system must have this characteristic to some degree, he suggests that Britain's distinctiveness is that "liquidity has become a fetish", which reflects investors' "lack of commitment". So, when "the going gets tough", investors sell their shares and banks withdraw loans, rather than "share the risk of restructuring and of managing any crisis".

It follows, according to Hutton, that the British system has "a permanent bias" to short-termism and "from this all else flows".(pp. 132 - 3)

A company's quotation may be "bad for longer-term prospects", according to Hutton

Hutton points an accusatory finger at investors in corporate equity as being particularly short-termist. He seems to regard it as a misfortune that one of the most liquid assets in capitalist societies is corporate equity listed on a stock market. Indeed, Hutton criticizes venture capitalists for sometimes putting pressure on successful innovative companies to float on the stock market, which may be "bad for the individual company's longer- term prospects".(p. 134) Once they are listed on the stock market, companies are vulnerable to take-over, which again - according to Hutton - may interfere with long-term planning.

Hutton follows Keynes and Tobin,

The attack on liquidity is the consistent theme of the first half of chapter six. No previous author has suggested so explicitly that financial market liquidity may be bad for economic efficiency. There have been earlier statements of the idea, but they have been much briefer, less considered and more piecemeal. Tobin has recommended that a tax be placed on foreign exchange trading, because "sand in the wheels" would reduce excessive turnover and harmful speculation, but he has limited his fiscal proposal to the foreign exchanges (2) Further back, chapter 12 of Keynes *General Theory*, on 'The state of long-term expectation', included a number of derogatory comments about liquidity. One particularly striking assertion is that "Of the maxims of orthodox finance none, surely, is more anti-social than the fetish of liquidity, the doctrine that it is a positive virtue on the part of investment institutions to concentrate their resources upon the holding of 'liquid' securities". Keynes also proposed - many years before Tobin - that [t]he introduction of a substantial government transfer tax on all [stock market] transactions" might prove "most serviceable", in order to curb the "casino" element. (3)

but he is much more forthright in his critque of liqudity - and of secondary financial markets in general

But Hutton is the first author to present a deliberate and sustained critique of financial market liquidity. The critique raises interesting issues for social organization, notably for the questions of whether and how secondary trading in financial markets benefits society. Most defences of financial markets are expressed in terms of the improvement in resource allocation achieved in the primary markets (i.e., when shares and bonds are issued, and bank loans disbursed). But they say less, or nothing at all, about how society gains from secondary market activity (i.e., the buying and selling of shares and bonds once they exist). Secondary market activity itself takes up resources, with incomes in stock-broking and investment banking being in most capitalist societies well above those in other walks of life. Hutton's critique prompts the question, "does society gain anything from trading in secondary financial markets or is such trading, with its Huttonite 'fetish for liquidity', parasitic on the rest of society?". Much of the saloon-bar criticism of the City is undoubtedly spurred by resentment of financial sector incomes. Does Hutton's book provide a respectable intellectual rationale for the claim that secondary financial markets are indeed parasitic?

Hutton's definition of and attack on short-termism:

Point 2. The critique of high returns

The second half of chapter six extends the critique of the British financial system by arguing that its short-term focus leads to demands for unduly high rates of return. Hutton claims, "The more intensively shares are traded, the more widely dispersed ownership becomes; the greater the threat of contested takeover, then the higher the premium companies feel they must earn in order to keep the shareholders happy. This is the fundamental weakness of the British system. British companies not only suffer one of the highest costs of capital in the world, but the febrile stock market compels them to earn a very big mark-up over even that cost of capital to fend off the threat of takeover and keep their shareholder base stable".(p. 157) To summarize Hutton's position, Britain's financial system requires its companies to achieve such high rates of return on capital that only a few capital projects qualify. He believes that, as a result, British companies under-invest compared with their international competitors, and British workers therefore use less advanced machinery and have lower output per head.

Hutton develops other criticisms of "the City", which do not depend on the "fetish for liquidity"

This is not to say that Hutton sticks doggedly to his central idea. Having characterised widely-dispersed share ownership as "the fundamental weakness" on p. 157, he alleges on p. 158 that a rather different point, the "lack of rationality about the future", is "at the heart of the problem". Hutton cites work by Miles which purports to show that the stock market values returns stretching beyond a year "less highly than it should". In consequence, "payback periods are shorter, target rates of return are higher and dividend pay-outs bigger than in other

Table 1 Returns on equities and cash, 1945-95

Table shows real returns (i.e., after adjustment for retail prices), % p.a. averages of five-year periods. There has been only one five-year period, out the last 11, in which cash has beaten equities.

Five years to	Ind. Ord. share index	3-month Treasury bills (i.e., cash for large financial institutions)
1945	11.4	-2.6
1950	2.2	-3.4
1955	11.4	-2.2
1960	17.2	2.1
1965	3.7	1.4
1970	5.8	2.0
1975	-7.9	-4.1
1980	6.8	-2.9
1985	16.6	3.5
1990	9.4	5.1
1995	8.8	3.7
Average of all 11 five-year periods	7.8	0.2

Source: Bacon & Woodrow, reproduced in NTC Publications *Pension Pocket Book 1997* industrial countries so that British shareholders are disproportionately highly rewarded for the 'risks' they run".(p. 160)(4) The City's international outlook is identified as a further handicap on British industry. In Hutton's view, the trouble is that the City can seek good, high-yielding investments in any country. As a result, "British companies have to compete...with the highest returns in the world if they are to get financial support". The disadvantage of Britain's "highly marketised" financial system, with its global perspective, is that companies "have to deliver insane rates of return to their owners".(pp. 166-7)

But the link between liquidity and high returns is the crux of his attack on short-termism

As the pages flash by, the link between financial markets' over- emphasis on liquidity (in the first half of chapter six) and the excessively high required rates of return (in the second half) begins to get lost. But concern about the under-valuation of future earnings streams and the City's internationalism is not new. If Hutton has anything original to add to the public debate, it is his proposed link between financial asset liquidity and the returns on physical capital. The core Huttonite principle, the crux of his attack on short-termism, is that the greater the liquidity of financial assets, the higher is the required return on physical capital.

Error in Hutton's analysis

Relationship between liquidity and return is ***inverse***

The trouble with Hutton's theory is simple: it is plain wrong. Moreover, it is not wrong in a small way because of a missing detail or a under-emphasized but vital qualification. Instead it is thoroughly wrong, the precise opposite of the truth. Hutton's claims a positive relationship between the liquidity of financial assets and the rate of return on physical capital. In fact, the relationship between these two variables is inverse. This is easy to demonstrate. A short digression into the subject of portfolio choice may be helpful.

Well-known trade-off between risk and return

Consider an investor running a portfolio. As is well-known, his choice can be analysed in terms of a trade-off between return and risk, usually measured by the variance of the return around its expected mean.(5) The investor may of course forego high returns in order to reduce risk. The literature on mean-variance analysis asks interesting questions about the social cost of risk, raising the possibility that a nation may suffer low growth because its investors are too risk-averse. Hutton might have had a valid and interesting case if he had claimed that "the British Establishment" had historically chosen safe, low-return, "gentlemanly" investments instead of risky, high- return "industrial" investments. But that is not what he has done. (If he had done this, he should have objected not to the high returns sought by British investors, but to their lowness.) (6)

But investors also face a trade-off between liquidity and return

Mean-variance analysis forms a large part of the modern theory of portfolio choice. But it neglects a vitally important dimension of the subject. In practice an investor also has a trade-off between return and liquidity. Admittedly, liquidity is a more impalpable concept than risk. It could be defined, following Hutton's perfectly satisfactory suggestion, as "the ability to reverse a lending or investment decision" and return to cash. Alternatively, it could be expressed more formally as the ratio of the dealing spread to the middle price quoted in a recogised market-place. (7). (It could even be elaborated as a quite complicated function of the dependence of the spread/middle price ratio on the length of the trading period or the size of the transaction.)

But - however liquidity is described - one point is definite. An investor will accept a lower expected rate of return on an asset, the higher is the asset's liquidity. Of course, the most liquid asset in any economy is money. As institutional investors' return patterns demonstrate, cash is the worst performing asset in the long run. (See the table on p. 6.) More generally, an investor will accept

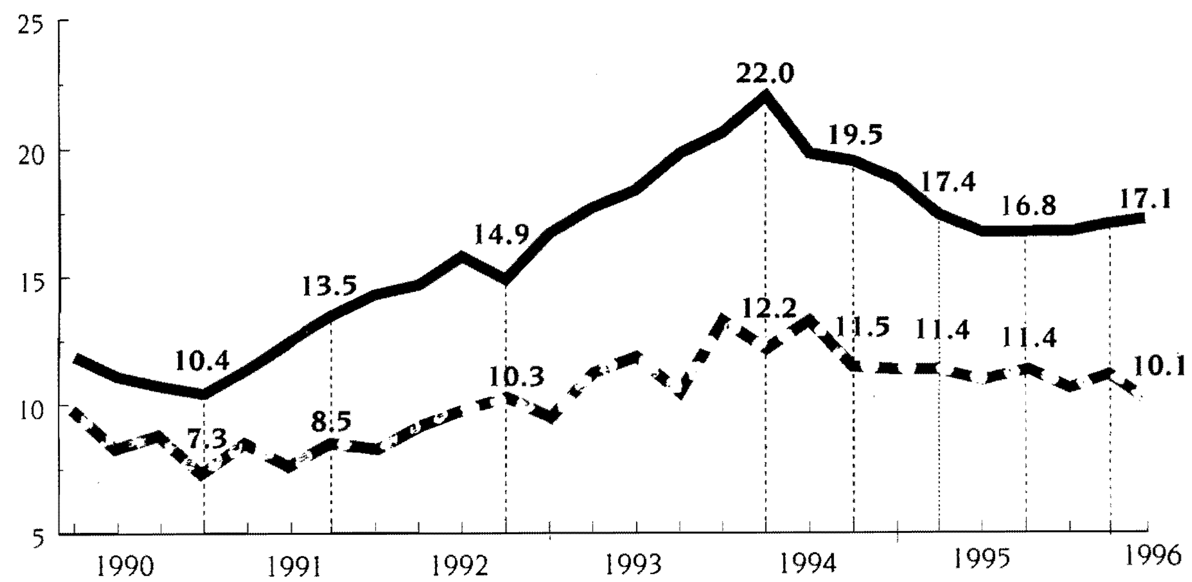
1. a lower expected return on a liquid security than on an illiquid security, when considering the choice in markets for quoted securities, and

2. a lower expected return on a quoted security (or a portfolio of quoted securities) than on an unquoted security (or a portfolio of unquoted securities, such as a venture capital fund).

It follows that a society with highly liquid financial markets will tend to have lower rates of return on capital than a society with highly illiquid financial markets; and that a society with organised secondary markets where assets can be traded in securitised form will also tend to have lower rates of return on capital than a society where assets cannot be so traded.

The gap in valuations between quoted and unquoted companies

The chart below is taken from BDO Stoy Hayward's *Private Company Price Index*, issue 3, 1996. The top line is the P/E ratio for the *Financial Times* non-financials shares index; the bottom line is the P/E ratio for private companies.



Earnings multiples are higher for quoted than unquoted companies, partly because of extra liquidity

Hutton is particularly misguided when he criticises venture capitalists for urging successful entrepreneurs to list their companies on stock markets. As all venture capitalists know, quoted companies are valued at higher multiples of their earnings than unquoted companies that can be bought and sold only "in the trade market" (i.e., by other entrepreneurs or companies). A large part of the explanation for the valuation premium commanded by quoted companies is that it is easier to buy and sell their shares. As the higher valuation of corporate equity reduces the company's cost of finance, the required return on capital is lowered by the extra liquidity conferred by a stock market quotation. The corporate finance department of the accountancy firm, BDO Stoy Hayward, maintains an index of price/earnings ratios of private companies in the trade market, based on data in the magazine *Acquisitions Monthly*. This chart is reproduced on p. 8. It shows that the P/E ratio on the stock market as a whole is typically 60% to 80% higher than on private unquoted companies.

Morgan Grenfell's European unit trust a warning about dangers of illiquidity

It is rather funny that Hutton's book, with its assault on liquidity, should have been receiving so much favourable comment just as the scandal broke over Morgan Grenfell's European unit trust, run by the disgraced fund manager, Mr. Peter Young. Mr. Young's folly was to invest his unit-holders' money in unquoted, and hence illiquid, companies. When the unit-holders wanted to withdraw their money, Mr. Young's fund could not meet their requests because it could not sell its investments except at a fraction of their cost price. If Hutton's thesis were correct, unit trust managers would be doing a service to their country if they behaved like Mr. Young. (This is not to deny that the market economy has a role for venture capital funds, where investors cannot easily withdraw their funds and the money is trapped for a long period. But it is undoubtedly true that investors require a higher return from such funds than, say, unit trusts or a well-diversified, easily-realisable share portfolio held at a firm of stockbrokers.)

Organized capital markets, giving liquidity to corporate equity, grow faster than GDP during economic development

While the theory of the relationship between return and liquidity is in its infancy (8), economics has in the last 30 years seen a burgeoning literature on financial development. One of its main conclusions is that, in their progress from low to high incomes per head, societies see the financial system growing faster than the economy as a whole.(9) It is indeed a salient feature of under-developed economies (such as those in Africa and parts of Asia) that their stock markets are not only badly-organized and illiquid, but that the ratio of their total capitalisation to national income is lower than in Britain and other industrial countries. The rate of return on capital is also typically much higher in under-developed economies than in rich countries belonging to the Organisation for Economic Cooperation and Development. Cross-country comparisons of this kind are compelling evidence of the benefits to societies of organized and liquid financial markets; they are far more convincing than Hutton's pseudo-historical conjectures about "the seventeenth century", "gentlemanly capitalists" and such like.

The empirical invalidity of Hutton's claims

Hutton wrong on theory

Hutton's most interesting new idea is therefore wrong. It is mistaken in terms of both economic theory and broad historical generalisation. Any plausible theory of portfolio choice has to include an inverse, not a positive, relationship between financial asset liquidity and the returns on physical capital, while the long sweep of history is from primitive, illiquid patterns of ownership to sophisticated, liquid financial markets, and from high to low returns on physical capital. The increase in asset liquidity and the decline in the return on capital take place in parallel.

but what about the facts?

But Hutton might be right about some aspects of Britain's financial institutions, even if the weaknesses are not quite what he thinks. For example, he would be correct that - if British investors require higher rates of return than investors elsewhere - British companies would have less capital per worker than their international competitors.(10) If Britain's financial institutions do seek unnecessarily high returns, this may not be due to their liquidity fetish, but it would still need to be discussed. In reviewing the evidence on the actual behaviour of the British financial system, four points need to be made.

i. Return on quoted equities *not* same as return on physical capital

First, the rate of return on quoted equities needs to be distinguished from the rate of return on physical capital. Hutton fails to make this distinction; he takes it for granted that the impressive returns achieved by, for example, UK pension fund managers over the last 20 years translate into a demand for a high return on new investments in plant and buildings. This is not the case. The return on corporate equity and the return on physical capital are related, but they are not identical. Conceptually they differ for many reasons.

Table 2 The return on capital in the leading OECD economies

Table shows "rate of return on capital in the business sector", % p.a.

	Average for:		
	1970-78	1979-87	1988-87
USA	15.3	15.2	17.5
Japan	18.3	14.0	14.7
Germany	11.8	11.0	12.8
France	12.7	11.2	14.6
Italy	11.6	13.2	15.1
UK	10.2	9.4	10.6
Canada	14.8	18.2	18.4
G7 as a whole	14.7	13.8	15.7

Souce: OECD *Economic Outlook*, December 1996, p.A28.

The rate of return on physical capital is, substantially, a technological and marketing matter; it is measured by the amount of profit (after meeting costs of production) in a particular period relative to the cost of the equipment or buildings. By contrast, the rate of return on quoted equities is a financial concept, which depends for example on pay-out ratios (i.e., the proportions of profit actually distributed to shareholders) and financial markets' valuations of prospective dividend streams over many periods (i.e., the change in the P/E multiples or dividend yield), as well as such mundane considerations as dealing costs. Moreover, the return on physical capital covers payments of interest to banks and bondholders, as well as the return to shareholders. Perhaps most fundamentally of all, equity investors are interested not just in a high rate of return on physical capital, but in a high rate of growth in profits and dividends. Companies (the tobacco giants) with a high return on capital but in a contracting industry may be less attractive to prospective shareholders than companies (in pharmaceuticals and electronics) with a low return on capital and exciting growth opportunities. In fact, equity investors routinely accept lower dividend yields on high-growth stocks than on average- or low- growth stocks, in the expectation that over time the returns on the different kinds of stock will be the same.

ii. Rate of return on capital

Secondly, because the rate of return on quoted equities is not the same as the rate of return on physical investment, Hutton's numbers need to be checked. Hutton is correct that British fund managers have over the last 20 years achieved spectacularly high returns on their investment in securities. But it does not follow that UK industry has had a high rate of return on physical capital or, more crucially, that UK financial institutions have pressed for higher returns on new investments than their counterparts in other countries.

is exceptionally low in the UK, contradicting Hutton's claim

The OECD has compiled statistics on "the rate of return on capital in the business sector" for its member countries since 1970. They are summarized in the table on p. 10. The message is very striking and totally contradicts Hutton's claims. *The rate of return on capital in the UK is the lowest of all the large OECD economies. In fact, since 1970 there has not been a single year when the rate of return on capital has been as high in the UK as in any other member of the G7 group of industrial countries.* This one fact effectively destroys Hutton's entire polemic about British companies being forced, by the City's reputed "short-termism", to seek high returns. Indeed, Hutton's talk about the "short-termist" City of London demanding "insanely" high returns from industrial companies is shown to be preposterous.

iii. *Ex post* returns on quoted equities are high, when *ex ante* return on capital is low

Thirdly, Hutton has made a grotesque analytical mistake in using historical, after-the-event (*ex post*) figures for the return on financial investments as the basis for his claim that the real-world, before-the-event (*ex ante*) required return on physical capital in the UK is exceptionally high. Investors in stock markets achieve capital gains when the dividend yield on equities falls. Further, if everything else is equal, the lower is the dividend yield on equities, the lower also is the return that the outside investors require on the physical capital. In other words, it is after periods of falling dividend yields and healthy capital gains (which will boost the *ex post* returns on equities) than the *ex ante* required return on physical capital is below normal. Conversely, it is after periods of rising dividend yields and poor capital gains (or losses) that the *ex ante* required return on physical capital is particularly high.

The real return on UK equities over the last 35 years have been about 6% or 7% a year. (The precise number depends on how the sums are done.) (11) But the 35 years splits neatly into two halves, the first before 1979 and the second afterwards. If a period of 15 or 20 years to 1979 is taken, the real return on UK equities was virtually nil; in the 17 years since 1979 it has been over 12% a year. Hutton has protested that the sort of rate of return secured on equities since 1979 is excessive and sets an inappropriate target rate of return for companies. But this is hopelessly misleading. Not only has Hutton himself been guilty of short- termism by nelecting to mention the longer-run 35-year record, but also he has failed to explain the dramatic contrast between the two halves of this 35-year period.

Table 3 The rate of change in capital productivity

Table shows increase in output per unit of capital, % p.a., based on a calculation for "total factor productivity". For details, see source. The UK was the only member of the G7 where productivity per unit of capital increased from 1979 to 1995.

	Average for:		
	1960-73	1973-79	1979-95
USA	2.3	-0.2	-0.2
Japan	-3.3	-3.7	-2.1
Germany	-1.4	-1.0	-0.6
France	0.6	-1.0	-0.6
Italy	0.4	0.3	-0.9
UK	-0.3	-1.5	0.5
Canada	0.2	-1.0	-2.4
G7 as a whole	0.3	-1.1	-0.7

Souce: OECD *Economic Outlook*, December 1996, p.A68.

His problem is that the poor returns in the first half were partly due to a rise in the dividend yield. In other words, a long period of inadequate returns on financial securities was the result of a fall in investors' valuations of corporate equity, which boosted the return on physical capital that was acceptable to them. So the required return on physical capital was high in 1979. The strong returns on equities since 1979 reflect investors' improving valuation of corporate equity, which lowers the return that they need on physical capital. It follows that the required return on physical capital is substantially lower today than it was in 1979. A fair presumption is that the free-market, capitalist-minded policies of the post-1979 period, when companies have been increasingly subject to the alleged "tyranny" of financial markets, have in fact expanded the range of capital projects that companies can undertake. Far from the City demanding higher company profitability today than in the corporatist era of, say, 1960 to 1979, the acceptable returns on equity are lower.

Fall in dividend yield on equities has delivered capital gains since 1979 and *reduced* cost of capital to companies

iv. Rate of increase in capital productivity another measure of capital market efficiency

Fourthly, both the rate of return on quoted equity and the rate of return on physical capital have to be distinguished from the rate of increase in the productivity of capital (i.e., in the output per unit of capital). In some ways it is this final concept which is the fairest arbiter of the success of a nation's financial system. If Hutton were right that the UK's financial system had failed since 1979, the increase in capital productivity ought to have been lower than in other countries. The OECD has prepared some useful statistics, which are reproduced in Table 3 on p. 12. It turns out that, once again, Hutton's views are not just mistaken, but thoroughly wrong-headed. *The UK is the only major industrial country where the productivity of capital has increased since 1979.* The increase is particularly salient when compared with the fall in the UK's capital productivity in the corporatist 1960 - 79 period and with the miserable performance of Japan, so much lauded by Hutton for the supposed "long-termism" of its financial sector. Japan has in fact over the last 20 years suffered the heaviest fall in capital productivity of any industrial nation.

and, on this measure, the UK has done well since 1979,

partly because of privatisation

It is not difficult to understand why Britain has been able so effectively to improve the management of its capital stock since 1979. Quite apart from the plethora of free-market reforms (curbs on trade union power, financial market liberalisation) which have done much for economic efficiency, there has been the enormous boost from privatisation. The evidence is now overwhelming that companies in public ownership from the late 1940s to the early 1980s were seriously inefficient, particularly in how they organized their capital stock. Privatisation has enabled their managements to achieve similar levels of output without extra investment and usually with much smaller workforces. Here lies a large part of the strong British showing in the international league table of capital productivity. If this is what Hutton's "vandalisation" of the economy by the financial system has done, let's have more of it!

which Hutton characterises as "vandalisation"!

Conclusion - the unsatisfactory case against short-termism

Hutton's critique of the British financial system is off-beam, even eccentric. He muddles concepts, ignores facts and rambles inconsistently between different arguments. It is a tribute to the eloquence and verve of his writing that Hutton has been able to craft a best-seller from such ingredients. Nevertheless, an interesting new topic is trying to escape from all the babble of *The State We're In*, namely the nature of the relationship between financial market liquidity and asset returns.

Hutton says that liquidity is bad, because it raises the required return on capital. Actually, he has got the argument the wrong way round. Liquidity is good because it reduces the required return on capital. Indeed, one of the main social benefits from secondary market financial activity is that, because it is associated with a lower return on capital, it expands a nation's equilibrium capital stock and thereby increases living standards. Economists are only beginning to theorize in this area, but the very-long-run evidence of history confirms the idea. A good general rule is that "liquid financial markets and banking systems grow faster than national income, as incomes per head increase". Secondary market activity is not parasitic and wasteful, but an integral part of market capitalism.

Short-termism, as defined by Hutton, is good for the econony

Shareholders' ability to buy and sell corporate equity is particularly helpful in ensuring that the capital stock is used efficiently; it may therefore be crucial in explaining why capitalism, whose key institutions were pioneered in Britain, has triumphed against rival systems of property ownership in the last 300 years. These institutions, both in Britain and elsewhere, may be characterised by "short-termism" in the sense defined by Hutton. In other words, they may give investors the ability to reverse decisions quickly, easily and cheaply in organized capital markets. But, if that is what short-termism means, it is a virtue - not a vice - of Western market economies. It is part of the explanation for their formidable efficiency in accumulating and managing capital. Hutton is right that since 1979 Britain has become more capitalist, with formerly nationalised assets coming under private ownership and the financial system operating more freely than before. Although it may come as a shock to him, the living standards of the British people have improved as a result.

Notes

(1) Alan Macfarlane (1987) *The Culture of Capitalism* (Oxford: Basil Blackwell), especially chapter 8, pp. 170 - 90, on 'The cradle of capitalism - the case of England'.

(2) James Tobin (1978) 'A proposal for international monetary reform' *Eastern Economic Journal*, 4 (3).

(3) Donald Moggridge and Elizabeth Johnson (eds.) (1973) *The Collected Writings of John Maynard Keynes*, vol. VII, *The General Theory* (Basingstoke: Macmillan), originally published in 1936, p. 155 and p. 160. So Keynes anticipated Hutton's phrase "the fetish for liquidity". Hutton refers to Keynes not in chapter six, but in chapter nine, 'Why Keynesian economics is best', especially pp.239 - 45. Hutton's previous book *The Revolution That Never Was* (London: Longman, 1986) is all about Keynes.

(4) David Miles (1993) 'Testing for short termism in the UK stock market' *Economic Journal*, 103 (4).

(5) Harry M. Markowitz (1952) 'Portfolio selection' *Journal of Finance*, 7 (1), pp. 77 - 91.

(6) Arrow has identified a social benefit from financial markets, using the mean-variance model. Where liquid financial markets help investors to diversify their portfolios, they improve the private and social trade-offs between risk and return. (See Kenneth J. Arrow (1984) *Collected Papers of K. J. Arrow: The Economics of Information* (Oxford: Basil Blackwell), p. 79.) The idea originally appeared in the 1965 Yrjo Jahnsson lectures.

(7) Timothy G. Congdon (1996) 'The role of central banking in economic development' *The Review of Policy Issues*, 2 (2) pp. 82 - 6.

(8) John R. Hicks' last book, *The Market Theory of Money* (Oxford; Clarendon Press, 1989), suggested a distinction between "fluid" and "solid" investors, developing ideas originally expressed in his 1974 lectures on *The Crisis in Keynesian Economics*. Fluid investors like the flexibility conferred by holding liquid assets in their portfolios, whereas solid investors are less keen on it. In principle, degrees of liquidity-aversion could be measured, just as with risk-aversion.

(9) Raymond W. Goldsmith (1969) *Financial Structure and Development* (New Haven and London: Yale University Press). See, for example, p. 40 which contains the remark, the "existence of clearly different paths of financial development is doubtful. The evidence now available is more in favour of the hypothesis that there exists only one major path of financial development, a path marked by certain regularities in the course of the financial interrelations ratio, in the share of financial institutions in total financial assets and in the

position of the banking system." (The financial interrelations ratio is the ratio of financial assets to tangible assets.) Goldsmith's point is that the historical record demonstrates that the FIR and the relative importance of financial institutions in the economy increase with incomes her head.

(10) Note that Hutton implicitly assumes diminishing marginal returns on capital and imperfect international mobility of capital. Both assumptions are plausible, but - in a world of increasing international capital mobility - the pressure (if any) from British investors on British companies for high returns would be less effective, since the companies of any nation could tap global capital markets. A radical criticism of Hutton's thesis is that, as the abolition of exchange controls leads increasingly to global capital market integration, the portfolio preferences of specifically British investors will become irrelevant to the financial targets of British companies.

(11) For details of this work, contact the author at Lombard Street Research.