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When capital markets rule

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The growth of equity will be good for economies

THE rivalry between different models of corporate governance partly reflects a broader battle over the best way of financing a modern economy. In this battle, the world's growing equity culture plays a crucial role, for it turns on one big question: is it better for economies if their companies rely mainly on capital markets for equity and debt, or on banks? It is a question that is pertinent not just to the debate about the respective merits of the Japanese/German model and the American/British one, but also to the choices that emerging economies should make about their future.

At first sight capital markets might seem a pretty dubious proposition to rely upon, especially in today's bearish climate. Capital markets are naturally short-termist and volatile. They attract huge inflows that can just as quickly turn into huge outflows. Investors' crowd behaviour can move prices out of line and lead to speculative bubbles. When such bubbles burst, the capital tap can be turned off just as quickly as it was turned on. Contrast the dotcom boom, when finance for even the most bizarre business proposition was to all intents and purposes free, with the bust, when even sound business plans could not attract capital at any price.

The consequence of all this is surely a damaging misallocation of capital that, so far from fostering growth, might actually discourage it. Even in America, in the early part of 2000 there were howls that the new economy and the Internet were gobbling up all the money available for investment, starving "old-economy" companies (which, unlike "new-economy" ones, actually made profits) of capital. Within months the position was reversed, and a lot of investors, many of them first-timers, had lost their shirts. No wonder that some countries (and some investors) mistrust capital markets, and especially stockmarkets; they seem so often to resemble Keynes's notorious casino.

Yet there are also substantial virtues in relying on capital markets. Because they react continuously and almost instantaneously, equity and debt markets immediately capture any changes in perception about the future course of economies, or about confidence, or about risk. This process of "marking-to-market" means that assets are quickly repriced to reflect new circumstances, including new ideas, new techniques and new technology, to all of which capital markets respond more quickly than banks. One example is the development of the junk-bond market in the late 1980s. Because they cut out a layer of intermediation, capital markets are also generally cheaper than banks.

Banks, on the other hand, have several virtues of their own. They are excellent instruments for gathering together small deposits into large pools of capital that can be made available for bigger borrowers. They can employ skilled loan officers to judge different credit risks, and they offer helpful advice to small entrepreneurs. Their intermediation miraculously transforms short-term, highly liquid cash (deposits) into long-term, largely illiquid assets (loans). They can redirect capital from low-return or poor-risk activities to high-return or lower-risk ones. And they can be more “long-termist” than markets.

And yet the downside to relying on banks can be huge. The tumble taken by most of the world’s stockmarkets this year may have grabbed the headlines, but to nothing like the extent that a big bank bust would have done. The 1930s depression was a consequence of America’s bank meltdown (made worse by foolish monetary and trade policy), not of the 1929 stockmarket crash. Banks, it turns out, are even more influenced by popular delusions and the madness of crowds than markets, as repeated bubbles in many different countries have shown. Bank lending can be subject to political interference. But above all, banks do not mark all their assets to market. In bad times they find themselves sitting on assets for which there is no market.

This has a number of adverse consequences. It aggravates bad-lending sprees: because asset prices do not adjust speedily, price signals are jammed and loans continue to go into the wrong activities. Hence the building of so many pointless office blocks during the savings-and-loans crisis in America, or the massive bursts of overinvestment in Japan and South-East Asia. Worse, the failure to mark to market means that getting out of a bust can be slow and tortuous—as Japan has shown in the 1990s. Even today, the true price of Japanese banks’ property collateral is unknown, because regulators do not allow it to be traded in the marketplace. The big difference between capital markets and banks, then, is not that one is prone to bubbles and crashes and the other is not; it is that capital markets bring home the pain immediately, making recovery quicker and easier.

Indeed, the Japanese and East Asian crises of the 1990s, rather like the depression of the 1930s, can best be understood as only the latest in a series of bank-created disasters. Governments everywhere have compounded the problem by devising schemes to underwrite deposits to protect depositors (who have presented banks with all those highly liquid liabilities) from such disasters. Because that exposes the exchequer to bank losses, governments then have to regulate banks more heavily, and depositors lack any incentive to monitor the health of their banks—a pernicious moral hazard.

Banks, in short, are what the late Professor Merton Miller once called a 19th-century technology that is also highly disaster-prone. Which is not to say, as some enthusiasts have suggested, that they can be got rid of altogether. The best-functioning economies are those that diversify their sources of finance, relying on markets when things go well but able to fall back on banks when risk appetites change. The classic recent example unfolded in the autumn of 1998, when debt and equity markets in America both seized up. President Clinton spoke of the worst crisis in 50 years; the Fed cut interest rates three times. But banks were able to step into the breach until markets recovered their nerve.

The evolution of finance

The evidence of the benefits of capital markets, and in particular stockmarkets, is not just theoretical. One study in 1998 of 47 countries found a strongly positive correlation between the size and liquidity of stock exchanges and economic growth. Similarly, investigations of development have found strong links between the growth of non-bank financial intermediaries and the growth of economies. For this reason, the IFC, the private-sector arm of the World Bank, is especially keen to promote stockmarkets in emerging economies.

Indeed, an evolution of finance seems to be at work. In the early stages of development, local banks (eg, country banks in Britain’s industrial revolution) are needed to gather local savings together in order to provide enough capital for growth. Later, big clearing banks that can operate at national level start to emerge. At that early stage companies rely largely on internal financing and bank loans. Banks are useful mainly because capital is so scarce. The problem is not so much a matter of allocating plentiful capital to the best use as of finding enough capital in the first place.

In the next stage of growth, capital is relatively more abundant, so markets are better placed to take over the task of capital allocation from banks. The initial capital markets, for bonds and equities, are soon complemented by others, such as commercial-paper markets. Once these are in place, the scene is set for the arrival of ever more sophisticated instruments for slicing and dicing credit risk to suit different investors. Convertibles, derivatives, high-yield bonds and the rest join the panoply, blurring the distinction between debt and equity. After all, most debt has what might be called an equity element embedded in it.

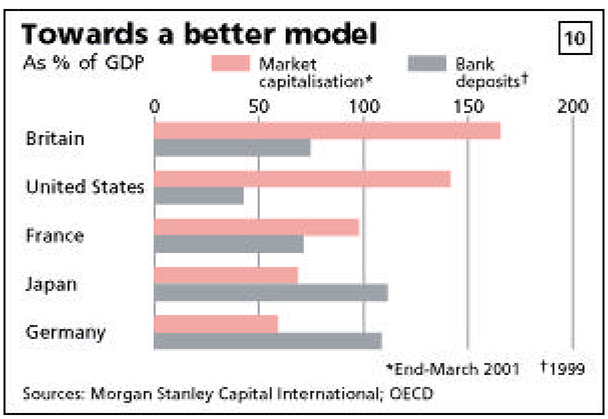
Consider the story of venture capital in Silicon Valley in the late 1990s. As the Internet revolution spread, the preferred mode of finance for its pioneers became venture capital, usually committed by risk-taking funds that had gathered together savings from rich individuals and institutions. Traditionally, venture capitalists have had to wait for many years, until their companies could point to a solid record of achievement and profit, before they could cash out. However, the Netscape IPO of August 1995 changed all that: the public equity markets seemed willing to invest in risky businesses that had never made profits and might never do so. The consequence was an explosion of venture capital, a rash of new Internet businesses, the dotcom mania—and the speculative bubble that gripped the Nasdaq stockmarket up to March 2000, after which the market crashed and venture capital dried up again.

What are the lessons from all this? Some maintain that the whole episode was a disaster, in which capital was thrown away on lousy business propositions, reputable investment banks ripped off gullible investors by sponsoring dubious IPOs supported by questionable research analysts—and lots of individuals got burnt. There is some truth in this picture, but it is nevertheless the wrong lesson to draw. The real significance was that, in a period of less than five years, capital markets were able to finance cheaply an entirely new industry; and when parts of the industry turned sour, promptly to reallocate the capital elsewhere.

The contrast is not just with the Japanese and East Asian experience of bank-financed overinvestment; in America, it is with the Texan oil bust of the mid-1980s and the New England property bust of the early 1990s. The pain from these was more widespread and longer-lasting than today's pain in Silicon Valley. And excessive as the TMT/Nasdaq bubble may have become, it has helped to finance a whole infrastructure that has boosted the American economy—and it has done it faster than a bank-led economy might have managed.

Equity culture vultures

America's greater reliance on capital markets than on banks is, according to the widely experienced Baron Lamfalussy, one of the reasons why, despite the excesses of its bubble, its economy has outperformed Europe's and Japan's over the past decade. Chart 10 illustrates the difference. Now the arrival of better-developed capital markets, and a stronger equity culture, first in Europe but increasingly elsewhere as well, should help the rest of the world to catch up. Banks will, of course, have to change a lot in a market-led system. Investment banking will become more important than normal commercial lending. Deposit-taking will shrink in relative terms; asset management will grow. These trends can already be seen at work, in the rash of recent mergers to create financial-services giants. More mergers are likely.



The question remains: could nascent equity cultures be marred by the markets' current troubles? In the short term, the answer is clearly yes. Even in America, the vogue for equities is fading, after so many investors have been punished so heavily over the past year. Earlier this year, the equity mutual-fund industry saw outflows for the first month in over a decade. Investors in other rich countries are also showing signs of aversion to shares. As for the developing world, equity markets have recently been something of a disappointment. The share of emerging economies in global stockmarket capitalisation has fallen from about 11% in 1996 to 6.5% today, far below their near-40% share of world output.

And yet most of this constitutes a blip, rather than a reversal, in a long-term trend. Even after the setbacks of the past year, global stockmarket capitalisation has tripled since 1990. Equity has grown in value faster than debt, and a lot faster than bank deposits. Most countries are seeing a slow but steady increase in the number of shareholders.

This change is unambiguously positive. A bigger role for capital markets should mean fewer and less persistent economic crises. The spread of share ownership will help to secure better pensions for today's baby-boomers. Above all, equitisation will underpin the system of market capitalism itself, by giving more people a bigger and more direct stake in the success of their companies. It is a far cry from the scene in Ivan Goncharov's 19th-century Russian novel "Oblomov", when the crook Tarantsyev explains the concept of shares to a colleague in crime:

> It's a German invention!...Some swindler undertakes to build a town of fireproof houses, for instance. He needs money, of course, so he starts selling papers at 500 roubles each and a crowd of blockheads buy them and sell them to each other. If the business is reported to be doing well, the bits of paper rise in price; if it's doing badly, the whole thing goes bust. All you've got left is worthless bits of paper. Where is the town? you ask. Oh, they say, it's burnt down, or there wasn't enough capital to finish building it—and the inventor has meanwhile run off with your money. That's what shares are!

In countries with primitive financial systems—not least Russia—such things still happen. But these days shares are more familiar, the regulation and operation of stockmarkets are better, and even corporate-governance systems are improving. The new century is set fair to be the age of the equity.