

**THE INCREASING  
RELEVANCE OF THE STOCK MARKET  
IN THE WORLD: A NEW SCENARIO.**

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## **ABSTRACT**

*This document has three objectives: firstly, to register the quantitative and qualitative changes carried out in the securities market, especially in the stock exchange; secondly, to state the factors leading to changes in such an entity; and finally, to point out the economic and social consequences that could arise from this new scenario.*

*This working paper is part of a wider research entitled “BUBBLES AND INSTABILITY”, which is intended to try and clarify the reasons why the bubbles, especially financial bubbles, are a current issue and one of the main aspects to be considered within these phenomena.*

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## 1. STOCKMARKET INCREASE \*

In the last 25 years, the stock markets have shown exceptional growth. The economic importance of stock markets in developed countries, taking the capitalisation of listed domestic companies as an indicator relative to the national product, has developed as shown in table no. 1.

**Table no. 1. % Market Capitalisation/ National Product**

	1980	1990	1999
Continental Europe (arithmetic mean)	17.36	47.09	114.54
United Kingdom	38.00	81.00	225.00
United States	46.00	54.0	152.00
Japan	33.00	164.00	95.00

Source: Rajan and Zingales 2001, p. 61. Table 3.

The data are self-explanatory. The value of shares relative to National Product has multiplied by 3.3 between 1980 and 1999 in the United States, by 5.9 in the United Kingdom and by 16.6 in Continental Europe. The only industrial country with a lower increase (2.8) is Japan, where a sharp decrease in market value took place in the 90's, which corrected the market bubble excesses of the previous decade (Torrero 2003).

Such economic growth in the stock markets of the industrial countries accelerated in the nineties. Between December 1994 and March 2001, after adjustments in respect of 2000-01 had been taken into account, the capitalisation percentage over the National Product had multiplied by 3.5 in France, by 2.6 in the United States and by 2 in the United Kingdom; in Japan it remained stable (Edison and Slok, 2001a, p. 7).

Overall, global stock market capitalisation has tripled in the nineties, and has undergone much faster progress than bank deposits and credit. At the same time, direct involvement of families in stock holding has increased extraordinarily in the developed countries compared to the available income in all countries (except for Japan). The significance of equitisation will be “to underpin the system of market capitalism itself, by giving more people a bigger and more direct stake in the success of their companies... The new century is set fair to be the age of equity” (The Economist, 2001, p. 38).

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Although the increase in stock markets has been important in developed countries, it has been higher in emerging economies. Some stock markets have been founded where previously there were none, and stock markets in some countries where their importance was formerly reduced, have become more important. The whole process also accelerated in the nineties. Table no. 2 shows the evolution of the market value of listed companies:

**Table no. 2. % Market Capitalisation / National Product**

	<b>1990</b>	<b>1998</b>	<b>% Increase</b>
Developed Countries	56.40	95.00	68.44
United States	55.10	142.80	159.17
Japan	98.20	54.20	- 44.81
Germany	22.90	38.90	69.87
France	26.30	46.00	74.90
United Kingdom	87.00	158.00	81.61
Emerging Countries	19.40	37.10	91.24
World Total	51.80	81.60	57.53

Source: Boutchkova and Megginson (2000, Table III)

Emerging countries made up 2.5% of total world capitalisation in 1983; 6.5% in 1989 and 6.3% in 1999. Excluding the United States, the share of emerging economies over the total would be of 5.6%, 6.5% and 11.9% respectively. The following data define the magnitude of the change produced:

- The share of the United States in world capitalisation was of 56.1% in 1983; in 1989, it had decreased almost to a half (29.9%) surpassed by Japan that same year (37.5%). In the second half of the nineties, America recovered strongly due to the colossal growth in technological companies, reaching 47.5% in 1999.
- The Japanese stock market was the most important in the world as regards to market capitalisation in 1989, when the financial bubble was at its peak; the decrease in the nineties was extremely significant, reaching 13% of the world total in 1999.
- The outstanding progress of the market in the United Kingdom is largely due to the effect of privatisation policies within the country, which has been the most important market jointly with Japan, but was not affected by the market decrease in the nineties like in the case of the Japanese.

In this event of generalised growth of stock market importance, the different rhythms of growth can seem surprising because they occur against certain deep-rooted ideas. The stock markets are considered to be essential in the institutional organisation of financial Anglo-Saxon systems

and, on the other hand, many analysts share the idea that this is the perfect and highest-developed formula of financial intermediation. However, the progress in connection with emerging and developed countries with predominance of banking intermediation over the financial system has been even higher. Even in the most operative side of the stock markets, this phenomenon is noticed in the trading volume, which is in the liquidity provided by the secondary market, as it is shown in table no. 3.

**Table no. 3. Trading Volume. (Thousands of Millions of \$)**

	<b>1983</b>	<b>1989</b>	<b>1999</b>	<b>% Increase 1999/1983</b>
Developed Countries	1,203	6,297	35,188	2,925
United States	797	2,016	19,993	2,509
United Kingdom	43	320	3,399	7,905
Japan	231	2,801	1,892	819
Emerging Countries	25	1,171	2,321	9,284
World Total	1,228	7,468	37,509	3,054

Source: Sornette 2003. Table 0.1, p. xiv.

The advance in European continental countries and emerging countries does not alter significantly the overwhelming predominance of the Anglo-Saxon market. In the year 2000, the three first positions of stock market capitalisation of the world were held by the United States, with 46%, Japan with 13% and the United Kingdom with 8%. France and Germany were situated at a considerable distance with 4%, and the Spanish stock market represented a modest 1% of the total <sup>(1)</sup>.

In this kind of comparison it seems appropriate to point out two aspects. Firstly, that those percentages do not reflect the level of development of the countries, but basically correspond to the institutional organisation of financial systems in the sense that they are polarised towards the markets or the banking intermediation. Another subject matter is that in the last two decades, we have witnessed a reduction of distances as a consequence of the attention given to the development of stock markets in countries where banking intermediation is the basis of the financial system.

This circumstance should be taken into consideration when we refer to the importance of stock markets in the 11 countries comprising the euro group, which underwent outstanding growth in the 90's, although the stock market capitalisation reached 85% of the Gross National Product, compared to 181% in the USA or 206% in the United Kingdom (Wise Men, 200, pages 9-10).

The second issue is that it can be useful to observe these processes under a wider temporary perspective. In 1900, the participation percentage share of countries in the world stock market capitalisation was as follows: USA 22%; United Kingdom 12%; France 8%; Germany 7%; Italy 5%; Japan 4%; and Spain 3%. The weight of Russia was 11% and India 10% <sup>(2)</sup>.

The evolution reflects, in some cases, different levels of economic growth (India and Japan) or in political upheavals (Russia), although it is also interesting to point out the relative regressions of European countries, that do not seem attributable to a lower rhythm of economic growth, but rather to a financial system oriented towards banking intermediation. We can say the same regarding the growing importance of the United States but on the opposite direction, that is, in favour of the markets.

Research by Rajan and Zingales<sup>(3)</sup> highlight that the importance of stock markets in relation to the national product was greater in 1913 in Belgium and France than in the United States, and that the subsequent evolution is not a consequence of the market forces, but of political measures in favour of a bigger or smaller movement in the business group. In the case of Europe, legislation veered towards the stability and defence of the established business positions; this resulted in the consolidation of significant stakes in the companies' capital, which is usually in the power of the banks, committed to their long-term funding. On the contrary, North-American legislation has favoured the reorganisation of the worst directives and the promotion of the best-oriented ones.

This idea of the stock market as a dynamic institution had already been suggested by Weber (1896). The German sociologist defended the stock market against the conservative sectors (farmers opposed to the commercialisation of future crops) and also against socialists, for whom the stock market was the symbol of capitalist iniquity. Weber stated that pure speculative commerce is helpful for private community and it has also important functions in price levelling and goods distribution (p. 17). Perhaps, it is appropriate to add that, at that time, regulation of forward transactions was neither as well-developed nor had reached such a complexity level as it had in Germany.

## **2. THE IMPROVEMENT OF THE OPINION CLIMATE REGARDING STOCK MARKET AS AN ECONOMIC INSTITUTION**

The outstanding growth of the stock market has been due to a group of factors to which I will refer further on. These factors have been able to develop to their potential due to being supported by the change of opinion climate with respect to the stock exchange as an institution. In the last two decades, the reticence established as a consequence of the Great Depression was starting to be left to one side; at that time, stock markets were considered an institution with destabilising capacity and a reduced economic function. In fact, from the end of the Second World War until the eighties, market economies had undergone important economic growth and the stock exchanges were not showing great prominence. This progress had been even greater in the countries where stock exchanges were of less significance.

For decades, this genuinely capitalist institution, the symbol of market economy, had played a secondary role. However, following radical changes, stock markets are now considered a key institution, not only for developed countries, but also for the promotion of progress in emerging countries.

The change of ideas concerning the economic and social effects of stock exchanges is based on the following points:

- a) **Revision of financial responsibilities in the Great Depression.** The contribution of Friedman and Schwartz (1963) exonerated the market for the disaster, and attributed it to the erroneous operation of the Federal Reserve, which had also tried to slow down a stock exchange boom that was considered to have negative effects on the current economy <sup>(4)</sup>. The interventionist attitude in the stock market and the failure in the maintenance of monetary figures had been the main causes of the disaster. Another mainstay in the review are the researches carried out half a century later questioning the overvaluation of the market in the twenties and demanding Fisher's assessment with regard to this.
  
- b) **Review of other episodes regarding destabilising speculations.** The ideas concerning the negative effects of the markets when driven by sharp speculation had been provided by events like the Dutch tulip bubble, the Mississippi, or the Southern Seas, as stated by Garber (2000) <sup>(5)</sup>. What this author accuses, is that the mythicised interpretations of some events were far from the attributed irrationality incorporated

in the economic culture. According to this author, the intention when calling these events madneses and irrationalities is to justify the interventionist policies (p.12).

- c) **Criticism of financial repression and liberalisation proposals.** The studies of McKinnon (1973) and Shaw (1973) are essential in emphasising the costs of public intervention in the financial system concerning savings and investments. In order to favour interest rates that are reasonable for those activities considered as strategic, the rates were situated at artificially low and usually negative levels in real terms. At the same time, saving was prejudiced and a cheap financing of public deficits was provided. Therefore, it was possible that the public sector appropriated income from the private sector, and the scale of risks and rewards was affected by the liberalised environment.

Instability has frequently been accompanied by financial liberalisation processes <sup>(6)</sup>, and experience has recommended greater caution and earlier reforms. In spite of everything, deregulation policies have generally been followed due to the fact that in an international deregulation capital flow environment internal deregulation was mandatory. The World Bank (2001, p. 22) states this precisely: “Domestic financial liberalization would be possible even without opening up the economy to the international capital movements, with the opening up, it becomes unavoidable”.

- d) **Failure of the banking system as the allocator of resources at an international level in the seventies.**

The eighties began with the recognition of the emerging countries with the highest debts, of the impossibility to comply with the financial obligations contracted since the late seventies, when energy prices were increased. This is a well-known process: the large private banks, particularly North-American banks, mediated large funds from oil-exporting countries to importing countries, and in general towards those demanding financial resources. The magnitude of this crisis for the lending banks obligated the North-American financial entities to establish programmes for permitting the adjustment of banking balances.

Three conclusions were derived from this event: 1) it was not possible to be confident that public sector and public companies were solvent debtors; 2) the magnitude of the indebtedness would not have reached such levels had the resources been channelled through traded assets, because their quotations would have warned about excesses preventing the outstanding debt accumulation of emerging countries; 3) intervention of

North-American authorities consisted of the conversion of the debt into bonds backed up by the United States government (Brady Plan) and that can be quoted in the markets, which permitted the continuous assessment of the financial capacity of those countries demanding funds and provided new financing organised on the basis of quoted assets. T.L. Friedman (1999, pp. 54-57).

e) **The collapse of socialist economies.**

The social and economic collapse of socialist countries consolidated the market as the only institution that was able to orientate the economy on a rational basis and, particularly, to assess continuously the economic decisions adopted by the agents. It is not so remarkable that, to a large extent, in the new institutional organisation of socialist countries, inspired by North-American experts, the establishment of stock markets was a prime issue.

f) **The nineties brought about a superior evolution of the countries that considered the market as an essential axis of the financial system.**

The progress of the United States in the nineties has been linked to the existence of flexible financial institutions promoting the efficient allocation of resources and the outstanding growth of productivity. The opposite happened in Japan and Germany, where they were still using resources on activities with no future, due to the deferring of adjustments and trying to hide the consequences of the errors undertaken. Markets allow the continuous revision of decisions, which is a key aspect, particularly in periods of fast technological change. Financing of innovative activities by financial markets promoting venture capital, and the banking crisis of Japan and the Far East countries, strengthened the prestige of the markets and the discreditation of banks. As has been stated by Carlin and Mayer (2000, p. 141) on this subject:

“Instead of performing the active monitoring and governance function that financial intermediation theory ascribes to them, banks are perceived to have been at the center of corrupt, crony systems. General perceptions have swung markedly from admiration for systems that have been associated with sustained high levels of investment and growth rates to severe criticism from their lack of openness and transparency”

The six points mentioned assist in the understanding of the current situation of the stock markets as an economic institution. A group of investigations carried out directly or supported by the

main centres of emission and diffusion of economic ideas have contributed to this favourable climate.

The World Bank had an important role in this change of direction. Within their 1990 and 2001 reports, the following important aspects are observed: "If finance is fragile, banking its most fragile part" (2001, p. 11). Crises can also be produced in the stock exchanges and they are not harmless "but are clearly less disruptive than bank failures" (ibidem, p. 12). Stock markets are therefore the key institutions to be developed and would be the main arm of financial liberalisation and of the imposition of a specific model.

The new ideas of the World Bank defend the creation of financial markets that are *well-regulated* and open to international investors, as the fastest formula for economic development, as it allows the poor countries to access the financial markets of developed economies. Therefore, instead of depending on the financial aids and loans managed by political organisations, local businessmen receive resources directly from private investors, avoiding corrupt or inefficient governmental structures and releasing the businessman from that servitude (Weber and Davis, 2000, p. 8).

As has been stated by the above-mentioned authors, the role of the stock exchanges has been defended by the Treasury Department of the United States, by the International Monetary Fund and by the World Bank. Capital flows, together with stock exchanges as key institutions, perform a subtle and institution-reforming function:

"... in contrast to trade flows, financial flows can directly drive changes in organizational structures. Whereas consumers of products may care little about whether their shoes were made in Maine or Malaysia... institutional investors are quite exacting in their requirements for governance structures".

(Ibidem, p. 3-4).

It is not just a question of channelling capital, but also of bringing about institutional and social reforms to ensure the effectiveness of this method of raising resources. The reference model would be what Kaufman (1994, pp. 6-8) has called the "Americanisation of Finances", which implies: 1) an increase in deregulation of markets and institutions; 2) a rapid increase in securitisation; 3) the promotion of a higher use of new financial instruments, particularly the derivative instruments; and 4) the promotion of the growing presence of portfolio managers, with the freedom to act in all markets, using all currencies, with a short-term orientation, and without maintaining permanent links with any market.

### **3. RECENT MAIN LINES OF INVESTIGATION SUPPORTING THE STOCK EXCHANGES AS A FINANCIAL INSTITUTION**

Lines of economic investigation including and supporting at the same time the prevailing trend in the new financial organisation, are based on three principal ideas. Firstly, there exists a clear relationship between the highest use of markets and financial assets and income level, and especially the rhythm of economic growth. Stock markets in the progress of economy are assigned a special relevance.

Secondly, the institutional organisation becomes the key aspect to explain the development level of countries and their future possibilities. Special attention has been paid to the legal tradition that favours, to a greater or lesser extent, the protection of property rights, which is a necessary condition for the development of stock markets.

Finally, a review of the importance of the functions performed by the stock markets has been carried out. The new idea-force is the acceptance of a limited function in the resource allocation, but highlighting, however, the role of the markets in the transmission of information and in the control of business management.

#### **3.1. Stock Exchanges and Economic Growth**

In the nineties, interest in the role financial institutions and markets play in economic development has been rekindled. <sup>(7)</sup> Limiting attention to the stock markets, the researches have highlighted their role as an institution suitable for contributions to the economic growth in emerging countries, as well as their importance as a variable in explaining the economic growth in the most-developed ones.

There had been a different appreciation of the possibilities of the stock markets in the nineties. Until then, stock markets existed in those countries with a sufficient income level that were able to generate savings. 24 out of the 49 countries with stock exchanges in 1950 were in Europe, and 13 were or had been British colonies. In the eighties and particularly in the nineties, an intense period of stock-exchange creation took place worldwide (Weber and Davis, 2000, p. 58). Sometimes it was not an *ex-novo* creation, but a revitalisation of markets that upheld a certain importance in other times. The most important case was that of Argentina, which has had a stock exchange since 1872, although after the Second World War this had a weak existence until its recent revival (Goetmann and Jorion, 1999).

Moreover, since the nineties, there has been a real flood of research concerning the relationships between finances and economic development. The study of Goldsmith (1969) is an essential reference, although since the nineties the cautionary statements of this author have been left to one side regarding the direction of causality between both variables towards putting the stress on finances as a growing engine; within the assets, institutions and markets, stock exchanges play an increasingly important role, not only for channelling resources, but also for promoting reforms to modernise the financial legislation.

In a study published at the beginning of the nineties, which is essential in the new line of thought, Levine (1991) points out the two key arguments: stock exchanges speed up the economic growth in two ways. The first is by making property changes possible in the companies, whilst not affecting their productive process; the second is by offering higher possibilities of portfolio diversification to the agents.

On this subject, the study of Levine and Zervos (1996) suggests that the level of stock exchange development is positively associated to economic development. In later research, the same authors (1998a) pointed out that the capacity of transmitting property in advanced economies eases the efficient allocation of resources, the capital formation and the economic growth. Also Demirgüç-Kunt and Maksimovic (1998) found a relationship between the rhythm of economic growth and the stock market activity in the field of transmission of securities (secondary market) more than in funds channelling (new emissions or primary market). The same authors, in a study carried out in 1996, with a sample of 30 countries for the 1980-1991 period, drew the following conclusions: stock market advances in emerging countries do not imply a decrease of banking business in the financing of business, but, on the contrary, lead to higher activity in banking systems. Banks and markets do not appear, therefore, as alternative or rival institutions, but are complementary to each other, reinforcing the whole activity of the financial system.

This idea of complementarity is reinforced in the research carried out by Demirgüç-Kunt and Levine (1996 a) using data from 44 countries, either emerging or industrial, for the years 1986-1993. The different measures of stock exchange size are strongly correlated to other indicators of activity levels of financial, banking and non-banking institutions, as well as to insurance companies and pension funds: “ Countries with well-developed stock markets tend to also have well-developed financial intermediaries” (p. 293). Apart from emphasising this integral development of financial institutions, the same authors are even more explicit and direct in a study in which they review the different contributions on this subject:

"New theoretical works show how stock markets might boost long-run economic growth, and new empirical evidence supports this view. Specifically, the level of stock markets development does a good job of predicting future economic growth. This aspect is important for the World Bank and policymakers in developing countries because it means that in many countries capital markets reforms should be high on the reform agenda". (Demirgüç-Kunt y Levine, 1996b, p. 224).

The econometric study of Rousseau and Wachtel (2000) uses data from 47 countries, covering the 1980-1995 period. The conclusion is also shown to be clear in the following:

"This investigation ... finds strong support for the notion that deep and liquid equity markets have had a significant and persistent impact on economic performance" (p. 1934).

The following countries are among those included in the above-mentioned study: France, Italy, Holland, Sweden, Switzerland, the United Kingdom, the United States, Japan, Jamaica, Jordan, Ivory Coast, Kenya, Trinidad and Tobago and Zimbabwe.

I feel sceptical about the significance of the results coming out of these kinds of studies including data of a very different magnitude and quality in order to quantify the relationship between financial variables and the complex structure generating economic growth. Regardless of this scepticism, which is quite generalised among experts who prefer making reference to the simultaneity rather than accepting defined quantitative relationships, and a specific causality direction, those studies, as Weber and Davis (2000, p. 9) declare, have been useful as a support for the line or argument of the Treasury Department, the International Monetary Fund and the World Bank in favour of the liberalisation of financial markets. In any case, as Wachtel (2001, p. 359) pointed out, what many people consider to be strong evidence that financial development promotes economic growth, has contributed to a higher interest for our role in the performance of financial institutions.

The effects of liberalisation in the stock exchanges of emerging countries has been analysed by Kim and Singal (2000). Attraction of foreign capital and the development of the stock market promote economic growth and a reduction of foreign financing costs; and incentives towards transparency in economic performance completes the list of positive factors. The main risk is a higher vulnerability derived from the possibility of a sudden flight of capital. All in all, the balance is extremely favourable.

In this way, the economic research has been dominated by the idea of the importance of the stock exchanges as an engine for emerging countries, but also as a growth accelerator for developed countries. However, some critical opinions still remain with regard to the suitability of stock markets, not only for the growth of industrial economies, but also with respect to emerging countries. Stiglitz's is a well-known opinion in favour of the prominence of banking financing and is against the stock markets, which can prejudice even the function of channelling savings towards investments by the banking system. Stiglitz is classified among those economists who share the remarks of Keynes concerning the distorting potential of stock markets <sup>(8)</sup>, considering reluctantly the economic consequences of stock exchanges. Although the analysis carried out by Stiglitz in his first studies was focused on the capacity of channelling resources and in the appropriate allocation to productive sectors <sup>(9)</sup>, his contributions in the last two decades include the analysis of the monitoring function from the perspective of expensive and imperfect information and the adverse selection.

According to Stiglitz, if the channelling function of stock exchanges cannot be appreciated in developed countries with secondary liquid markets, little can be expected from emerging countries, which lack them. Therefore, he thinks that they do not offer a realistic alternative to other financing formulas, basically bank credits (Stiglitz, 1989). The concept of the North-American economist is very influenced by the experience of new industrial countries of Eastern Asia, where the main pillar of financing was the banking system and the big industrial conglomerates related to it. It must be pointed out, summarily, that the financial, banking and industrial crisis which took place in the late nineties does not seem to have altered significantly this positive view of Stiglitz, who maintains the arguments, difficult to be refuted, that the rhythm of growth and the extremely fast transformation of those societies would not have been possible with a different model of financing relationships. Stiglitz takes a step ahead considering that "Improvements in secondary capital markets may even have adverse effects on primary capital markets, as funds are drawn away from domestic banks" (1993, p. 349).

The modest capacity for channelling resources is a key aspect in Stiglitz's concept, and the foundation of this lack is the different level of information of asset issuers and purchasers. In developed countries, that difference of information leads to the distrust of the purchasers, because if the directors, who know well the situation of the society, opt to issue new shares at current prices, it is reasonable to suspect that they have been overvalued and they are taking advantage of the sale. If such exploitation is present among emerging countries, where an important institutional prevention network tries to avoid or mitigate them (audit, rating companies, etc.), the risk is much higher when the cautions do not exist (Stiglitz, 2000).

In the study carried out by Marone (2003) regarding the economic effects of the creation of several stock markets in African countries in the nineties, according to the recommendations of the World Bank and the IFC (*International Finance Corporation*), and even accepting that there is a positive correlation between the appearance of new stock exchanges and the economic growth, the causality is not clear and in this respect he joins the group of sceptics regarding the current economic effects related to the creation of new markets. The critics are even more severe in Singh (1993):

"Essentially, this paper suggests that is arguable that, even in advanced countries with well-functioning markets, the stock-market are likely do more harm than good to the real economy" (p. 23).

According to this author, the profusion of stock markets does not correspond to a higher level of development of finances, but is the consequence of specific reasons, particularly of privatisation programmes (Singh, 1997, p. 777). He states that stock markets are a very strong symbol of capitalism, but market economy progresses better without their dominance. As opposed to the ideas of the World Bank, the expansion of markets is not the necessary consequence of progress in financial development. Evidence of this is that such evolution did not take place in the main continental European countries, without an important presence of stock markets, which had however four decades of strong growth after the Second World War (Ibidem, p. 780).

Regarding the effect of the stock markets on the economies of emerging countries, Singh and Weise (1998) highlight the following negative effects: the short-termism view, the possible sudden withdrawal of resources, the incidence on the foreign exchange market and the possible alteration of established financial circuits:

"The dominance of stocks markets may undermine the existing group-bank financial systems which have served many developing countries well, particularly in the dynamic economies of East and South-east of Asia" (p. 618).

The distrust towards the economic effects of the stock exchanges includes the main critical idea of the short term of the markets, as opposed to the more steady and at a longer term commitments implied by the financing of the banking system. This review was maintained until the early nineties. A good example is the study performed by Mullin (1993) in which, although acknowledging the importance of the markets as a financing method for emerging countries, he regards the stock exchanges as negative to the extent that they introduce a culture stimulating a lack of commitment, which could be an obstacle for long-term investments. The appeal of this

argument decreases as the emphasis changes from the financing function of the markets to one of information, comprehended from the late nineties. With the new assessment of these effects, lesser commitment stops being a negative fact and transform into a positive one due to it being an expression of the markets' capacity to orientate the investments towards the most promising sectors. All in all, this is evidence of market flexibility in contrast to the higher inflexibility of banking agents, who persist in making allocation errors using more resources so that they are not obliged to recognise and face up to the consequences.

The creation of new stock exchanges and the revitalisation of others is a process parallel to economic globalisation or, more precisely, to the role assigned to financial markets by what Weber and Davis (2000, p. 46) called the American view of globalisation, according to which the finances act as the spearhead force undertaking positive reforms of the highest mobility of resources. Time plays a fundamental role in those studies where incidences of stock exchange liberalisation processes are measured, permitting companies of these countries access to the foreign stock markets, and allowing foreign investors to freely operate with national securities. The initial impact is always positive, as privatisation and liberalisation imply an inflow of resources promoting economic growth. This is the result of the research carried out by Levine and Zervos (1998,b) who measured the evolution after this opening in 16 emerging countries. Also Martell and Stulz (2003) recognise the favourable effects in the first year after liberalisation, although a subsequent decline is observed as these effects were gradually dispersed after the initial positive boost. This was also perceived by Kim and Singal (2000, p. 27) regarding the returns of quoted securities.

This brief summary aims to provide an understanding of the current situation of the stock exchanges and the rise in the consideration deserved by the institution as from the nineties. There are also critical views, as above-mentioned, but the prevailing line of thought grants an important predominance to the stock markets as an institution, which is, to a large extent, an innovation. It is not only the beneficial effects attributed to the stock exchanges in emerging countries, but also the dimension of stock magnitude, already considered as an economy flexibility index, which becomes an explicative argument for the growth potential of all countries. As the relevance of financial markets is higher in the Anglo-Saxon world, and the economic evolution in the nineties in the United States has exceeded that of developed countries with different models of financial systems (Japan and Continental Europe), the main conclusion is proven.

An extremely significant observer, Wolf (2005, p. 28), describes the new situation created, as of the nineties, as:

"The long decades of post-second world war decline of the English- speaking, high-income countries have ended. Since early 1990s they have been doing better than many other long-established high-income countries and, above all, than the four dominant non English-speaking countries: Japan, Germany, France and Italy. Between 1991 (the trough of the US cyclical downturn before the slowdown in 2001) and 2004, the gross domestic product of Australia, the US, Canada and the UK (in that order) rose considerably faster than those of France, Italy, Japan and Germany...".

Therefore, the configuration of American finances is a model to be imitated. In the research carried out by Gugler et. al. (2004) the issue is clearly stated when making reference to the government of the companies:

"The evidence reviewed in the previous section, which comes from this most recent period, clearly implies that Anglo-Saxon systems are better at protecting shareholders than other systems, and that they lead to superior macroeconomic performance. This superior performance suggests that countries which do not possess Anglo-Saxon type corporate-governance institutions might achieve better economic performance by adopting them" (p. 149).

To conclude these brief ideas, it is necessary to remember that these are just the opposite to the one existing at the beginning of the decade, and that the changes in the appreciation of the institutional organisation have taken place jointly with the success of economic growth in the different period. Therefore, prudence is advisable regarding the establishment of accepted ideas regarding the different models of financial organisation.

### **3.2. Institutional reforms. Protecting the investor.**

The models of business control are classified into two large groups: countries with external control (the United States and the United Kingdom), and those with internal control, which is at the same time divided by Gugler et. al (2004, p. 130) into the Germanic model (with a main shareholder) and the Japanese model (with exchanges of directors and cross-holdings).

The main guidelines to orientate the reforms of stock markets are, generally speaking, the ones existing in the Anglo-Saxon model. An essential characteristic of these is the atomisation of shareholders, that is, the non-existence of a reference shareholder in most of the cases, either majority or minority, with an effective position of control. Reference shareholders, usually

banking institutions, constitute a normal situation in the countries where banking intermediation predominates in the financial system, and this is a consequence of the low importance of the markets in these cases. However, according to some experts, these are a hindrance that hampers the total development of equity markets, which is understood as the convergence towards the Anglo-Saxon model, not only in its economic importance, but also in its institutional organisation.

The protection of investor's rights is the keystone for the promotion of equity markets. The existence of a legal and regulatory framework guaranteeing the small shareholder's rights is essential so that the purchase of financial assets, and of equities in particular, is a normal alternative option without methods of wealth appropriation by directors or reference shareholders that cause distrust in the ordinary investor.

Investor protection in the Anglo-Saxon countries is focused on the reduction of conflicts of interest (agency problems) between shareholders and directors; in countries where the normal situation is the existence of reference shareholders, the aim of the protection is to safeguard the ordinary shareholder against possible neglect of those holding the effective control. Therefore, the assessment of the control position is an important index of the capacity of wealth appropriation by the control shareholder. Dyck and Zingales (2002) carried out an investigation of 412 transactions implying the transferring of the companies' control in the nineties; the average value of the control position was 14% of the shares' price, but with broad differences going from the -4% of Japan to the +65% of Brazil.

Sometimes, it is true that the shareholders with a control position provide financial aid to companies, using their own resources, but in general, data shows the predominance of the contrary situation, that is, they tend to obtain resources or benefits from the affiliates in countries where the protection of the ordinary shareholder is weak (E. Friedman, Johnson and Mitton, 2003).

The crisis in the new industrialised countries of Asia, and the stagnation of Japan after the explosion of the housing and stock bubble, have emphasised the consequences that can be derived from the control positions with a higher capacity of appropriation when they are divided into financial-industrial groups with an unique direction (*keiretsu*, *chaebol*), by means of transfer prices in goods and assets within the groups. It is important to highlight, as Faccio et. al. (2001, p. 71), that it is not only a question of justice in the distribution of income and wealth, but also that these organisations can bring about an inefficient allocation of resources. It is possible for the control shareholders to undertake investment projects with a low or negative

profitability, if the capacity of appropriation by other means compensates the low returns of the company.

The research group headed by La Porta has carried out numerous contributions <sup>(10)</sup> regarding the suitability of the countries legal organizations for the development of their financial systems. As Levine (2002, p. 4) stated, these authors do not try to declare themselves to be in favour of those systems based on banking agents or markets, but to stress that the foundation of finances are contracts whose real validity depends on the legal rights established as well as on the guarantee of their performance. The quality of financial services and, therefore the allocation of resources, depend on the running of the legal organisation.

Limiting their attention to the stock markets, La Porta et al. use a quantitative approach to the legal aspects, classifying the countries into four groups according to their legal tradition: English, French, Germanic and Scandinavian. Regarding the protection of investors, the highest level corresponds to the English system (*common law*) and the lowest one to the French system (*civil law*); those countries included in the Germanic and Scandinavian legal traditions take a middle position in this respect. Civil tradition is the oldest and most influential one, and has the highest presence worldwide. Its origin is Roman Law, a code is used as the main formula to order the legal material, and academics have a big influence in the explanation and application of rules; the French, Germanic and Scandinavian models fall within civil tradition. In the *common law* tradition, judges are the ones who decide on the conflicts and their resolutions are valid precedents (La Porta, 1996, pp. 1118, 1119).

The main objective of the research carried out by these authors is to demonstrate that the level of protection for the investor is decisive for the importance and efficiency of stock markets in the different countries. The protection establishes the dimension of markets and the main issue is that the legal organisation hampers the exploitation by directors and shareholders with effective control. Legal cautions must not be considered only in the ordinary legislation establishing the commercial procedures in general and the penalties to the offenders, but also in specific regulations governing the performance of agents who act in the stock market, especially the issuing requirements to companies, when it is preferable that the control organisations are established by independent institutions.

The balance of powers and the judicial independence, key aspects of the political freedom, are essential requirements for the security of property rights. According to the authors, this question has notable implications:

"We measured economic freedom as security of property rights, the lightness of government regulation, and the modesty of state ownership. We measure political freedom as democracy, political rights, and human rights" (2004, p. 446).

The main explicable factors of the level of share distribution are rigour and adaptation of protection. Therefore, these authors reject Roe's opinion (1994), which considers the extent of the distribution as the consequence of a deliberate policy in the United States against the political power concentration in the company (La Porta et. al, 1999,a, p. 511).

The positive effects derived from a wide distribution of capital have resulted in a greater assessment of shares in the market (La Porta et. al, 2002, p. 1168). A good measure to reduce the exploitation of positions of power is to promote high-dividend policies because they lessen the financial autonomy of those who control the companies <sup>(11)</sup>.

The analysis by the group headed by La Porta try to present an explanation of why the stock markets are essential in some countries and not in others. Once the superiority of the Anglo-Saxon model has been demonstrated, the way is clear: those countries that wish to promote the stock markets must reform their institutions in keeping with the Anglo-Saxon model. The quick and deep reforms are immediately acknowledged by the institutional portfolio managers who decide on the direction of financial flows.

The message is considered to be valid for all countries, either emerging or industrial. Efficiency of the legal organisation conditions the capacity to obtain external funding for the companies (Demirgüç and Maksimovic, 1996, 1998); however, the rhythm of the reforms and the quick rapprochement to agreement with reference model differs substantially from some countries to others. Morin (2000) has pointed out that France is starting to operate more and more according to English and American guidelines, distancing itself progressively from the German and Japanese model of capitalism. The key aspects of the French evolution are very significant:

"... first, it will, in the long term, put an end to the cross-shareholdings system; second, it promotes the entrance of new investors, especially foreign institutional investors; third, the new investors bring with them new norms of company management" (p. 37).

In this last aspect, the share of foreigners in the capitalisation of French companies has increased dramatically, from 10 to 35 percent between 1985 and 1997. The advances in internationalisation in other countries have been remarkable, but have been maintained within more moderate proportions: the United Kingdom 9%; Japan 11%; and USA 6% (Ibidem, p. 41).

International capital flows are situated according to the extent of the reforms carried out to incorporate the institutional investors. In their research, Montiel and Reinhart (1999) reach the conclusion that market depth, measured according to the number of quoted companies, is essential information to orientate the movements of investors.

The establishment of multinational institutions like the *International Finance Corporation* is an important occurrence in favour of a greater international integration. The promotion of investment funds in shares of emerging countries with the purpose of gaining resources and easing the diversification of institutional investors from developed countries is particularly encouraged (Lavelle, 2000).

The trend of convergence towards the guidelines and rules of the Anglo-Saxon model is also encouraged due to the requirements established by the English and North-American stock exchanges to admit the shares of other countries for contracting. Karolyi (2004) has confirmed that the most favoured companies for the access of foreign companies to Wall Street are those with possibilities and disposition to comply with the requirements set out by the ADR <sup>(12)</sup>.

The confluence with the American financial model implies a trend towards the uniformity of the desirable framework not only for emerging countries, but also for the industrial countries with less-developed markets. The objectives, the legal, accounting and even supervising regulations are common, and the integration level is progressive, as proven by Saunders and Walter (2002). Therefore, the trend towards uniformity is set in a globalised world where finances act as the vanguard enforcing internal reforms in this direction.

## **4. FACTORS THAT EXPLAIN THE HIGH RELEVANCE OF THE STOCK MARKETS**

### **4.1. Economic importance of stock exchanges**

In the first section of this study, I have reviewed the growth of stock markets in the last two decades. Now it is time to analyse the main factors that encouraged this progress.

A forewarning is that academic contributions have followed with delay the rapid changes undergone by financial markets. In most cases, the studies concerning finances-economy provide the explicative logic of changes observed in the economic reality induced by the market

dynamism and the evolution of financial variables. It is not always like this; in the specific field of financial innovation, theoretical advances made possible the generalisation of the use of derivative products <sup>(13)</sup>. However, in the study regarding the relationships between finances and economy, or more precisely, in the macroeconomic effects of finances, the analysis are usually orientated and inspired by the observed effects of financial variables on the real economy.

I have emphasised the rapid growth of stock exchanges; if, in general, it is important to date the diagnosis and contributions of researchers, when the changes are fast, the chronological aspect is even more necessary.

It must be stated that the revolution that took place in the last twenty-five years does not constitute the acceleration of a previous trend, but rather a breaking-off point. In fact, financial markets worldwide had a reduced importance between 1930 and 1980. According to Rajan and Zingales (2003b, p. 197), a part of the explanation lies in the decrease of international capital flows during that period; in such a closed environment, the established business class drew back from the possibilities offered by an open and competitive financial order for the development of new projects. According to this interpretation, the international liberalisation of capital movements has forced internal liberalisation, promoted competitiveness and has launched the dynamics for the promotion of financial markets.

I will interpret three statements from the last two decades, which provide an idea of the changes undergone by the consideration of the stock market as an institution.

In 1984, two distinguished economists specialising in finances (Fisher and Merton) presented a research expressively titled: *Macroeconomic and Finance. The Role of the Stock Market*. The objective of such a study was focused on the analysis of four possible reasons to explain "the lack of emphasis on the stock market in macroeconomic analyses of the business cycle" (p. 61). The first is that a general belief seems to exist, which is empirically based, that the stock exchange is a weak predictor of the investment rate and other components of National Product. The second reason is that the interest rate is usually considered an appropriate indicator of capital cost, even in an uncertain environment. The third is that many macroeconomists believe that analysis of the business cycle must be focused on deeper variables such as preferences and technology. Finally, the fourth reason is "widespread distrust of the reliability of stock prices as indicators or causes of investment because it is believed that stock-market participants are rather poorly informed and/or that stock prices are significantly influenced by irrational waves of optimism and pessimism among investors" (Ibidem, pp. 61, 62).

One decade later, in 1993, Smith and Sylla presented interesting clarifications regarding the significance of stock markets in an study concerning the transformation of financial capitalism: "Despite the great attention they receive from the broadcast and print media, their influence in the modern economy can be exaggerated". In fact, North-American companies have obtained between 60% and 80% of their financial needs from withheld benefits since the sixties; the remaining percentage has been obtained from loans, with little incidence of obligations and funding from the issuing of shares, this being nearly unnoticeable. "The capital market thus might first appear to be a marginal affair, generating a few more dollars for corporations and governments, and a few more jobs for the economy" (Ibidem, p. 6).

However, as the authors highlight, the function of assessment and information is very important in order to consider the directors' merits. There are some signs that the markets have regained their significance in the past:

"It is well worth noting that in some respects the Wall Street institutions and markets of today seem to be exhibiting a tendency to return to the commanding positions they reached nearly a century ago. Parallels can be drawn to show that now, and then financiers are using the large pools of capital at their disposal to reshape the US economic landscape; to buy, sell, and control corporations; to oversee the international flow of capital to and from the United States; and in the process to enrich themselves" (Ibidem, p. 8).

The third reference corresponds to the current decade. The advance of stock market presence is already appreciated in all directions:

"... the stock market plays a far more crucial role in today's economy than at ever has in the past. For the first time in history, over half the America population owns stocks, either directly or indirectly, meaning that to an unprecedented degree the financial well-being of the population is tied directly to stock prices. Many millions of people depend on stock market returns to fund their retirement, and the notion that even Social Security funds should be invested in stocks has gained a degree of acceptance that would have been unthinkable not long ago" (Smith, 2001, p. 309).

Below, I refer to the main aspects explaining the current importance of the stock exchange.

#### **4.1.1. Families as shareholders. Effects on consumption**

In the last two decades, the wealth effect has become a primary variable in the function of consumption; the incidence of stock fluctuations is particularly considered. In approximately 1975, the research by Bosworth reflected the limited entity of the stock exchange:

"In the vast literature of consumer demand, only a few studies have focused directly on the influence of changes in stock prices and of their associated capital gains and losses. In addition, those studies that have explored this relationship differ in their emphasis in two distinct mechanisms by which the stock market might affect consumer demand. The first, which is closely identified with the life cycle model of consumer behavior, emphasizes the effect of change in wealth. The second uses the stock market as a proxy measure of optimism or pessimism (so-called "consumer sentiment") (pp. 258, 259).

In the last two decades, the scene has undertaken a total change. In all countries (except for Japan, for the above-mentioned reason) a very important increase in family balances has taken place. Assets have increased compared to available income, which is a consequence of the revaluation of financial assets and real estate, and indebtedness has also hardly been increased. A very important aspect is the progress of proportion of the asset whose value is related to the running of markets. This evolution is due to private pension plans and investment funds; the presence of equities in these institutions has increased in the period in question, although they follow the fluctuations of quotations and interest rates.

Table no. 4 shows the appreciation of a generalised increase of the Families Financial Balance and the acceleration of the trend since 1980.

**Table no. 4. % of financial assets and liabilities of families in connection with the Gross National Product (Arithmetic means)**

	1970	1980	1990	1998
Anglo-Saxon countries				
Assets	173	146	200	280
Liabilities	46	49	70	73
Europe and Japan				
Assets	96	109	164	207
Liabilities	31	39	52	50

Source: E.P. Davis and B. Steil (2001, p. 31)

Anglo-Saxon Countries: United States, United Kingdom and Canada.

Europe and Japan: France, Germany, Italy and Japan.

The increase of the families balances is important for three interrelated reasons, as has been established in the Report ordered by the Group of 10 (Heikensten et. al, 2002, p. 7): Firstly, the change in the price of assets produces a variation in wealth that is higher than in the past in

terms of recurrent income; secondly, it is possible that the higher weight of assets with market valuation increases the sensitivity in spending decisions; finally, the increase in both sides of the balance implies a higher risk of macroeconomic instability.

The presence of shares in the family balance is essential. According to Poterba (2000, p. 99) between the end of 1989 and 1999, the value of assets of American families in real terms was increased by nearly 15 thousand billion \$; more than 60% of such increase was due to the revaluation of assets. The importance of the wealth effect of consumption has been remarkable:

"If 1 \$ of additional wealth generates 3 cents of additional spending, the 1995 to 1999 increase in household net worth could account for a consumption increase equal to roughly 2'8 percent of disposable income in early 2000. This would represent a 3'0 percent increase in consumer spending, or an increment to aggregate demand of roughly 2 percent of the GDP" (Ibidem, p. 108).

These changes, so significant in the evolution of the North-American economy, explain the constant concern of the Federal Reserve to quantify their effects. It would not be excessive to state that sometimes, the weight of the effects derived from the valuation of assets in the last ten-years decisions of the Central Bank in the United States has been higher than inflation's, which is the first focus of attention for monetary authorities. The President of the Federal Reserve has been very receptive towards the phenomenon of wealth growth and its effect on the economic cycle, and he constantly makes references to this issue in his public declarations. At the beginning of the year 2000, he pointed out that the expenditure derived from the property and real state valuations could have increased domestic purchases by an average one percent in the second half of the decade, and boosted imports by almost the same percentage, as well as employment and immigration (Greenspan, 2000, p.4).

The boom in the technological sectors, the so-called new economy including Telecommunication, Media and Information Technology (TMT) Sectors, has been of fundamental importance in the nineties. I will refer below to the significance of these sectors from the stock markets point of view. It is necessary to point out the effects of the evolution of technological share prices on consumption. The study of Edison and Slok (2001 a) <sup>(14)</sup> presents data of the main countries not only regarding the evolution of stock capitalisation compared to the Gross National Product, but also the trend of family shares in relation to available income; he also offers these separated data between traditional companies and those included in the New Economy (TMT); moreover, he presents not only the effects of the extremely fast growth of the

valuation of the latter market segment, but also the ones produced by the collapse of prices between March 2000 and March 2001.

The effect of the stock wealth evolution on the consumption of the different countries depends on the importance of the latter on the National Product, and on the weight of shares in the family balance. Data from the nineties, particularly in the period 1994-2001, include the already mentioned general guideline: in all countries, except for Japan, the significance of these two ratios has increased; the rhythm of growth has been higher in France and Germany than in the United Kingdom and the USA, although the final Balance corresponding to this period shows that, despite the reduction of distances, the differences between both groups of countries are still substantial and reflect, all in all, a different structure of financial systems, although some signs of convergence can be appreciated (pp. 6, 7).

Such guidelines can be observed even more intensely when considering the capitalisation of TMT companies in relation to the countries National Product. Between December 1994 and March 2000, the increase is remarkable with respect to the described standard; in the following year, the sharp correction is also general, and importantly, TMT companies register much higher figures in the United States and the United Kingdom than in Europe. The evolution in France deserves special mention, where a process of convergence higher than in the rest of the Continent is observed, in comparison to Anglo-Saxon countries.

The above-mentioned authors point out the higher impact on the consumption of price variations over the expenditure in shares of traditional companies in the United States and the United Kingdom compared with Continental European countries. However, similar behaviour is observed as regards to price alteration within TMT companies, and it is suggested that consumers consider the wealth variant from the ownership of technological shares as more volatile, and they do not include them in their consumption habits to the same extent (p. 16). The conclusion of the authors clarifies the transcendence reached by the stock markets:

"... the analysis suggests a strong link from equity markets to consumption in countries with widespread stocks ownership, large stock markets, and in countries where stock options are used as payment to employees "(p. 20).

In emerging countries, the growing importance of the stock markets also affects private consumption. According to the research carried out by Funke (2002, p. 1), in the short term, a 10 percent fall of shares in real terms is associated to a reduction in real consumption, around

0.1-0.3 percent on average in the 16 countries included. These effects have been intensified in the nineties with the growth of the stock markets.

#### ***4.1.2. Effects on Investment***

In a research published in 1990, Morck et. al. consider the relationship between the stock exchange and investment. The study compares empirically four theories intended to explain the link between both variables. The first theory rejects the prominence of the stock exchange as informer or inductor of the investment decisions of business directors, with the argument that the latter have better information. The second accepts a higher predominance of the stock markets, with the directors using the quotations as indicators to orientate them with regards to the future. The third theory, the most frequently used, establishes the connection by means of the cost of external funding of the companies. And finally, the fourth theory admits the influence of quotations on investment decisions, as the directors must please the shareholders; otherwise, there would be a higher possibility of a Takeover Bid with the dismissal of the passive directors (p. 158).

The investigation does not produce conclusive results, although the financial and predicting function of the market is rejected. However, it is warned that the stock market includes in its prices the available information but without effect on investment. In short, "The market may not be a complete sideshow, but nor is it very central"(Ibidem, p. 199).

The situation changes completely when the effects of the stock exchange evolution on investment in the nineties are considered. In the study carried out on this regard by Edison and Slok (2001 b), the relationship is analysed in detail, by countries, disintegrating the stock market into two components: the traditional stock exchange, which has undergone a remarkable growth in the nineties, and the companies included in the above-mentioned TMT group of companies, which indisputably played the leading role in the stock exchange boom.

The researched link is the decrease of capital cost, particularly in the companies devoted to Information Technology (IT) due to the spectacular growth of share prices. As a consequence, a considerable reduction of what could be called the "maturing period" has taken place so that the companies can acquire the sufficient dimension and have the necessary records to gain the investors' confidence. What can be observed in the recent technological revolution is that the companies react more rapidly to the market (Michelacci and Suárez, 2004, p. 476).

Throughout the decade, outstanding growth in the issue of new shares took place in the United States, as well as in Europe, although not to the same extent as in the USA. The essential explanation of the difference lies in the orientation of the Anglo-Saxon financial systems towards the markets, while the weight of banking systems is higher in Europe.

At the same time, the advance of the technology sector has promoted changes in the financial sector itself. The requirements of these kinds of companies, banks and other financial institutions has promoted the need for information technology and precise networks of telecommunication infrastructures for globalisation. According to Revell (1997, pp. 64, 65), changes in finances were included by the changes in industry; therefore, the appearance of large banks between 1870 and 1920 was due to technological changes towards the intensity in production of large companies in the industry, which are strong capital consumers, with external funding needs. A similar phenomenon took place in the nineties, and the boom of TMT companies led to financial changes.

Changes undergone by industry are not the only ones leading to variations in finances. Effects are also produced in the inverse relationship, that is, changes in finances also have an influence on companies. Svaleryd and Vlachos (2005) have emphasised how the financial sector affects industrial specialisation and international competitiveness. On the other hand, Beck et. al. (2004) point out that the development of finances exerts an extremely positive effect in the industrial sectors in which small companies play an essential role. In conclusion, industrial progress affects the configuration of assets, markets and financial institutions; at the same time, financial sophistication produces changes in the sectorial structure of industry.

The conclusions of the study carried out by Edison and Slok highlight the strong influence of the growth of stock valuations on investments during the nineties, particularly in TMT companies where the occurrence is similar in Anglo-Saxon countries and in Continental Europe. According to the authors, the similar answers could be due to the fact that the structure of such sectors are similar and also due to Europe turning towards market financing. The situation is very different in traditional companies, in which there is a higher index of stock valuations over investments in Anglo-Saxon countries than in Europe, where it is negligible. The authors point out that this inflexibility could be due to the different legislation in Europe, the lower incidence of public offers, the higher influence of employees in business decisions and companies with a higher level of debt (p. 13). The authors' final message corroborates the economic importance attained by the stock exchanges and the higher prevalence in the business cycle:

"... monetary authorities should watch closely stock markets developments in order to identify how it affects the business cycle and subsequently inflationary pressures. The analysis also suggests that it is not sufficient to look at the broad indices but it is also necessary to look at individual segments of stock markets in order to identify if these segments have a tendency to initiate activity through IPOs or venture capitalists, which may enhance the link with the real sector "(p. 15).

Stock markets have gained importance in the nineties as a means to channelling savings into investment. The companies new share issues are all time highs, playing a decisive role in financing technological companies. Mass investments in the telecommunications sector and, particularly the boost given to the new companies of capital risk, would not have been possible without the markets that facilitated the financing and permitted the progress for the tremendous foreseen benefits. Another issue is that the expectations of the technological sectors are disproportionate and therefore, investments exceed, by far, the reasonable levels. Stock markets in the nineties performed the expected financing function, although in previous decades this was of much less importance.

#### ***4.1.3. International Transfer of Resources***

As aforementioned, towards the end of the eighties the distrust that had been generated as a consequence of the non-fulfilment by the financial service of the debts of emerging countries started to disappear. The new provision of resources would not be produced basically in terms of banking credits like in the past, but by using, to a large extent, financial assets, quoted in markets, that could be liquidated immediately, which implies the participation of thousands of investors, that is, a higher risk diversification. At the same time, the quotation level provides continuous information regarding the debtors' situation, which allows an estimation of the risk in each country and prevents an excessive accumulation of financial responsibilities, which could give rise to a traumatic situation for borrowers and lenders.

With this coordination, in the nineties there was an extremely important increase in the financing for emerging countries using assets quoted in the market. The new situation would be the consequence of the following four factors:

- 1) The financing needs of emerging countries, sometimes promoted, like in South-American countries, by the limited capacity of saving and tax collection; in others, like in South-Eastern Asia, the huge investment process surpassed the saving generation, although this was important.

- 2) The accumulation of financial resources in the institutional investors <sup>(15)</sup> with the growing prominence of pension funds, a key institution to which we will refer to below.
- 3) Reluctance towards public companies management, emphasised by the collapse of socialist countries, brought about by the privatisation process of big companies in all countries, either developed or emerging.
- 4) The new financial theory would stress the possibility of reducing the portfolio risk by means of diversification, including those of international nature, due to the limited correlation in the evolution of emerging and developed markets.

Towards the end of the eighties, a study by the World Institute for Development Economic Research (WIDER) disputed that developing countries should liberalise their financial systems with the purpose of attracting the substantial funds available from institutional investors, particularly from pension funds. In fact, some progress occurred in this direction, giving rise to a flow of resources that exceeded the most optimistic forecasts (Singh and Weisse, 1998, p. 607).

In this increase of financial flows, special importance is given to those materialised in the shares purchase. Tirole (2002) points out the reasons for their impetus:

"... the ideological shift to free markets and the privatizations in developing countries; the arrival of supporting infrastructure such as telecommunications and international standards on banking supervision and accounting; the regulatory changes that made it possible for the pensions funds, banks, mutual funds, and insurance companies of developed countries to invest abroad; the perception of new, high-yield investment opportunities in Emerging-Market economies; and the new expertise associated with the development of the Brady bond market" (pp. 3, 4).

The creation and development of stock exchanges has been closely linked to the privatisation processes. Perotti and Oijen (2001, p. 45) highlighted the fact that successful privatisations strengthen the property rights and the faith in the institutions, which improved the trust towards share investment. These effects have also been especially important in emerging countries with less-developed legal systems that promoted initiatives on this regard.

The review by Claesens (1995) reveals the trend of financial markets towards a higher integration, securitisation and liberalisation, which has promoted the flow of resources by

means of shares; the decrease of interest rates in the developed world has contributed in this direction, leading to the search of profitability opportunities in other countries.

The internationalisation process is seen in the highest percentage of foreign companies in the investment portfolios of the most-developed countries. In 1980, the 98% of share trends of North-American investors corresponded to national companies; in 1996, foreign companies made up 17% of North-American investors' portfolios; furthermore, either a foreign company or foreign investor was present in one out of each four transactions. (Tesar, 1999, pp. 235, 236).

## **4.2. The growth of institutional investment**

From the nineties, a substantial growth of assets managed by institutional investors can be appreciated. It is not a matter of new formulae, but of the boom of institutions with extensive history, which benefited from a legal and fiscal environment in order to progress. An essential characteristic of the institutional investment is its professional nature. This is nothing new either, but it is important to stress the outstanding growth of professional workers regarding financial analysis and portfolio management, whose basic duty is to offer the most favourable option between profitability and assumed risk to the non-specialised audience. The increase in the number of institutions, the sophisticated management methods, international vision and the implication of all the markets confer an exceptional importance to the formulae for decision-making and to the labour interests of this group.

The importance of institutional investment, especially pension funds, explains the concern for the decision criteria of portfolio managers, as this affects the allocation of resources and, therefore, productivity, economic growth and employment. In the United Kingdom, a country with a great institutional investment tradition, such a concern has been set in the line of research entrusted by the Treasury Department to Myners, who is carrying out successive reports since the year 2000 regarding the quality of pension fund management (Myners, 2004). However, this extremely interesting field is outside the objectives expounded in this document.

Institutional portfolios are designed according to the needs of those demanding these assets. The essential part is diversification in order to reduce risk and optimise the profitability expected according to the estimated risk. The weight of equity portfolios is significant; the preference for shares must be situated in an environment of decreasing interest rates, jointly with the optimism generated by the economic growth boosted by the technological sectors that are widely represented in stock exchanges. In the United States, where the above-mentioned trends are more intensely evident, the percentage of adult population owning shares, either directly or by

means of pension or investment funds, has risen from 40% in 1992 to 51.8% in 1998; within this increase, the highest growth relates to pension funds (Edison and Slok, 2001, p. 9).

Table no. 5 shows the trend towards a higher acceptance of shares by families and particularly, the outstanding progress of Investment institutions. If we take into consideration the growing influence of equities in them, we can conclude that the higher acceptance of risk by families is a generalised fact.

**Table no. 5. % of assets compared to total financial assets of the families**

	1970	1980	1990	1998
Anglo-Saxon Countries				
Deposits	31	38	30	21
Bonds	11	8	06	4
Shares	29	19	16	23
Investment Institutions	22	26	38	46
Europe and Japan				
Deposits	52	62	45	38
Bonds	9	10	12	9
Shares	15	8	15	19
Investment Institutions	11	11	19	25

Source: E.P. Davis and B. Steil (2001, p. 32)

Anglo-Saxon Countries: United States, United Kingdom and Canada.

Europe and Japan: France, Germany, Italy and Japan.

The research carried out by Freeman (2000, p. 17) analyses the importance of institutional investment in eight countries with developed financial systems, which confirms the general trend, although with interesting differences in the growing rhythm of institutional investment and the weight of shares in the portfolios of these countries. For the purpose of this research, it is interesting to highlight the following aspects:

- a) Regarding magnitude, the figures for the United States, and to a lower extent Japan, the United Kingdom and Canada, contrast with the small presence in the remaining countries: Germany, France, Italy and Spain <sup>(16)</sup>. The average percentage of pension funds resources compared to the GNP of the first group of countries was 74% in 1997, and only 5% in the second group.
- b) The weight of shares in the pension and investment fund portfolios varies substantially in the two groups of countries. In the first group, the average percentage of shares in the pension fund portfolios was 57.5%, in contrast with 9% in the second one.

- c) However, there is a rapprochement of the positions; the average growth rate of pension funds in the countries comprising the first group in the period 1997-2002 is estimated to be 12%, while the second group reaches 33%.
- d) There is also convergence in the percentage of portfolio shares, growing significantly until 2002 in the countries of the second group, an estimation of 22.5% for pension funds and 28.2% for investment funds. In contrast, the percentages for the first group are 58% and 54% respectively.

In short, institutional investment progresses in all countries, with pension funds being the key institution. Also, the progress of the relative importance of shares in the portfolios is general. And finally, a process of convergence is observed among the countries of both groups, as institutional investment will grow faster in those countries with financial systems that are traditionally formed around banking intermediation.

The explanatory reasons regarding the growth of institutional investment are as follows (Blommstein and Funke, 1998, pp. 15-17):

- The growth of life expectancy of the population, which means a greater need of funds accumulation, particularly for the section of population with a higher standard of living and financial culture.
- The progress in communications and information technology and in data processing has led to a reduction in costs and an extension in the range of services. The intense competition has promoted a dynamic process of financial innovation.
- As regards pension funds, a step forward has been taken concerning the method of defined contributions prevailing over defined pensions. The change in direction implies that the final amount depends on the success of investment management, within an unrestricted framework where it is possible to select the professionals responsible for portfolio composition and movement.

Given that pension funds have become the main participants of collective investment, I will summarize the circumstances contributing to the progress of this institution.

Collective investment institutions have progressed during the last four decades without pause, although the growth has increased in recent years; relative participation of the institutions and

their behaviour in the market have also changed. The first step was of investment funds as a formula so that families could access to diversification and professional management. The boost of the last years corresponds, however, to the pension funds, as they have been favoured by fiscal legislation, permitting tax deferral, and by the possibility of the individual being able to choose their own managers according to their needs, preferences and risk appreciation.

Aglietta (2000) has referred to the two philosophies inspiring the establishment of pension funds. The first, inspired by Bismarck, considers pensions as a deferred salary, as the counterpart of contributions made by the worker during his/her working life. The second, using Beveridge as a reference, includes a basically individual concept:

"Under both doctrines, society is responsible for the security of those rights and the social debt bears an intergenerational dimension of solidarity and risk. With the principle of pay-as-you-go, this dimension has the advantage of being transparent and guaranteed by the state. The risk is political and arises because the working population may eventually refuse to pay the cost of ensuring equality of income for retired people. Funded systems entail a financial risk which arises because financial markets may be unable to deliver the real income promised in the financial contract" (Ibidem, p. 157).

Therefore, the steering of retirement programmes towards private options pushes the responsibility of covering these needs onto the financial markets evolution, especially the stock markets. This is the reason why, those objecting to the privatisation of social security usually emphasise that retired people cannot accept the total assumption of the risk of a typical portfolio made up by fixed income and equities.

Although, if the flow of contributions to private pension funds and the orientation of pension fund investments towards shares have constituted a firm support to the increase of market quotes, the returns for pension funds in the excellent stock exchange situation in the nineties has, at the same time, influenced in the increase in business profits, due to the amount of contributions in the plans with defined profits being reduced. It is possible that this fact has contributed to an overvaluation of shares of those companies with this type of plans (Coronado and Sharpe, 2003, p. 323).

A higher presence of collective investment institutions exerts an influence in several directions. Firstly, promoting changes in legislation and in company regulation with the purpose of protecting the good end of investments; secondly, leading to an active presence of institutions in the management of companies; thirdly, increasing the possibilities of financing companies,

either apart from or jointly with the banking system; and finally, a sophisticated management requires the growth of asset liquidity, the banking entities playing an essential role in its provision. For these reasons, Blommestein (1998, p. 48) points out that "... a sound banking system is a sine qua non for the function of liquid capital markets with a dynamic institutional sector".

So, we can witness that the issue of liquidity presents new characteristics with the significance of institutional investment. Liquidity is not the only essential aspect for financial instruments and innovative markets to be operative, but also company management is altered in respect to traditional bases. Institutional investment expansion is a parallel process with the least importance of traditional control packages, usually controlled by banking agents. However, the new owners value liquidity to a much larger extent, which is essential in the case of investment funds in order to carry out settlement of shares, and necessary in any case to perform a flexible investment policy. At the same time, the greater significance of vigilance of affiliated companies determines the portfolio mobility. Therefore, a conflict arises between the active control of management in affiliates and portfolio management based on the liquidity of share positions (Coffee, 1991).

#### **4.3. Review of the functions assigned to the stock markets**

The growing importance of stock markets requires a greater familiarity with the risk associated to share ownership. In the Anglo-Saxon countries, where this contact with risk already existed, the progress of institutional investment and financial innovation has deepened and general financial culture has become more and more linked to risk assessment by means of sophisticated calculation and management methods.

This trend has also taken place in countries, either developed, like in Europe, or emerging, where share ownership was not usual in the financial balance of families; furthermore, such a trend has effectively influenced the design of financial systems of socialist countries. All in all, share ownership by families has made them more receptive to the understanding and acceptance of a financial culture focused on risk assessment (Haliassos and Hassapis, 2002).

In the case of Europe, the progress of financial markets and the relative fall of banking intermediation cause some questions that are difficult to answer precisely. Rajan and Zingales (2002) question whether the growing weight of financing by means of the markets is a consequence of the long stock exchange boom in the nineties or if it is due to more stable and deep reasons. The question is complex as the fall of relational financing of a banking nature is

produced simultaneously with the growth of financing importance by means of risk capital, which exactly emphasises the relational nature of financing. On the other hand, the development of this formula requires highly-developed stock markets that allow profit taking by liquidating investments.

As I stated previously, financing by means of share issue is hardly of importance except for the periods where there has been a strong boom in the stock exchanges and the sudden increase of new sectors, such as the technological in the nineties. However, other reasons explaining the current situation and assistance received by stock markets have become extraordinarily interesting. Rousseau and Wachtel (2000) point out the following four reasons: 1) stock markets constitute an exit to end business projects based on relationships, like those financed by means of risk capital; 2) allow the channelling of resources towards emerging countries; 3) make possible the conversion of short-term assets into longer-term ones; and 4) the assessment of company assets is an essential source of information and contributes to the efficiency of financing intermediation and the allocation of resources.

Now, the key function of stock markets is the emission of signals to orientate the investors and allow them to revise their positions: "... the problem of misallocation of resources due to the lack of price signals in the relationship-based system is more severe, because it lacks a self-activating mechanism to correct it" (Rajan y Zingales, 2000, p. 13). As Ball (1991, p. 25) has clearly stressed: "... many do not understand that the function of capital markets is to *price* of the resources *not to allocate them*".

Therefore, the issue of resource allocation is not considered the primary function of the stock markets. Levine (2003, p. 55) points out that the financial services rendered by markets differ from those provided by banking intermediaries. Stock exchanges play an important role in the transmission of risks and in the provision of liquidity and information; banks, on their part, focus their attention on long-term relational financing and are controlled by the directors.

According to Mayer (1994), the transfer of property is primarily the function of the stock markets; it is especially important in certain activities in which the investors' differences of opinion are appreciable for the assessment of expectations of new companies turning to the market, or in activities of a speculative nature such as hydrocarbon explorations or the pharmaceutical industry:

"... contrary to the traditional view described in the introduction, the primary function of UK-style stock-markets is neither the financing of firms nor the correction of

managerial failure. Instead, it is the creation of markets in property rights for firms that allow transfer of ownership to occur in relation to investor's views about the likely future value of control and the appropriate strategies of firms. What this style of ownership does not accommodate is the interest of more than one group of stakeholders, in particular creditors. This implies that UK stock-markets may be well designed for certain activities but not those where collaborative investments between a number of interested parties and large external finance are required"(Ibidem, pp. 191-192).

Rajan and Zingales (2002, p. 17) declare similar findings. According to these authors, the relational system tends to have comparative advantages in the financing of fixed assets in capital-intensive industries, but not in industries based on technological information. The first is more understandable; the second must be adapted to the varied and changing opinions of the market, which is very appropriate for activities whose perspectives are highly uncertain.

As I stated previously, stock exchanges are nowadays considered an essential institution to favour the growth of emerging countries. In the case of China, Shirai (2004) reviewed the compliance of the functions expected from the stock markets: 1) to finance company investments; 2) to control the company management to improve their results; and 3) to make the share prices orientate the investors. The wide functions assigned to the markets contrast with the limited achievements, even in an economy with such a tremendously fast growth as China, due to the instability of the legal system and to the limitations of information and judicial organisation. Despite these deficiencies, stock markets are contributing to the gathering of funds and to the diffusion of economic and financial information.

In the old socialist countries, the creation of stock exchanges for the orientation of the investors has been considered a crucial step. Apart from providing information and liquidity, stock exchanges must facilitate signs so that massive privatisations are carried out within a rationality framework. Again, in this case, it has been stressed that the large institutional difficulties have thwarted to a large extent the hopes pinned on the process: "Unfortunately secondary markets in transition economies have tended to date to be more like casinos than rational capital markets" (Mendelson, 1993, p. 915)

The growing importance of stock markets also becomes apparent in other fields. I do not mean to review all notable aspects, but I will just mention the company management control, the revitalisation of the stock exchange as a predictor and anticipator of the cycle, the significance of quote evolution in retirement plans, the stock exchange component of payment and reward of directors, and the tax effects derived from price fluctuation.

Regarding the monitoring function on companies, it is sometimes stated that an important shareholder is in a better situation to follow-up and control the management of professional directives than a numerous and atomised group of shareholders. According to other experts against this idea, the advantage of objectivity of opinions and stock market decisions are highlighted:

"The board of a company may be able to assess the manager's performance more accurately than the stock market. The problem is that this kind of subjective information is not readily translated into compensation decisions. It is difficult for a board to punish a chief executive officer (short of firing him) because directors also need to cooperate with management along a number of dimensions. Stock prices are uniquely suited for compensation purposes, not so much because they are accurate, but because they are objective, third-party assessments "(Holmström and Tirole, 1993, p. 707).

Objectivity and neutrality assigned to the markets maybe need some refining, due to the lack of moderation and sensitivity in detecting management and accounting problems noticed at the end of the nineties with the "new economy fever". On the other hand, the whole concept based on market atomisation has been altered, with the boom of institutional investment, which led to an increase in the intensity of shareholding. This necessarily affected the position that must be adopted by the institutional portfolios managed with professional criteria, becoming the most important shareholders.

In fact, as highlighted by Monks (2001, p. 84), until recently, the differentiation was noticeable between *direct investment* in companies, aimed at participating in management, and *portfolio investment*, aimed at obtaining the highest possible investment profit, but without the purpose of controlling or contributing to the management. The significance of the share positions of institutional investors and the difficulty of liquidation gave them stability and promoted an active position in the company management.

The average participation of Pension Funds in the 25 most important companies worldwide amounted to 15.3% in 1999 (Ibidem, p. 93). The growing importance of pension funds, as shareholders and lenders, has been considered by Drucker (1991, p. 106) as the most spectacular change of power in economic history; therefore, it is obvious that they assume a more active role not only in the control of company management, but also in significant financial transactions. Moreover, the possibility of sell could not be operating simply for reasons of

volume, and it could be mandatory to adopt a belligerent position <sup>(17)</sup>, which implies an essential modification in the role played so far by institutional investors.

The new situation has generated several researches ranging from the adaptation of institutional investors to perform the monitoring function, to the political and economic consequences of the new distribution of power resulting from the growing presence of institutional investors as shareholders, as well as the adaptation of the current methods of stock exchange negotiations <sup>(18)</sup>.

Regarding the characteristic of the stock exchange as a predictor, Levine and Zervos (1998, a, b) find a positive and significant relationship with stock market liquidity, considering, as a measure of it the relationship between trading volume in respect of stock exchange capitalisation and the size of the economy: "Stock market liquidity is a robust predictor of real per capita gross domestic product (GDP) growth, physical capital growth, and productivity growth..." (1998 a, p. 538).

On the topic of technological sectors, the evolution of the stock exchange appears in some studies to be linked to the development of the so-called productive cycle of investment in technology. According to this interpretation, the negative behaviour of quotations in the seventies would correspond to the mediocre evolution of investment and productivity, which is a consequence of the advance in more productive technology that would make the existing one obsolete. The next stage, that of the use of new discoveries, would lead to an increase in investment, employment and stock exchange quotes (Manuelli, 2000).

The study of Hobijn and Jovanovic (2001) also emphasizes the connection between the evolution of the stock exchange and the exploitation of new technologies by the companies. The sluggishness of stock markets in the seventies and the early eighties could be explained by the low investment in information technologies by the companies. As new companies enter the market and use the available technology, a recovery of investments and stock exchange prices occurs. In this same direction, Laitner and Stolyarov (2003) consider that the investment assimilation of the microprocessor is in the centre of the technological revolution, which reduced the market value of companies using previous technologies; the dissemination of new technologies will proceed jointly with a sharp upturn of productivity and stock exchange prices, as occurred in the nineties.

Thus, financial and real variables appear perfectly linked, including the correct advance of expectations by companies and shareholders. According to this model, what seems to be

difficult to explain is the fall of technological shares in the year 2000, which occurred while, at the same time, productivity continued to progress. Le Roy (2004, p. 792) explains this clearly:

"Of course, if accelerated productivity growth caused the price run-up in the 1990s, we are left without an explanation for the price collapse, given the productivity growth has been continuing at very high rates".

The evolution of the stock exchange affects retirement decisions. The predominance of pension funds with defined contributions, but with undetermined final amounts, depending on portfolio assessments, in which the weight of equities is growing, generates uncertainty and unpredictability. The research carried out by Friedberg and Owyang (2002) analyses the effects of the large fall of the stock exchange in the years 2000-2001 regarding the retirement delays. Calculations made by Gustman and Steinmeier (2002) reflect the labour significance of stock exchange fluctuations:

"... the analysis suggests a stock-market boom such as the one experienced in the late 1990's can raise retirement rates of individuals in the affected cohorts by around three percentage points per year in the years immediately following the boom, and that these effects persist for several years thereafter. A stock market collapse of comparable proportions would cause a roughly comparable reduction in retirement" (p. 29).

The stock exchange boom, the access of young companies to the market, especially in the technological sectors, has generalised the participation in the stock exchange capital gain as a form of payment to the directors. In the late nineties, these kinds of incentives had a growing importance in total remuneration, not only in the United States, but also in Europe (Edison and Slok, 2001, p. 9).

The change in the positions of directors, described by Dore (2000, p. 12) as business counterrevolution, occurred gradually, going from the Golden Age of managerial capitalism in the seventies, which, even in the United Kingdom and America, assumed an attitude of responsibility towards other company components (personnel, clients, suppliers), to the establishment of shareholder profit as an essential and even unique aim, as has been defended by economists as important as M. Friedman.

The trend of an increasing prominence of the shareholder's rights has assisted in the growth of institutional investment. On one part, the higher influence of institutions has facilitated the execution of takeovers, with a price of the shares estimated to be lower than the potential one;

on the other hand, concentrated ownership has put the companies' directors under pressure in favour of higher profitability (Lazonick and O'Sullivan, 2000, p. 16).

Corresponding to this change of focus, a growing part of the directors' salaries was being associated with the evolution of quotations, progressively considered the essential indicator of management success. The pressure induced by the discoverers of undervalued shares in respect to potential profits (raiders) and even by the institutional investors themselves, increasingly assuming tasks of vigilance and control, contributes towards setting the shareholder's money or the creation of value, as an essential reference. Accordingly, the share price is directly linked to the directors' wealth, which has promoted the share repurchase programmes by the companies, the incentives based on stock options, and the presentation of financial information prepared according to the parameters that the financial analysts assess to be the best, with the purpose of having an influence on quotations.

Pressure and encouragement to the directors were not limited to the presentation of financial statements, to the optimistic evolution of expectations, or to a favourable interpretation of the accounting regulations for their immediate interests, but this affected the company management itself. The directors of the companies added the same performance principles of the raiders to their performance, selling assets that encumber the results, cutting down on expenditure effectively, relocating the production centres, and contracting the services that would mean an improvement in total results outside the company. As stated by Kennedy (2000, p. X), the result of this action, especially in the second half of the nineties, was the improvement of business profits, the rise of share prices, and a notable growth in directors' salaries, related to the upward trend of quotations.

Therefore, the stock exchange appears as the key institution controlling the management of directives, and leads to the reorganisation of the companies with the purpose of improving the results, the price of shares and the directors' salaries themselves.

Finally, the significance of the stock markets has become evident in the tax sphere. The stock exchange boom in the nineties has contributed to the tax income (Poterba, 2000). Eschenbach and Schuknecht (2004) have studied the channels by which the change of assets' price affects tax collection. Tax income arising from the capital profits and from the collection of tax on consumption has special relevance, which is a variable affected by the wealth effect. On the contrary, the reduction of tax rates and the increase of tax exemptions have exerted an exceptional effect on the net business profits and, consequently, has been a primary driving force of the stock exchange rise in the last two decades (McGrattan and Prescott, 2004).

## 5. A NEW SCENARIO

In view of the above, capitalism has entered into a new stage where the significance of financial markets, the higher familiarity with risk and the growing importance of institutional investment within a global framework constitute the essential features. Some financial researchers have warned about the newness of the situation.

According to Rybczynski (1997, p. 5), the financial system in respect of the exercise and distribution of property rights, has gone through three different stages: 1) capitalism of proprietors, when ownership and management coincide; 2) managerial capitalism, when proprietors delegate the right to use the resources and to decide the distribution of cash flow to professional managers contracted for this purpose; and 3) institutional capitalism, when the proprietors delegate the powers to control the performance of the contracted managers to collective investment institutions, which gather and manage an important part of the community savings. Financial assets negotiated in markets prevail in the institutional capitalism stage:

"Financial markets enable non-financial firms and other organisations to raise cheaper external funds in the form of marketable securities and other financial instruments traded in financial markets. The securitised phase of the evolution of the financial system is linked to the transformation of managerial capitalism into institutional (or financial) capitalism" (Ibidem, p. 9).

As maintained by Minsky (1996, p. 368), capitalism is a dynamic system and takes different forms that could even coexist in time. In the case of the United States, the financial stages could be divided into: commercial capitalism; industrial capitalism and wildcat financing; financial capitalism and state financing; paternalistic, managerial, and welfare state capitalism; and money manager capitalism.

In the last stage, the current one, institutional investment is an essential characteristic, leaving its mark in company management:

"The pensions and mutual fund have made business management especially sensitive to the current stock market valuation of the firm. They are essential ingredient in accentuation of the predatory nature of current American capitalism" (Ibidem, p. 363).

There is a connection between the view and interests of financial capitalism of an institutional nature and those of business directors. Now, both groups agree that their salaries and futures depend on their successful stock market research. Business directors must try to not let short-term results dash the expectations of financial analysts, who contribute to the decisions of professional portfolio managers with their reports. The latter compete in an extremely demanding market and are constantly and continuously measuring the results of their management. As both groups are orientated to the short-term, they pressure for the quarterly results, are induce to advance profits and the application of accounting regulations concerning these objectives. Hence, the pressure on audit firms for a relaxed interpretation of accounting principles, a lower reliability of their reports and the spread of financial scandals based on the fraud of accounting statements.

The main point is that the financial community, that is, business directors, investment banks that advise, and managers of investment institutions agree in their interest in promoting share overvaluation. In heated periods, as in the spectacular rise of technological shares that collapsed in the year 2001, these effects were extremely pronounced.

The trend of boosting the overvaluation of assets by company directors has been noticed by researchers as distinguished as Jensen (2002) <sup>(19)</sup>:

"The origin of the crisis is what I call "costs derived from the overvaluation". The danger of maximizes value: "directors do not have any real opportunity to obtain the results that justify that valuation, safe by pure luck. It is like the heroin for the directors, as are happy until the delirium when the action raises because it gives them to be able, cheap access to capital, the opportunity to buy companies that are not overvalued.... Then the bad part comes: the market makes its projections, the directors cannot fulfil them and they are pushed to make decisions that in the long run destroy value" (p. 41).

On their part, investment banks:

"... have been willing and happy corroborators in maintaining investor optimism about technology stocks, as evidenced for example by the preponderance of buy recommendations and optimistic growth forecasts" (D'Avolio et. al. 2001, p. 26).

Regarding the analysts:

"In sum, analysts had strong incentives to demand high growth and steady and predictable earnings performance, both to justify sky-high valuations for the companies they followed and to avoid damage to their own reputations from missed predictions. In too many instances, too many executive teams and too many analysts engaged in the equivalent of liar's poker" (Fuller y Jensen, 2000, p. 42).

Regarding the managers of investment institutions, the pressure of reaching a good position in the ranking of returns obtained, also sets a short-term policy having in the market fluctuations its main source of information to adopt decisions: "If ever there was a principal-agent problem never likely to be resolved it is that between the ordinary joe prospective pensioner and the hot-shot pension fund manager trying desperately to beat the index" (Dore, 2000, p. 14).

I will insist on the same idea: as Kennedy (2000, p. 167) declared, the real conflict of interests is set out before the short-term concept of retired people and the management of pension fund portfolios, oriented to the short-term by the competitive pressure of the labour market of managers. The possible conflict of interests between investment managers and retired people has led some experts to advocate the abandonment of active portfolio management and substitute it by investment on indexed funds with lower management costs and a greater guarantee of results similar to stock exchange indexes (Lakonishok et al. 1992).

Within this line of opinion we must include those economists who recommend company directors not to take so much consideration of the Wall Street expectations that much and establish the managerial objectives emphasising on the long-term aspect (Fuller and Jensen, 2000, p. 46).

The predominance of stock markets sets out an essential point: the speed of economy adjustment, particularly when it is to adjust to considerable ruptures of a positive trend or to absorb the effects of a shock. Due to the nature of a relational system, such as the one based on banking intermediation, this calms the effects of the cycle, shares the effects of shocks in a broader period of time, and provides an institutionalised security network (deposit insurance, access to the central bank funds) to prevent situations of panic. The counterpart is a lower speed of adjustment and a longer maintenance of situations that should be eliminated, as they are a hindrance to economic development.

Adjustment is faster with financial markets, sometimes even without warning; the capacity to lessen the effects by means of public interventions is lower, not only for the market size, but also because there are no defined institutional manners. However, this does not mean that

economic and monetary authorities do not want to have anything to do with market evolution, especially in critical stages, but their performance is more punctual and discretionary.

Profound problems arise due to the different speeds of adjustment. The capacity to fit the intense variations in the valuation of assets depends on the flexibility of the whole economic system, and especially that of the labour market. All in all, this fitting capacity depends on the institutions, which are the consequence of the prevailing ideas existing in society regarding economic organisation guidelines. Thus, if the idea of convenience, or inevitability, to promote or accept a higher weight of financial markets is established, the speed of change in finances should be fit with the institutional adaptation, the flexibility of the rest of markets and the acceptance of the consequences by the community.

From a strictly economic point of view, the issue arising from the predominance of the markets is that adjustments are more intense although the investors are those who suffer them directly and in the first term; adjustments under the relational model are slower and they are withstood by the whole society to a larger extent, even under an intergenerational perspective. On the other hand, markets are more accessible to the financing of new entrepreneurs' initiatives, and relational finances imply the maintenance of businesspeople and consolidated groups to a larger extent <sup>(20)</sup>.

Times of change are given to paradox. We could say that the defence of banking intermediation is made by the economists who are more critical towards the effects of markets acting without compensating public interventions, like Stiglitz. Opinions on this matter used to be associated to Keynesian inspiration, which requires some clarifications. Firstly, as Keynes was a monetary and finance-oriented economist, it does not seem that he was very interested in the institutional aspects of finances, and particularly in the effects of banking intermediation. Secondly, the *General Theory* (1936) was developed in a convulsive financial world and the English economist warned of the distorting effects of stock markets, that he personally suffered while he was conceiving and drawing it up; this is why Miller refers to Keynes as the "patron saint" of bubble theorists (1991, p. 103).

However, in my opinion, the Keynesian mark emphasising the distortions of the stock markets, if it has been justified, should be related with the adjustment difficulties that Keynes noticed in the most-structured societies, like the English society, and that constituted the main reason of his rejection to return to the gold standard in 1925 on a pre-war parity. Keynes' ideas regarding accommodation difficulties of the economic agents before sudden changes in the financial

circumstances provide an appropriate field for thought, and connect perfectly with the ideas of his master, Marshall, whose motto was precisely "*Natura non facit saltum*".

## NOTES

1. These data originate from Dimson, Marsh and Staunton (2002). Table 2.1, p. 12.
2. Ibidem, p. 21.
3. The following remarks are based on their studies (2001, 2002 and 2003b).
4. These aspects are stated in more detail in Torrero 2004.
5. This book by Garber includes his main researches carried out in the nineties concerning this subject matter.
6. The study by Díaz-Alejandro, 1985, is extremely in depth and premonitory. This issue is expounded in more detail in Torrero (2002, pp. 437-440; 2003, pp. 119-130).
7. Some essential studies regarding this topic include those carried out by King and Levine (1993, a, b). The issue is expounded in more detail in Torrero (2002, pp. 435-437).
8. Keynes' ideas concerning stock markets are analysed in Torrero (1996, 1998a, 2000 and mainly 1998b).
9. See, for example, Stiglitz (1972).
10. The following brief reference has been drawn up based on La Porta et.al, 1996, 1997, 1998, 1999 (a), 1999 (b), 2002, 2003, 2004.
11. The research by Faccio et. al (2001) is included here.
12. *American Depository Receipt*. Titles representing foreign shares assessed in American stock exchanges.
13. The development of this “intellectual adventure” is followed up in detail in the research by Dunbar (2000).
14. The research by Edison and Slok (2001, a, b) extends the content of the study published by the World Monetary Fund (2001).
15. Pension Funds, investment Funds, Professional Patrimonial Administration, Insurance Companies and Banking Entities.
16. In the first group, the influence of financial markets, except in Japan, is higher; its presence in this group is clearly explained by the low importance of social security of a public character. In the second group, banking intermediation is essential.
17. They invalidate, in fact, the organisation model based on the *exit* instead of the *voice* option, according to the classic distinction made by Hirschman (1970). In this second instance, in the case of the *voice* option, those interested in companies that are not in accordance make their protest clear to those in management and negotiate to resolve the situation.
18. The studies carried out by Coffee (1991), Roe (2002), Romano (2002) and Monks and Minow (1995) are of importance.
19. A good example of the quality of analysis by the economist and of his discernment is the warning in 1989, when Japan was at its peak, concerning contradictions in the management of Japanese companies, which were highlighted during the long stagnation after the financial and housing bubble. See Jensen (1989). Regarding the analysis made by Jensen concerning the Japanese situation, see: Torrero (2003, pp. 88, 89, 184, 196).
20. The previous opinion is based on several readings, particularly those by Rajan and Zingales (2003,b).

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