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Capital Market Inflation and Privatisation in Capitalist and Post-Communist Economies

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Abstract: This paper examines the conditions under which privatisation has been associated with capital market inflation in early and contemporary capitalism. It is argued that this association with capital market inflation creates an unstable financial structure. The lack of private financial accumulation under Communism has constrained privatisation through capital markets. But the alternative privatisation through foreign direct investment has created a stronger financial structure, albeit creating an industrial structure that is more vulnerable to adverse international circumstances.

JEL Classification: G2, P34

Key words: capital markets, privatisation, Ponzi finance, pension funds

Pension Funds and Capital Market Inflation

Toporowski (1993a) and Toporowski (1994) sketches out a capital market inflation approach to the analysis of capital markets. The starting point of this analysis is the view that the value of capital market assets (i.e., long-term securities) is determined by the flow of funds into the capital market. This flow of funds may be equal to, or greater than, or less than the amount that companies and governments are seeking to raise in finance from the capital market. For the purposes of this introduction we may leave aside government financing: Although government bonds constitute the main

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business of actual capital markets, the *function* of these markets in economic theory and practice is concerned with the finance that they raise for companies, rather than governments.

If the inflow of funds into the capital market exactly matches the amount of finance which companies (and governments) wish to raise, then this situation corresponds to the neo-classical balance between saving and investment in the capital market. However, this balance in practice occurs, if at all, by coincidence rather than as an outcome of market mechanisms: There is no 'equilibrium' in real capital markets, and there is no guarantee that the financial inflow will fund the most productive ventures. If the inflow is less than the amount that companies (and governments) wish to raise, then the frustrated financing requirement will be satisfied elsewhere, usually from the banking system.

If the inflow exceeds the amount of finance that companies (and governments) wish to raise, then the excess inflow circulates around the market increasing stock prices until it is eventually taken out of the market by an additional financing demand from companies (or governments) or by an increase in the liquidity preference of investors. This capital market inflation alters the behaviour of investors and companies. An increase in the revenue of investors or renters from capital gains makes investors less concerned about the dividend or interest income that they receive from their stocks, and more concerned with following conventional speculative trends in order to maximise capital gains. Companies find that it is easier to increase profits through various forms of corporate restructuring, replacing debt with equity or common stock in take-overs, mergers and acquisitions, or buyouts, than through productive investment. The excess demand for securities leads to a bank disintermediation in which the banks' best borrowers (large companies and governments) issue securities rather than borrowing from banks. Capital market inflation therefore results in under-investment in fixed capital and a banking system dependent upon lending to unstable and poor quality borrowers.

In Toporowski (1998) it is argued that the capital markets in the industrialised countries have been seriously inflated by the systematic proliferation of funded pension schemes. Funded pension schemes collect up contributions from employers and workers and invest these contributions to provide pensions when the workers eventually retire. Funded schemes have been replacing the previous pay-as-you-go schemes in which current contributions are used to pay current pensions. The new schemes have large contributions in excess of their actual pension liabilities in their initial immature phase. Placing these pension fund surpluses in securities markets has inflated capital markets. However, the surpluses are in fact revenue foregone by the previous pay-as-you-go systems of pension finance (in which current employees directly pay for current pensions). The counterpart of these surpluses is therefore a deficit of the previous pay-as-you-go system, obliged to maintain pension

entitlements to pensioners under the old system, while deprived of contributions from current workers and their employers, now making their contributions to the new funded schemes. The obvious and first solution to this, until the 1980s, would have been to finance the pay-as-go deficit with government bonds sold to the new and immature pension funds.

In 1984, the Conservative Government in Britain pioneered an apparently new form of finance, with the sale to financial investors of shares in the previously nationalised British Telecom company. This was a huge success, especially when the managers of the sale gave individual private investors priority in the allocation of the new shares, causing institutional investors (primarily pension and insurance funds) to bid up the price of the new shares in the stock market in order to acquire their desired portfolio allocation. This issue of shares was followed by the privatisation of the main state industries in the UK. Since then, in Britain, the vast bulk of additional finance raised in the stock market (i.e., funds raised in addition to those used to replace debt) have been privatisation issues. This apparent success caught the imagination of those politicians, economists and financiers who regard the private sector of the post-war mixed economy as the most dynamic element of the economy, and who consider that its lack of vigour since the 1960s has been due to the financial burden of a public sector bloated by its industrial undertakings. The fall of Communism in Eastern Europe and the financial problems of developing countries have all been held up as a clear vindication of this view. The multilateral agencies responsible for co-ordinating economic policies in various countries, the International Monetary Fund, the International Bank for Reconstruction and Development (the World Bank), the European Bank for Reconstruction and Development, and the Organisation for Economic Co-operation and Development, have all adopted privatisation as a key feature of their recommendations for 'sound' economic policies (See World Bank [1989]). It forms a crucial part of the 'structural adjustment' which the IMF and the World Bank enforce on countries to which they lend.

Ponzi Finance and Privatisation

privatisation has generated a whole literature on industrial competition and pricing, based largely on the presumed benefits of *laissez-faire* and the efficacy of price controls. In the latter respect, this literature stands out in sharp, if not obvious, contrast with the treatment of price controls under Communism. However, these arguments are beyond the scope of a book concerning with financing structures. In this paper privatisation is examined as a 'financial circuit' giving rise to a very particular Ponzi structure of financial claims and liabilities. Ponzi financing is a term

invented by the American economist Hyman P. Minsky to describe a system of financing in which current liabilities are met by increasing future financial obligations (Minsky [1975], Minsky [1978]). The most obvious recent examples of Ponzi finance have been the pyramid banking schemes which have occurred in Albania and Rumania in the 1990s, where deposits were used to pay inflated returns to earlier depositors.

We may start off with the simple observation that when a government issues a bond to finance its activities, the bond is a future financial liability for the government, against which it has the funds raised by the bond. When a government sells a state enterprise into the private sector by issuing shares on the stock market, the financial effect is exactly the same as issuing bonds with one exceptional feature. Funds are raised for the government, but the shares or stocks sold are a future financial liability of the company privatised rather than of the government. In this way the financial manoeuvre is performed of generating funds for the government by stock issues which are claims not against the government but against commercial companies. The view of privatisation as a 'zero-cost' transfer of government liabilities to the private sector is given in Andrade (1998).

This system of privatisation is a form of Ponzi finance because it depends on the willingness of investors to purchase claims against private companies with money that is not used to increase the future revenue-generating capabilities of the companies concerned, but is used to finance government expenditure. In a situation of capital market inflation through pension fund surpluses, it is not difficult to find investors willing to buy such stocks. The difficulty with this kind of finance is that, like Ponzi financing schemes in general, it can only have a temporary success in obtaining finance. When a government runs out of apparently profitable companies to sell, it can no longer raise finance in this way. Hence the financial embarrassment of the Labour Government in Britain which, having embraced privatisation, came to power in May 1997 after the profitable state companies had been sold. The government of the US has experienced a different kind of financial embarrassment, due to the paucity in that country of state enterprises capable of being sold to private investors. In post-Communist Eastern Europe, with huge state industries, the problem has been a shortage of willing investors capable of giving money to the Government in exchange for state enterprises, and then putting *additional* money into the enterprise to finance their re-equipment in order to be able to obtain the revenue to pay the obligations entered into under privatisation (see Toporowski 1997).

The amount of finance which a government can raise in this way is therefore constrained by the number of commercial enterprises at the government's disposal, and the flow of funds into the capital market i.e., the degree of capital market inflation. In a situation of capital market inflation, the actual or potential profitability of the companies concerned becomes a lesser consideration as the capital gain (the

increase in the value of the stock) constitutes a larger, or even the bulk of the return on investing in the privatisation stocks. Nevertheless, the actual profitability of the companies concerned may be affected by the way in which privatisation influences government expenditure.

The connection between government expenditure and the profits earned by companies is given by the flow of funds identity. According to this, the net inflow of funds into the industrial and commercial sector of an economy (i.e., its financial accumulation, or gross profits) in a given period is equal to that sector's gross fixed capital investment, plus the government's fiscal deficit (its expenditure minus its revenue), plus the trade surplus of the economy (exports minus imports). (Strictly speaking to this should be added capitalists' consumption, and saving out of wages should be deducted - See Toporowski [1993b] and Kalecki [1971]). The transfer of the ownership of state companies to private ownership does not, by that act, increase investment or the trade surplus. However, it does put more money at the disposal of the government. The proceeds of privatisation may be used either to reduce the government's borrowing, or they may be used to allow increased expenditure. If privatisation is solely used to reduce the government's borrowing, so that the balance between expenditure and revenue remains exactly as it would have been without the privatisation, then that privatisation has no effect on the inflow of funds into, or the profits of, the corporate sector. All that happens is that the new stock of the company appears in the capital market to replace the government bonds that would otherwise have been issued to finance the fiscal deficit. Such privatisation merely transforms government liabilities into corporate liabilities without actually putting any money into the companies that have been privatised. With unchanged profits and a higher stock market capitalisation, the earnings per share of listed companies on average will fall.

If however the proceeds of privatisation are used to increase government expenditure, above what it would otherwise have been, then this will appear as an increase in the fiscal deficit without any increase in government borrowing. The larger fiscal deficit will result in a greater financial inflow or higher gross profits in the corporate sector, as savings are mobilised and circulated through the real economy. It should be noted that the commercial corporate sector has been increased in size by the transfer of the formerly government companies to the private sector. The liabilities to the capital market of the commercial corporate sector have also been increased by the issue of the new privatisation stocks (modern equity shares or common stocks may be treated as liabilities of the companies issuing them). To service the additional liabilities with dividend payments, and avoid the running down of reserves, higher corporate profits are necessary in proportion to the increase in liabilities. This argument suggests that, in absence of an increase in corporate fixed capital investment or in the trade surplus, an effective way to increase those profits is

to increase government expenditure without raising additional revenue. Indeed, it could be argued that it is the least that the government can do for having saddled the corporate sector with the liabilities for its expenditure, while denying the privatised companies the proceeds of their issue of privatisation stocks in the capital market.

John Law's Privatisation

The political and financial promoters of privatisation in Britain were quick to claim the credit for pioneering what they have regarded as an entirely new method of raising government finance and rolling back the frontiers of state involvement in industry. However, this policy is not new and the emphasis on its novelty is a way of concealing the financial consequences of earlier privatisation. In 1717, the Scottish adventurer and economist John Law was given permission by the Duc d'Orleans, the Regent of France during the minority of Louis XV, to establish the Company of the West (Compagnie d'Occident). The company was given extensive trade monopolies in the French colony of Louisiana, which covered an area of the present-day United States much greater than the present Louisiana. Following a series of take-overs, a large holding company commonly known as the Mississippi Company was established. In the autumn of 1719, the company was given additional rights to issue shares. The money raised from the new issues was used to repay French government bonds and pay government annuities, a financial burden bequeathed to the French State by the magnificence of the Sun King Louis XIV. In return, the holding company was given extensive trading monopolies, minting rights and tax farms from Senegal to Louisiana. This 'privatisation' was therefore of the first type described above, i.e., it involved replacing debt by the obligations of the new company, without increasing government expenditure.

The success of the Mississippi Company invited emulation, even in the country which was to pioneer capital markets, England. The South Sea Company, which had been formed in 1711 to exploit trading monopolies in the South Seas, granted by the Crown, started to issue shares. In 1720, following the huge and apparent success of the Mississippi Company in relieving the debts and financial obligations of the French government, the South Sea Company was allowed to take over the major share of the British national debt. As in France, the possibilities for managing government debts bloated by the expensive War of Spanish Succession from 1702 to 1713, gave the company an influence out of all proportion to its actual trading prospects. The Bank of England, which had been established in 1694 to manage the Government's debt, gave important support and an aura of respectability which common stock promoters lack. Writing at the time of subsequent scandals associated with the East India Company, Adam Smith took a characteristically dim view of the

flotation of joint stock companies for foreign trade, like the Mississippi and South Sea Companies: They 'have seldom succeeded without an exclusive privilege; and frequently have not succeeded with one. Without an exclusive privilege, they have commonly mismanaged the trade. With an exclusive privilege, they have both mismanaged and confined it.' (Smith [1904], vol.II, pp. 373-374). Smith may therefore have taken a very different view of privatisation to that of his latter-day acolytes.

Both the Mississippi Company and the South Sea Company pioneered a prototype of privatisation in France and Britain. They collapsed in 1720, not because of that aspect of their activities, but because they became in effect pyramid banking operations, with new finance being raised to buy in stock and keep up its price. (Details of these exciting financial innovations are given in Murphy [1997]). Had the proceeds of selling government stocks to these companies been used for additional expenditure, creating business and profits for French and British companies, the Companies may perhaps have obtained some increase in profits which may have enabled them to support a more modest stock issue. But insofar as financial success breeds excess, such a policy may merely have encouraged an even greater stock issue and an even more calamitous subsequent collapse.

The fact that these Companies promoted a form of privatisation does not of course mean that the privatised companies of the 1990s are similar Ponzi structures. Similar tactics have also been used in the two privatisation periods to create a second class of investors willing to pay a premium to the first buyers of new stock, by limiting entitlements to the stock on issue. The premium paid to the first owners of stock attracts more demand, even though the premium is only temporary until those excluded from the first stock allocation have secured their desired shares. Law did this at the height of the Mississippi Company mania by limiting new share issues to existing stockholders: What would nowadays be called a Rights Issue, while making sure that plenty of credit for buying the stock was available from his Banque Royale (Murphy 1997, pp. 190-193). In the privatisation's of the 1980s and 1990s, individual investors have been given preferential initial share allocations, forcing large and liquid investing institutions to bid up the price when the secondary markets in the new stocks opened. Arguably the latter have been far more careful in their issue of stock. Although Ponzi elements are present in all financial inflations, each of these inflations is different. The change of economic circumstances and financial innovation alter the form of financing arrangements as well as justifying that sanguine optimism which is the precondition for capital market inflation and the successful construction of fragile financial structures. The essential difference between today's privatisation and those of the Mississippi and South Sea Companies is that Ponzi structures were developed in those companies themselves, using the finance raised from stock issues to buy in stock to keep up its price. In the

industrialised countries, at the end of the twentieth century, the Ponzi structure lies not in the privatised companies but in the pension funds that dominate the capital markets and have effectively bought the privatised companies. They are using the finance raised from pension contributions to buy in stock, thereby driving up its price to levels which cannot be sustained. When pension funds' pension payments exceed the inflow of their contributions the inflow of funds into the capital market ceases and may even be reversed, causing prices to fall. In both cases, capital market inflation has been the financial precondition for privatisation.

Post-Communist privatisation

In the Post-Communist economies the conditions for privatisation differ considerably from the 'showcase' conditions obtaining in the United Kingdom, Western Europe, or even a semi-industrialised country like Chile, where privatisation gives all the appearance of a successful industrial and financial policy. The Communist countries experienced an industrialisation drive in which the private sector was, for the most part, obliterated. Communist governments tried to limit income differentials, and limit private holdings of wealth to those supporting personal consumption, artisan, craft and agricultural production, and smaller retail trade outlets. This meant that as industry developed there was no corresponding accumulation of financial wealth in private hands.

The Communist restrictions on the private accumulation of financial wealth has financial consequences lasting far beyond the fall of Communism and sanguine attempts to construct capitalism overnight by even the most radical forms of shock therapy. Among these consequences is the relatively small proportion of new companies with substantial holdings of financial wealth unencumbered by liabilities to the banking and financial sector. Such unencumbered financial wealth, or internal finance, is important because it allows companies to engage in investment with minimal financial risk. The high proportion of external finance means that companies are much more dependent upon good cash flow, to service their liabilities. In the economic and financial instability that has followed the fall of Communism, this 'liquidity hunger' gives rise to excessive borrowing and resort to criminal activities (the so-called 'mafia capitalism'). Needless to say, these have exacerbated the financial instability of the Post-Communist countries.

Limited private financial accumulation is also a basic obstacle to privatisation, a crucial reform if the 'transition' from communism to capitalism is to be successfully achieved. Whereas privatisation has been achieved in Western Europe thanks to the inflation of Western European capital markets by immature pension funds, the embryonic stock markets of Eastern Europe can only be inflated by inflows of funds

from abroad, or from the banking system against liabilities to banks. The Western European option of using pension funds to inflate the markets is not feasible because, by and large, established pension funds in Eastern Europe have at best minimal investible surpluses, while new, immature pension funds are constrained by the relatively small proportion of the labour force in Eastern Europe that is in stable, remunerative employment. Hence the propensity of Eastern European stock markets to inflate using borrowed money. As the Japanese banks have found since 1991, this is the most risky way of speculating, because it threatens insolvency as soon stock prices cease to rise more rapidly than the rate of interest charged on borrowing. Hence, the data on Eastern European markets shown in table 1 shows them as largely undeveloped, even if the largest of them, in Prague, Warsaw and Budapest, have been expanding rapidly.

Table 1: The stock markets of eastern Europe

	1991	1992	1993	1994	1995	1996
Prague						
Listed Companies (Numbered)	-	-	-	1025	1635	1588
Market Capitalisation (Million US$)	-	-	-	5938	15664	18077
Warsaw						
Listed Companies	9	16	22	44	65	83
Market Capitalisation (Million US$)	144	222	2706	3057	4564	8390
Russian Trading System						
Listed Companies (Number)	43*	54*	90*	145*	170*	73
Market Capitalisation (Million US$)	244*	218*	18*	151*	30000*	37230
Budapest						
Listed Companies (Number)	21	23	28	40	42	45
Market Capitalisation (Million US$)	505	562	812	1604	2399	5273
Vilnius						
Listed Companies (Number)	-	-	-	13	351	460
Market Capitalisation (Million US$)	-	-	-	4	157	900
Bratislava						

Listed Companies (Number)	-	-	-	18	18	816
Market Capitalisation (Million US$)	-	-	-	1093	1235	2182
Ljubljana						
Listed Companies (Number)	-	-	16	25	17	21
Market Capitalisation (Million US$)	-	-	n. a.	595	515	663
Zagreb						
Listed Companies (Number)	-	-	-	29	61	n. a.
Market Capitalisation (Million US$)	-	-	-	514	581	n. a.
Bucharest						
Listed Companies (Number)	-	-	-	-	7	17
Market Capitalisation (Million US$)	-	-	-	-	100	61

* Estimate. n.a. Not available
Source: Collated from International Finance Corporation Emerging Stock Markets Factbook 1997, Washington, D.C.

A second peculiarity of Post-Communist privatisation is the run-down condition of the state industries that are being privatised. A common feature of all the Communist countries in the decade of the 1980s was that their governments felt the need to satisfy rising consumer demand, in order to fend off domestic discontent and ideological competition from apparently more successful capitalist countries abroad. A number of Communist governments (notably Poland, Hungary, and former Yugoslavia) were also under pressure to service large foreign debt commitments. The practical way of addressing both difficulties was to reduce the share of investment in national income. The under-invested condition of Post-Communist state enterprises contrasts sharply with the relatively good state of productive capacity in the state enterprises privatised in Western Europe. Except for smaller retail outlets which were rapidly privatised at the end of the 1980s, and the beginning of the 1990s, the privatisation process in Eastern Europe has been complicated by the need for the new owners of the state companies to invest often twice as much and more than was paid for the companies, in order to renew their equipment. This has acted as a deterrent to privatisation, and has ruled out 'give-away' privatisation, by share distributions to all the population for example, as a means of giving the state companies a new life in the private sector. Needless to say, adequate privatisation

and re-equipment finance has not been available from the shallow and speculative stock markets of Eastern Europe. Instead Post-Communist governments have turned to the private sector in the advanced capitalist countries to help them out of their privatisation dilemma.

In the Post-Communist countries, the sale of state companies to foreign companies has largely by-passed local stock markets. On occasion minority holdings in privatised companies have been floated on the stock market. But, with the exception of companies in key sectors such as the Russian extractive industries, there has been a preference in all countries to sell majority ownership to foreign companies which are in a position to modernise the former state companies' productive assets. This has not just by-passed the local stock market, but has also generated very limited revenue for the government. In many cases governments were obliged to sell enterprises for nominal amounts, and often with tax advantages and subsidies far outweighing the proceeds of enterprise sale. In Poland in 1991, for example, privatisation generated only 0.8 per cent of total government revenue. By 1996, this had risen to a mere 3.8 per cent (Rocznik Statystyczny, 1997, p. 474). Virtually no additional government expenditure has therefore been financed by privatisation revenues, because very little net revenue has been obtained.

Another reason why very small financial inflows were generated by the sale of state enterprises to foreign companies is because very little of the subsequent modernisation of those enterprises used locally produced and purchased plant and equipment. Modernisation has mainly occurred through the transfer of surplus equipment from factories abroad with excess capacity, to Post-Communist countries where demand for better quality manufactured goods has boomed in the wake of the initial recession and of the widening distribution of income after the fall of Communism. It satisfied a foreign industrial rationale, rather than merely providing a profitable opportunity in the host country. Hence German, Italian, Korean and Japanese car companies with unused capacity serving their traditional markets in Western Europe and North America have taken over Eastern European car companies, notably in Poland, the Czech Republic and Hungary, in order to be able to re-equip them with surplus equipment from their productive bases at home. By contrast, computer hardware companies, facing buoyant demand in their markets, have been much slower in buying into Eastern Europe.

In the capital account data, the transfer of equipment into Eastern Europe appears as foreign direct investment. As Table 2 shows, this has increased rapidly. By contrast, the net inflow of portfolio investment into Eastern Europe has been much smaller than net foreign direct investment. While it rose initially, it has subsequently fallen off as the financial crises of Mexico and East Asia raised questions about the stability of emerging markets in general.

Table 2: Capital flows to countries in transition (billions US$)

	1991	1992	1993	1994	1995	1996
Net Private Capital Flows	-1.4	7.4	10.8	17.0	28.7	26.1
of which:						
Net Direct Investment	2.4	4.2	6.0	5.4	13.0	12.4
Net Portfolio Investment	0.8	-0.8	3.6	2.9	3.7	2.1
Net Official Flows	1.7	-0.1	3.0	-11.0	8.5	-9.1
Change in Reserves*	0.4	-0.6	-12.7	-8.0	-34.5	2.9

* Minus sign indicates an increase in reserves.
Source: International Monetary Fund, *World Economic Outlook 1997,* Washington, D.C.

Conclusion

It has been argued that the privatisation process in the Post-Communist countries has been severely constrained by the absence of a longer process of private financial accumulation preceding the transfer of state enterprises to the private sector. This has obliged privatising governments to sell their enterprises directly to foreign companies from more advanced capitalist countries. Limited capital market intermediation means that the Ponzi financing element in Post-Communist privatisation's is smaller. However, privatisation through inward Foreign Direct Investment has raised little revenue for governments. Such privatisation has also been constrained by the geographic and industrial distribution of unused capacity, with those companies experiencing the greatest excess capacity in the more advanced capitalist economies being the most keen to use privatisation as a vehicle for transferring their surplus equipment to more buoyant markets. This form of privatisation has also made industry in the Post-Communist more vulnerable to developments in those more advanced capitalist economies, in the same way that foreign direct investment in Eastern Europe during the 1920s made that region experience much more acutely the world-wide recession that followed the 1929 Crash.

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