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Making the City work

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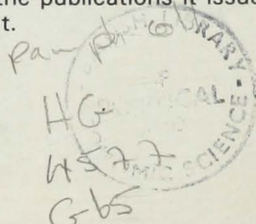

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Introduction

In the late 1980s, the once arcane business of the City of London has swept into the public domain. First, Big Bang in October 1986 blew away the restrictive practices of the London Stock Exchange. Then spiralling City salaries, a wave of giant takeovers and complaints from British industry about 'short-termism' turned the spotlight on one square mile of central London. The scandals of Guinness and insider trading drew the workings of financial markets from their ghettoes on the City pages into the news headlines. Even the *Sun* responded to the surge in private share ownership by creating a City section. The stockmarket crash in October 1987 failed to still popular interest in the City.

These new editorial priorities cannot be dismissed as propaganda for the Casino Society, since they also reflect the growing importance of the financial services industry. The City houses a host of markets and institutions. Some are familiar and domestic: the insurance industry and the clearing banks. Some are little known and international: the Euromarkets, the futures markets and the currency markets. Others have been trying to transform themselves from sleepy cartels into modern international markets: the stockmarket and the commodity markets. The City's many markets not only influence the rest of the economy, they also constitute an important industry in their own right.

Britain has possessed a sophisticated financial industry for hundreds of years. But over the last 15 years, financial services has become Britain's fastest growing industry, employing about 800,000 people and earning £9 billion a year for the overseas current account. When the common market in financial services is ushered in by the European Community in 1992, further growth can be expected as British firms exploit their competitive advantages.

Yet despite this apparent success story, people outside the City—many of them not on the left—frequently criticise its role in the British economy. Most of these critics accept the need for properly-regulated markets in other industries, yet eagerly join in ritual denunciations of wheeler-dealing City gents and sometimes threaten crude interventionism. However, the nationalisation of the banks or the closure of the Euromarkets would entail heavy political and economic costs without resolving the real problems of the financial system.

Often these criticisms are based more on prejudice than fact. For example, investment in the British stockmarket is supposed not to benefit industry, while investment in overseas stockmarkets is seen as direct support for our industrial competitors. And the accusation that the City conspires to promote high interest rates and a strong pound, at the expense of industry, no longer stands up. Nor can the argument that the City fails to provide enough capital to industry be sustained.

However, there are causes for great concern about the City, its relationship with the economy, and its role in Britain's political agenda. This pamphlet touches on some of them.

Public interest

The City's investment institutions should come under closer scrutiny not only because of their influence on

industry, but also because they control the public's savings. Many politicians still view capital and labour as diametrically opposed forces. But these two categories now often converge on the same individuals, thanks to the growth of collective savings vehicles which now own three quarters of British shares. Most of the money tied up in pension funds and insurance companies is the savings of lower and middle-income groups. The ownership of the means of production has never been more widely spread over the population, yet control has become narrowly concentrated in institutional hands.

Parts of the British financial system have long been bloated. The invasion of foreign firms around the time of Big Bang provided an extra bubble of wealth, which the crash popped. A more fundamental and permanent cause of the City's wealth has been the systematic over-pricing, over decades, of many financial products aimed at consumers and companies. The City's own beloved market theories should be turned against it to root out the waste. The competition-enhancing reforms of Big Bang should be extended into the remaining cartelised corners of the old City, such as the fixed fees for merchant banks underwriting new share issues.

To keep themselves in work, swarms of money managers, brokers, analysts and traders juggle and rejuggle the portfolios of pension funds, insurance companies and unit trusts. This 'churning' is wasteful, since most money managers underperform the market and they pass on their dealing costs, ultimately, to savers. Churning also makes the markets more volatile, and it can discourage institutions from making a long-term commitment to companies.

One reason the City has grown so fat is that financial services are notoriously difficult to value. Just as ordinary individuals have been easily bamboozled into buying expensive life assurance policies without noticing the large commissions they have to pay, so—even after Big Bang—finance directors continue to pay too much, for example for takeover advice or for products designed to reduce risk such as futures and options. The answer is more competition coupled with better regulation; they are not mutually exclusive.

Financial consumerism is not of interest only to the rich. Many financially inexperienced people from middle and lower-income groups are receiving comparatively large sums to invest, from redundancy packages, maturing life insurance policies or the sale of inherited parents' homes. Their interest in new ways of saving extends beyond collective vehicles—to shares (about nine million people own them), to portable pensions, and to a variety of interest-bearing bank accounts. They must be protected from the countless abuses of consumer finance—from the overpricing of unit trusts, to the murky and secretive charges levied by the high street banks, to the scandalous rates of interest charged by credit card companies.

Political debate

Over the past few years, as competitive international markets have become its driving force, the City has shed much of its school-tie clubbiness. Once, peer-pressure made financiers play the game. Now, in much larger, impersonal firms where people do not know each other, the new regulatory framework established by the Financial Services Act is supposed to impose discipline. The important debate about the changing nature of the financial industry and its regulation has been subject to little discussion outside the City. Yet given the importance of investment to the economy, not to mention the huge expansion of personal savings, developments in the City should not be left to insiders.

Much dislike of the City stems from an excessive respect for the supposedly uncontrollable power of financial markets. The trends to deregulation and internationalisation have certainly weakened the ability of any government to

resist this power. But one which understands financial markets, does not preach inflationary policies and is prepared to stick to its guns need not be mesmerised—as the Chancellor of the Exchequer, Nigel Lawson, has shown. The problem for a Labour government is that if it tried to stand up to markets or to confront City opinion, its credibility would be weakened by a dearth of serious policy.

What is needed are practical proposals to reform the City's many shortcomings. But critics must stop tilting at a largely imaginary City and accept its economic importance. The Labour Party could establish a credibility-enhancing role for itself as a well-informed watchdog for this vital industry. Its failure to take many of these issues seriously, while millions of voters have been expressing more than a passing interest in financial markets, has contributed to the overall feeling that Labour is out of touch.

1. Why financial markets are useful

Many believe the City wicked and parasitical: wealth created through finance is supposed not to be real wealth. The truth, however, is that a pound earned through selling someone a service such as an insurance policy is just as real as one earned by selling that person a car. A successful economy needs banks to finance investment and institutions to manage savings just as much as it needs, say, hairdressers and telephone sterilisers.

Capital markets serve a number of useful purposes. They widen choice for people wishing to save, by allowing them to diversify and to switch their investments. They provide companies with cheaper sources of finance than bank loans. Even new markets such as futures and options can be beneficial, provided they are properly understood and controlled: they enable companies and investors to insure themelves against foreign exchange, interest rate and stockmarket volatility.

Stockmarkets provide a means of evaluating the worth—and the performance—of companies. There is probably no better means—the October 1987 crash and crazy lurches in the market notwithstanding. For the price of one company relative to another is a good indicator of its performance, whatever the absolute level of the stockmarket. A falling share price relative to the rest of the market is usually an indication that something is wrong and that managers should perform better.

In Britain and America, a weak share price may trigger a takeover. In Japan and Continental Europe (of which more later), the stockmarket plays a smaller role and the banks a larger role in checking management performance. Nevertheless in these countries too, the stockmarket remains a means of evaluating the relative success of companies. In communist states, bureaucrats fulfill this checking function. They are less well placed than stockmarkets to do so. For share prices effectively

gather, process and reflect much more information relevant to a company's prospects than a group of bureaucrats can ever hope to do.

Stockmarkets can often provide a good—though not an infallible—means of allocating capital.

New capital comes either in the form of debt (bank loans or bonds), on which the borrower pays a rate of interest, and which must be repaid after a certain number of years; or in the form of equity (shares). An investor with equity in a company has a share in its ownership; receiving dividends but never being paid back.

Companies can tap stockmarkets by selling shares either when they float themselves on an exchange (a new issue), or when they return to the market at a later stage for more capital (a rights issue). In 1987 companies raised £14.5 billion on the London stock exchange. Institutions put money into companies whose relatively high share price reflects the collective wisdom of the market that that company is likely to prosper. Unimpressive companies find it hard or impossible to issue shares on the stockmarket.

A big problem with stockmarkets is that share prices can be subject to fads and fashions. But short-term fluctuations do not affect most of us. The pension funds and insurance companies which invest some of our savings in shares are not seriously harmed by the stockmarket yoyoing. What matters for the value of our savings is how the market moves over decades. Over that timespan, today's 5 per cent rise and yesterday's 5 per cent fall are irrelevant. In the long term, fundamental values assert themselves over speculative bubbles.

The crash of October 1987 was a correction to a speculative over-valuation of the market. We should not be overconcerned about stockmarket crashes. In neither Britain nor America has the October crash made a significant impact on the real economy.

Nevertheless, price gyrations may harm the small investor and damage business confidence. The Government could consider using a state body to intervene on the stockmarket to smooth out some speculative excesses. The Bank of England already does that on the foreign exchange markets, and effectively underpinned the whole equity market after the October crash, when it guaranteed that it would buy shares from the BP privatisation issue at a set price. In Japan, the Ministry of Finance asks the big four securities houses to intervene when it wants to brake a fall. In France, the Caisse des Dépots (a state-owned bank and manager of government funds) has at times supported the stockmarket. The British Government does not possess the resources to stop the market falling if fundamentals are pushing it down; but there might be occasions when it would want to iron out fluctuations and give the speculators a bloody nose.

Efficient markets

The economist Burton Malkiel recently reviewed the huge body of academic literature on whether stockmarkets are efficient—ie, whether prices accurately reflect all available information. He concluded: "Pricing irregularities may well exist and even persist for periods of time, and markets can at times be dominated by fads and fashions. Eventually, however, any excesses in market valuations will be corrected".

This 'efficient market theory' predicts not only that stockmarkets are efficient, but also that they follow a 'random walk' pattern. That is, no individual can ever succeed in predicting the way the market is going to move, because that will depend on information that has not yet become available. As soon as fresh information appears, the market instantly takes it into account, and prices adjust accordingly. Given that one individual can never know as much about a company as the combined knowledge of everyone else in the market, he or she will only be able to out-guess the market with the benefit

of inside information.

Researchers have found various exceptions to efficient market theory, which show that stockmarket prices are sometimes driven more by speculation and psychology than rational expectations. But assuming that in the long term, markets are normally efficient, this theory implies that some sectors of the City are less than useful. Efficient market theory implies that a chimpanzee throwing darts is as likely to pick a winning stock as a highly-paid analyst or fund manager. An analyst may believe his knowledge of a company allows him to see that it is undervalued; but provided that knowledge is based on publicly-available information, someone else will have spotted the anomaly too; the prices will have already moved up before the analyst makes his recommendation.

Broad support for this theory comes from the statistics that show that in America and in Britain, about 80 per cent of fund managers perform *worse* than the market average. One might expect at least 50 per cent of them to provide advice that beats the market. But fund managers do not, because of the expenses they incur buying and selling shares and the fees they charge their clients.

And consider the performance of British money-managers in 1987. In the first half, most funds got out of gilts and property, which turned out to be the year's best performers. In the summer they stampeded into equities, so that by October, the average pension fund had 85 per cent of its money in equities. And all the year they cut back their exposure to Japan, although it turned out to be the best performing of the major markets. The performance measurement services have worked out that if the funds had stuck with the assets they had at the start of the year, they would have made a return of 7 per cent. But the median actual return was between 2 and 3 per cent.

So most pension funds *would* do no worse by employing a chimpanzee. It is not surprising that the fastest-growing sort of fund management now is 'indexation', which involves investing in all the leading stocks and then sitting tight. Indexation guarantees that a portfolio will perform no worse than the market overall. In America, more than 10 per cent of total pension fund assets of $1.7 trillion is already index-linked (ie, tracks the stockmarket indices).

Thus much of the analyst and fund management industry could be regarded as superfluous. But people who lack financial expertise do need advice on the risks involved in different sorts of investment. Furthermore, a few brilliant company analysts and money managers do out-perform the market, because they think of original ideas. And even if one individual can seldom get ahead of the market, the system as a whole needs analysts. It is only because analysts and fund managers compete to spot price anomalies ahead of their peers that stockmarkets are usually quite efficient. However, many of the City's less-respected analysts could be thinned out without impairing market efficiency—and the need to trim costs has already forced many stockbrokers to do this.

Many market-makers can also be regarded as parasites. They are traders who hold books of securities and deal with—'make markets to'—other market-makers or the public. A salesman or trader who sells a bond to an insurance company is adding value, and providing a service that the investor requires. But if traders shuffle bonds or shares amongst themselves, no wealth is created, and the traders become a cost to the community.

But for financial markets to work efficiently, some market-makers are needed. They provide liquidity, which means that they enable other people to sell their securities. Liquid markets allow a company to grow through retained earnings without its shareholders clamouring to get their money back directly from the company—thereby threatening to brake its growth. Liquidity generally makes prices more efficient, and it encourages small in-

vestors to participate, since they will be confident of not getting stuck with what they buy. Liquid markets cheapen the cost of capital, since investors are prepared to accept a lower return in exchange for liquidity. But an excess of market-making firms is more of a burden than a benefit. After Big Bang about 25 firms made markets in ICI stock. The price would have been just as efficient with half that number.

International markets

Some view the international side of the City as parasitical. For example, John Plender wrote in the *Financial Times* on 15 June 1987: "[The City] is growing faster than most [industries] because it thrives on many of the instabilities that are contributing to low growth in the world economy. The City is taking a percentage of the huge capital flows that stem from trade imbalances and from financial volatility. It is thriving much as a drug company thrives in an epidemic".

This is true for the foreign currency markets. If the world could agree on a stable exchange-rate system, many currency dealers would be laid off, and companies would not have to spend so much on currency futures and options. But most City activity is not dependent on the speculative short-term flows that we would all be better off without. The City fulfills a need in the world economy as a place where providers of capital can be brought together with its users, where companies can rely on finding a pool of financial expertise, and where markets that have been driven out of other centres by an excess of regulation can flourish.

Over the last 25 years, the Euromarkets have provided the City with its fastest-growing, most efficient and generally most honest sector. They are called Euromarkets because they are based on Eurocurrencies (a Eurocurrency is any money held outside its home market—a dollar in a London bank account is a Eurodollar). These markets grew up in London because it was free of the taxes and regulations which smothered them elsewhere. For example a Swiss tax on securities trading pushed Eurobonds to London, while America's reserve requirements made it cheaper for American banks to make their international loans in London than New York.

Britain's new regime of financial regulation is stricter than anything in force anywhere else in Europe. But now that these international businesses have come to Britain, they are unlikely to be pushed out by the new regulation, since the City's concentration of financial talent is a powerful magnet. Most of the people who work in these international markets are not parasites. Eurobond salesmen, international merger experts, managers of funds for foreign clients and arrangers of export finance for less developed countries all thrive in the City—and by charging fees to foreigners contribute to Britain's invisible exports.

Nor can the City's domestic side be branded as mainly parasitical: insurance brokers, managers of unit trusts, venture capitalists, building society clerks, computer operators of systems for settling share transactions, and bankers who vet loan applications are not 'thriving on an epidemic'. They are providing services which are essential in any modern economy.

The City's contribution to the economy

Over the past 15 years, the biggest contributors to economic growth in Britain have been oil and finance. But while oil has had little impact on employment, financial and business services have provided the largest source of new jobs. Despite the crash of 1987, finance's contribution to the economy is unlikely to wane. For in the long run, as more of the world economy becomes developed, the demand for international financial services based in London—such as insurance, money management and borrowing through loans and bond issues—is

likely to increase.

In 1976, banking, finance, insurance, business services and leasing together accounted for 10.7 per cent of GDP. Manufacturing then accounted for 29.6 per cent. By 1986, output of the financial sector had grown to 15.8 per cent of total GDP. Over the same period, manufacturing slumped to 24.3 per cent.

The employment figures tell the same story. According to the *Employment Gazette*, jobs in 'banking, finance and insurance' grew from 1.7 million in June 1981 to 2.3 million in June 1987 (compared to 5.1 million people then working in manufacturing). But the *Gazette* sneakily dresses up the figures to exaggerate the importance of finance. For further on, it provides a breakdown of the sector 'banking, finance and insurance'. That sector in December 1986—then totalling 2.16 million—turns out to consist of banking and finance, 527,000; insurance, 229,000; property, 225,000; and 'business services', 1,185,000.

'Business services' appears to be a dustbin into which the statisticians have thrown anything that does not fit easily into another pigeon hole. They include public relations, auctioneers, the law, accountants, architects, computer services, market research, advertising, office design, surveyors and employment agencies; and dozens of other obscure categories which have little to do with finance, such as telephone sterilisers, non-medical bacteriologists, inventors and private detectives. So a better employment figure for financial services, ie, people who really work in banking, finance and insurance, would be about 760,000.

The financial boom's indirect impact on jobs has been considerable. To mention just some industries beginning with C: construction, computing, consultancies, car firms, carpet-makers and clothing factories have all gained. Although the boom has exacerbated disparities in regional growth rates, not only London and the South East have gained. There are plenty of insurance brokers, unit trust salesmen, bank clerks and building society cashiers in the rest of Britain. Money management is Edinburgh's fastest growing industry, employing 12,000 directly. The official figures do not provide a regional breakdown on a more detailed basis than 'banking, finance and insurance'. But of that broad and rather misleading category, London and the South East employed 1,083,000 in December 1986, and the rest of the country—by a statistical fluke—1,083,000.

The financial sector's contribution to the balance of payments is becoming indispensable. In 1986, Britain's deficit on visible trade grew to £8.5 billion. Fortunate, then, that financial services earned a net surplus of £9.4 billion. Net earnings from Britain's insurance industry grew from £810 million in 1976 to £4.28 billion in 1986. Banking provides

Table 1

City of London's foreign earnings, 1965-1986 (£ millions)

	1965	1968	1976	1979	1985	1986
Insurance	81	198	810	1,074	2,909	4,260
Banking (net)	82	67	118	−96	1,311	2,296
Commodity trading	80-90	57	309	284	611	572
Brokerage	30-35	55	215	331	547	645
Investment trusts	–	35	47	58	183	188
Pension funds	–	5	14	46	587	638
Unit trusts	–	2	11	23	113	175
Leasing	–	–	–	4	66	50
Securities dealers	–	–	–	–	318	552
TOTAL	250-290	419	1,524	1,724	6,645	9,375

Source: Central Statistical Office

the next biggest slice of overseas earnings: its net contribution rose from £118 million to £2.3 billion in 1986. Table 1 reproduces the 'City' table from the Government's Pink Book (which contains the official figures on earnings from invisible exports).

This table amalgamates two groupings of balance of payments statistics in the Pink Book:

- financial services – fee income earned from foreigners by British banks (including foreign banks in Britain), commodity brokers, stockbrokers, insurance underwriters, etc.
- interests, profits and dividends (IPD) – the earnings on Britain's overseas assets (such as interest paid to British banks and earnings from investments overseas) minus the outflows on its overseas liabilities (such as interest and dividend paid from Britain to other countries).

These two components of the City's invisible earnings have grown at similar rates. The biggest factor behind the surge in IPD has been the huge outflow of portfolio investment since Mrs Thatcher withdrew foreign exchange controls in 1979. From 1979 to 1986, gross overseas portfolio investment went up from £12.3 billion to £145.7 billion (while gross foreign portfolio investment in Britain grew from £10.4 billion to £42.9 billion). That outflow boosted gross portfolio income from £540 million in 1979 to £5.7 billion in 1986.

Large chunks of the City's overseas earnings such as those from the Eurobond Markets go unrecorded. The City's invisible earnings are probably several billion pounds higher than the Pink Book suggests.

Brain drain

The financial sector has grown so fast, particularly in the securities markets, that City firms have suffered from shortages of skilled labour. The result has been spiralling wages and a brain drain on the rest of the economy. Ten years ago, the brightest graduates went into the civil service and the media. Today they choose investment banking and management consultancy. So it is not surprising that throughout the 1980s, complaints have grown that the City siphons off a disproportionate share of human resources.

But does the brain drain matter? For if financial services create wealth, surely Britain needs its cleverest people to work in finance and keep it ahead of the rest of the world. It does matter, because banking already has more than enough good people to stay competitive, while manufacturing industry suffers from a lack of talent.

Surprisingly, even some of the free market enthusiasts of the London Business School have expressed alarm that about 60 per cent of their students go into finance and management consultancy, and only 40 per cent into manufacturing.

That is unremarkable, given that manufacturing seems to be unable to match finance in offering high salaries or great responsibility at an early stage. Some American investment banks have paid £25,000 starting salaries to graduates, because while markets were growing rapidly, they were held back by shortages of good people.

There is little that a government can do to correct this imbalance in a free economy—except wait for the inevitable correction. Market forces are already cooling the sizzling salaries, particularly in the bond and share markets which had paid the most. Turnover has fallen since mid-1987, forcing firms to trim costs by cutting recruitment and pay. Wages will not fall far, however, in the many areas of finance that are international. This is because New York firms pay the most, so that if a London firm pays its bond traders less than the going rate, they are liable to cross the Atlantic. But recruitment has fallen sharply and will fall further. More graduates will have to go and make things; the fewer who go into the City will still be paid a lot.

2. Is the City too international?

One of the most powerful myths about the City is that its international bias damages the real economy. Each post-war generation chooses its own version. In the fifties and sixties, the City was accused of keeping sterling artificially high, at the expense of the competitiveness of British industry. In the sixties and seventies, it was said, the foreign exchange markets unpatriotically speculated against the Labour Government, landing us with sterling crisis after sterling crisis. And during the Thatcher era, the big investment institutions have channelled capital overseas which should have gone into British industry.

The first version of this critique *was* true. Until the mid-1970s, the City wanted a high exchange rate for sterling. The Bank of England's lobbying for a strong pound contributed to Harold Wilson's reluctance to devalue before 1967. British banks opposed devaluation partly because they feared it would provoke an outflow of 'sterling balances' (money that foreign governments had deposited in London). British banks profited from this business and knew that a weak currency would push foreign governments to withdraw their money or switch out of sterling. Many of the runs on the pound in the 1960s and 1970s were aggravated by this money leaving the country.

These sterling balances are no longer significant. Sterling has mercifully ceased to be a leading reserve currency. Now it is short-term speculators—including the world's largest banks—who drive currency crises.

The City no longer has a strong rationale for preferring a high pound. Most of its foreign business is priced in dollars not sterling. If Lloyd's insures an aeroplane belonging to Pan-Am, the airline will pay its premium in dollars. About three-quarters of Lloyd's income is in dollars. The underwriting fees and trading spreads which clients pay to Eurobond firms are mainly in dollars. Foreign institutions which ask London firms to manage their money seldom pay the management fee in pounds. Thus a weak pound has little effect on the City's international business.

A cousin of the high-sterling critique of the City is the high-interest rate bogey. The City's supposed lust for a vigorous pound is one reason given for its supposed enthusiasm for high interest rates. This rang truer in the past than today. The banks used to do particularly well out of high interest rates, since they paid nothing on current account deposits from the public. Thus if the rates they charged their customers rose, the banks' profitable 'spread'—the gap between the cost of funds and the rate of interest received—grew larger.

But over the past 20 years, the proportion of banks' funds on which they have paid nothing has shrunk. Banks have borrowed larger quantities of money in the wholesale money markets—where they must pay interest—than from the public. Furthermore, competition from the building societies and foreign banks has forced them to pay the public interest on some sorts of deposit. So high interest rates have ceased to be a free lunch for the banks.

Other groups in the City—particularly firms trading bonds and shares —prefer falling interest rates. Take an

investment bank holding a large trading position of Eurobonds, which pay a fixed rate of interest of say 10 per cent. If interest rates decline, the value of these bonds will rise. More indirectly, equity markets also gain from falling and low interest rates: lower rates imply higher company profits, bigger dividends and better economic growth. So share prices rise.

Investment banks did very well from falling interest rates during the period 1982 to 1987. Those were the years when the world's bond and share markets enjoyed an almost uninterrupted rise in value. The underlying cause of this 'bull' phase was the taming of inflation, which had two results. First, people wanted to put their wealth into financial assets such as bonds and shares, rather than into, say, property and gold, since securities are a good investment when inflation looks too low to erode their yield.

Second, lower inflation dragged down interest rates. Because people with money to lend believed inflation was beaten, they were prepared to lend at lower rates of interest than they would have earlier. The continuous fall in interest rates—American long-term bond yields fell from 15 per cent in 1982 to 7 per cent in 1987—helped propel stock and bond prices upwards. The rising value of bonds and shares fuelled the profits of securities firms. Even the dimmest of traders can make money in a bull market, simply by holding on to securities. Surging profits allowed salaries of over $100,000 to become commonplace in London and New York.

Thus investment banks dislike increasing interest rates, and their influence in the modern City is certainly no weaker than the clearing banks. However, the City *does* retain a bias against inflation. If it believed that government policies were inflationary, it would favour a tightening of short-term interest rates, as a means of reining in the money supply. Investors would demand higher bond yields at the long end to compensate them for inflation eroding the value of their investment. And the City would oppose a steep slide in sterling since that would fuel inflation. But provided that inflation is not a worry, the City as a whole has no particular preference for high interest rates.

Unpatriotic markets

The foreign currency markets have attracted considerable odium since the world's system of fixed exchange rates fell apart in the early 1970s. A free market in currencies appears to deprive sovereign governments of the power to manage their economies in the way they want: if a British government tried to reflate, speculators would sell sterling.

There is no question that the markets *do* restrict governments' freedom. But it is worth remembering that markets will not push sterling up or down unless fundamentals such as the balance of payments or differing rates of interest and inflation—or expectations of changes in those fundamentals—are tilting it in that direction anyway. If the British government reflated, the trade deficit would almost certainly worsen, and laws of supply and demand would push sterling down. So the speculators would be quite logical to bet on a fall in the pound. But although speculators exacerbate currency crises rather than create them, because they follow herd instincts they often make currencies overshoot further than the fundamentals justify.

One solution would be a return to old-fashioned foreign-exchange controls. From 1939 to 1979, anyone wanting to invest overseas had to bid for a limited pool of foreign currency. The scarcity of the available investment currencies meant that their price—which fluctuated according to supply and demand—was always at a premium to the normal exchange rate. Thus if an insurance company wanted to buy American shares, it had to pay a 'dollar premium' of perhaps 20 per cent.

The point of these exchange controls was to discourage investment overseas

and thereby support sterling. But the evolution and internationalisation of the world's capital markets since 1979 means that exchange controls would now achieve even less than they did when they were in force. As Harold Wilson well knows, exchange controls failed to prevent sterling crises.

One difficulty is practical. The force of 800 bureaucrats in the Bank of England who monitored the controls was disbanded in 1979. A replacement force could not be trained instantly. And if, before a general election, a government committed to exchange controls seemed possible, there would be a run on the pound as people tried to get their money out. Such a currency crisis would not win a party advocating exchange controls many votes.

The development of new techniques such as swaps, futures and options would also make it virtually impossible to enforce controls. These techniques make it easy for the crafty to buy and sell currencies without anyone else knowing the purpose of the transaction and who is behind it. A return to currency controls would provide a boon to a whole industry of lawyers, accountants and crooks who specialise in their evasion. This industry is now underemployed, since most European countries have largely abandoned their controls over the last decade.

Controls could stop British residents from selling sterling. But that is not enough to protect the pound in an era of international capital markets. Foreigners now hold over £50 billion worth of gilts (British Government bonds), Eurosterling bonds, British shares and property. Because this has grown so large during the 1980s, controls would give little succour to the pound if people outside Britain wanted to sell it.

Could the Government ban foreigners from selling sterling assets held in the United Kingdom? To effectively expropriate foreign investors would be counter-productive. Foreign governments would probably reply by seizing British assets in their countries. And since we have more foreign assets than any other country bar Japan, we would end up net losers. As for sterling assets held by foreigners outside the United Kingdom—including thousands of sterling bank accounts—the British government is powerless to prevent their sale.

Any attempt to ban or control the trading of sterling in London would simply push the business to rival financial centres like New York and Tokyo. And it would harm the City's standing as a centre for foreign banks to locate. Controls could also damage industry. It would not help the efficiency, profitability or ability to compete internationally of a firm like Pilkington, if it were discouraged from, say, investing in a new glass factory in France or buying a specialised glass producer in America. Many of Britain's most successful large companies—for example BP, ICI and Glaxo—are those which have become truly international.

So if exchange controls are now a museum piece in the armoury of finance ministers, what, if anything, can a British government do against gyrating currency markets? One way forward would be to join a fixed exchange-rate mechanism, such as the European Monetary System – which in principle could be extended to cover most of the world's developed economies. A commitment by governments to exchange-rate stability would weaken the power of speculators, lead to lower interest rates, and provide industrialists with a stable environment within which they could make investment decisions.

But an international system of linked currencies is only feasible if governments are prepared to co-ordinate their economic policies to reduce global imbalances, such as America's trade deficit. A fixed exchange rate system would require member countries to avoid macroeconomic policies markedly different from those of other members.

Such a system would not prevent a British government from introducing specifically socialist economic policies—for example public works, a

wealth tax, industrial investment and workers' control—within a given macroeconomic framework.

Capital exports

When the Conservative Government abolished exchange controls in 1979, British money surged overseas. Britain's net external assets grew from £12 billion in 1979 to £162 billion in 1986, second only to Japan's £179 billion. British pension funds increased their overseas assets from an average of 5 per cent to 15 per cent of their total investments. This reflected more than a change in the law: North Sea oil gave Britain a current account surplus which had to be balanced by capital outflows. Many see this outflow as harmful and relate it to chronic underinvestment in British industry.

This view, however, is based on a misconception of what happens when an institution such as an insurance company builds up a portfolio of foreign securities. It normally buys already existing bonds and shares. The consequence is not to create new jobs abroad, but merely to push up prices in say, the New York stockmarket or the Japanese government bond market (other things being equal, the cost of capital in these target markets will be fractionally lower than it would otherwise have been).

The capital outflow does not harm employment at home. For if the pension funds were banned from investing abroad they would simply put more money than they already do into British property, shares and gilts. That would raise the prices of these commodities, but not necessarily create new jobs (only the small—albeit growing—proportion of total investment that goes into *new* bond and share issues could be said to finance job creation). Underinvestment in British industry has many causes (see page 19)—but does not stem from a shortage of capital.

Indeed, the capital outflow has probably helped industry, through its effect on the exchange rate. From 1979 to 1981, when the high value of the pound damaged industry so severely (remember the demise of the MG car?), capital exports stopped it going even higher. But the capital outflow has since slowed, and been overtaken by the growing income on our overseas assets. This has nicely balanced the oil industry's declining contribution to the balance of payments.

Thus an attempt to stop institutions from investing overseas would not be worth the effort. It would needlessly antagonise City opinion, when there are plenty of other issues (read on) on which it *is* worth picking a fight. Let fund managers put billions overseas; but chivy them to put millions into new enterprise in Britain. The former does not preclude the latter.

3. Does the City starve industry of finance?

The City has been accused of failing to meet the needs of industry and not just by those on the left. Attention has focussed on the supposed reluctance of British banks—unlike those in France, Germany and Japan—to provide their industrial clients with long-term finance.

The Wilson Committee's report on this alleged failing concluded in 1979 that a 'finance gap' did not exist for most sorts of company. Wilson found that the banks had got better at lending for longer periods. Since the Wilson report, the clearing banks have continued to improve their record on long-term lending, partly thanks to competition from foreign banks which have been eager to lend over several years.

But the City's record of industrial financing still leaves much to be desired. There is still little lending for more than five or seven years, except against the security of property. Banks generally limit their relationship with companies to the narrow provision of money, and are weak on advice and helping companies when they fall into difficulties. Companies in the regions are liable to suffer from the increasing concentration of financial expertise around London. And many small firms still find it impossible to raise the money they need.

Small is difficult

Wilson's one criticism of the City was that it failed to provide enough money for small companies. This spurred the Conservative Government to encourage several new channels for small company finance. Sources of money now include:

- the Loan Guarantee Scheme, set up in 1981, partly guarantees loans that banks would normally consider too risky. The LGS has proved popular, and allowed 16,000 small businesses to borrow £530 million between 1981 and 1986;
- Britain's rapidly growing venture capital industry. The number of independent funds which specialise in lending to start-up or young companies has increased tenfold since 1979, to more than 100. The total pool of venture capital either invested or ready for investment, is about £4.5 billion;
- the Business Expansion Scheme, set up in 1983, which gives tax incentives to individuals who invest in small businesses. In the four years ending March 1987, 883 companies raised £502 million by the BES;
- local enterprise boards (such as the Greater London Enterprise Board) which lend to small firms; and more than 250 local enterprise authorities that offer advice and put small companies in touch with venture capitalists.

The result is that small companies are better off in the late 1980s than the late 1970s. But the improvements do not go far enough. A 1986 report by the National Economic Development Office concluded that there remained a shor-

tage of equity finance for start-ups, and for firms needing equity of £100,000 or less. The Unlisted Securities Market and the Third Market (junior stockmarkets for smaller companies which want to avoid the extravagance and complications of listing on the big London stock exchange) generally provide sums of £1 million or more. Venture capital funds typically invest sums of £150,000 to £1 million. And although share issues through the BES can provide sums of less than £100,000, 82 per cent of BES money has been raised in amounts of over £100,000.

Investors in Industry is one of the best providers of small amounts of equity. About 2,500 of 3i's 5,000 outstanding investments (both loans and equity) are in sums of less than £100,000. The Loan Guarantee Scheme also reaches the smaller end of the spectrum, but it cannot provide equity. Small firms need access to equity, since it is more flexible—dividend payment is voluntary—and often cheaper than debt.

Many small businessmen, particularly in high-technology manufacturing industries, find that venture capital companies and the BES are ill-suited to their needs. American venture capitalists have a better record on providing advice to the firms they invest in. British venture capitalists often take a hands-off approach. Furthermore, about half of British venture capital funds refuse to invest in start-ups, insisting on companies with a proven track record.

The BES has encouraged investment in the wrong sorts of businesses. It has allowed investors to earn tax breaks on putting money into shops, restaurants and wine bars—and, since the 1988 Budget, residential property. Because there are so many virtually riskless investments available, the limited pool of money that is attracted to the BES avoids apparently riskier targets such as manufacturing firms in the regions. In 1985-6, only 23 per cent of BES investment went into manufacturing, and only 16 per cent went into firms in the Midlands and the North.

Although the BES has provided the first stage of equity finance for many companies, the smallest firms find it punitively expensive. Costs are fixed, so that a company raising £50,000 may have to pay the same £10,000 arrangement fee as a company taking £100,000. Whatever the type of finance, smaller companies suffer from fixed costs—for lawyers, accountants, advisers and so on—irrespective of the amount raised. A company raising venture capital usually pays set fees of £20,000 to £25,000, whether the investment is for £100,000 or £500,000.

There is plenty of anecdotal evidence that the City often fails small companies, particularly those in high-technology industries. Take two problems of the mid-1980s. First, the Cambridge firm Camputers, which made one of the first and best microcomputers, the Lynx. The company had management problems and ran into difficulties when IBM launched its micro. In 1984 Barclays Bank pulled the plug and the company was wound up, although no one disputed the quality of the Lynx machine. Camputers' technological expertise was dispersed and wasted. Second, Dragon, which was Wales's attempt at a microcomputer company. Dragon was backed by Prutech, the venture capital arm of Prudential, and by the Welsh Development Agency. Again, the product was good but the management inadequate. Both backers pulled out and the company folded.

For small firms such as these, advice on marketing, management systems, financial control and product development would often be more useful than capital. But most British bankers lack sufficient experience, knowledge and contacts. The Department of Trade and Industry's proposal in 1988 to subsidise management consultancy for some small firms is a small step in the right direction.

No to nationalisation

Given some of the failings of the current

system, nationalisation of the clearing banks remains an appealing battle-cry. However, state ownership is opposed by the bank unions, and it would demotivate many of the best senior managers. The recent French experience suggests that nationalisation can harm the long-term interests of banks. For example, Banque Paribas's strategic expansion into foreign markets was held up because civil servants took so long vetting its management's strategy. In terms of efficiency, there is little reason to believe that civil servants and Labour politicians could run the clearers better than their existing managements.

As for ensuring that the banks act in the national interest, and that they follow the wishes of a democratically elected government, the means already exist. Because of the special position of banks in the economy, the Bank of England tacitly agrees to bail out any large bank that fails. In return, banks have to submit themselves to the regulation and the tutelage of the Bank of England. In the mid-1980s, the Bank twisted the arms of the unwilling clearers to make fresh loans to Third-World debtors (it could have told them to lend less in the first place, but it lacked the foresight to do so). And in 1987 the Bank was instrumental in removing the chief executive of Morgan Grenfell, the merchant bank caught up in the Guinness affair. The Government could use the Bank's regulatory powers to insist, for example, that all lending to an unpleasant regime should cease. And it retains the right to appoint a new Governor.

Given the Bank of England's powers, there should be little cause for concern if some of our leading banks or merchant banks were to be bought by foreigners. If Lloyds Bank were owned by Citicorp, it would still have to behave as a public-spirited corporate citizen—for example by contributing to a rescue package for a bank or industrial company—or its licence would not be renewed. British financial firms have pursued strategies of expansion through overseas purchases, so it would be churlish to deny reciprocal rights to foreign firms if London is to be regarded as an international financial centre. And some of the sleepier British firms could benefit from being bought by the technologically more advanced foreigners.

But is not nationalisation needed to direct credit towards the small and high-technology companies that do suffer from a finance gap? The clearers are quite efficient at lending short- and medium-term to most sizes of company. Given the difficulties of changing corporate cultures that have developed over decades, if the state attempted to convert the clearers into long-term banks, the prospects of success would be slim while much that is good could be damaged. Better to plug the gap with other institutions.

Yes to new institutions

To fill the holes left by existing banks and venture capitalists, a British Investment Bank is needed. In their 1987 Fabian pamphlet (*An Investment Bank for the UK*), Charles Williams and Dennis Turner argued the case for a BIB based on an expanded and restructured Investors in Industry. The advantage of building on 3i is that it already contains a fund of industrial expertise. And it has the right sort of culture: its staff feel that because of its stable ownership structure, 3i can take a more long-term view than most banks.

Investors in Industry resembles the state investment banks that exist in most European countries—with a few exceptions. 3i is a fraction of their size, it makes equity investments and it does not make subsidised credits. To protect 3i's morale and culture, its size and scope should be increased organically, and with great caution.

British industrial firms of all sizes could gain from access to institutions such as Crédit National in France, the State Investment Bank in Sweden and Kreditanstalt fur Wiederaufbau (KfW) in West Germany. These long-term banks support weighty research depart-

ments, and have built up industrial expertise which can be used to help client companies. They do not lend to lame ducks, but concentrate their resources on new industries. And they tend to lend on the basis of a company's cashflow. This allows the banks to take a long-term perspective, since they are not too worried about the level of debt so long as the interest can be serviced. British banks, by contrast, usually assess companies on an accounting basis, which means they work out if the break-up value of a company can repay its debt.

A key characteristic of most national investment banks is their ability to provide subsidised credit. There is plenty of evidence that the cost of credit is one factor holding back investment. In West Germany, KfW carried out a survey of all its clients, and discovered that only 20 per cent of them would have carried out their investment in the way they did without KfW's subsidies on long-term, fixed-rate loans.

Distorting markets through subsidies is not intellectually fashionable in the late 1980s. But the BIB should subsidise credits for certain industries, where it decides that the national interest requires a boosting of investment. An undistorted market has clearly failed to provide Britain with a position in vital and growing parts of the electronics industry, such as semi-conductors. The BES, after all, provides a state subsidy to rich investors in small firms; why should the state not indulge entrepreneurs? It is essential, however, that lending decisions should be taken on uncompromisingly commercial criteria.

A BIB should prime investment in Britain's regions. Most venture capital and BES investment is targeted towards companies in the South East. Investors in Industry already has a regional network of 27 offices, so would be an ideal vehicle on which to build a BIB.

More resources should be pumped into regional initiatives to regenerate industry. There are currently only two regional development agencies—for Scotland and Wales—and more are needed. They should be modelled on the highly successful Scottish Development Agency, which takes a hands-on, long-term view of industrial finance. Regional agencies should be prepared to participate in setting up new firms, and if necessary find people who have particular skills that a venture needs. For example, it cannot be assumed that a genius who invents surgical lasers will handle the firm's finances brilliantly.

Smallish firms in the regions could use local bonds to raise the sort of long-term finance that neither local branches of banks, with their short-term view, nor the City, which is too far away, could provide. People from say, Manchester, could be clued up about a local firm and its prospects, and prepared to buy its bonds. A partial guarantee from the local enterprise board would give the investor some security (a complete guarantee would take away the point of the scheme, since the bonds would then be simply liabilities of the local authority). Such bonds would often be held to maturity, but could be traded through a local stockbroker or even newspaper advertisements.

The traditional complaint about the City has been that it does not provide enough industrial finance at the right price. Sometimes this criticism carries weight. But a more fundamental and surreptitious failing concerns the relationship between the providers of capital—whether banks or institutional investors—and the managers of industry, *after* the financing commitment has been made. The City has infected British industry with its culture of short-termism, and it is to this that we now turn.

4. Short-termism

'Short-termism' has proved the most persistent criticism of the City during the 1980s. Not only socialists and industrialists, but also many stockbrokers and merchant bankers have claimed that the City's emphasis on short-term returns has harmed industrial investment. The most ardent defenders of the status quo tend to be the free-market professors in the business schools.

The critics claim that the City harms industry in two specific ways: through the short-term time horizons of fund managers; and through the stockmarket's inability to take a long-term view of company prospects. In their simplest forms, neither criticism stands up to analysis. But in more subtle ways, both contain elements of the truth, which is that City firms often lack sufficient commitment to the companies they finance.

The short-termist critique of the City has arisen from the apparent link between two marked characteristics of the British economy. First, Britain has a poor record on investment, research and development and training. Second, Britain enjoys (or suffers from, depending on your perspective) a more highly developed capital market than any other country bar America. Aspects of this 'sophistication' include:

- a relatively important role for the stockmarket in the provision of long-term funds, and a small role for the banks;
- a high concentration of share ownership in the hands of a small number of institutional investors. The people who manage this money are subjected to stringent and short-term performance measurements, so therefore tend to trade institutional shareholdings for a quick gain, rather than treat them as long-term investments;
- the absence of stable bank shareholdings in industry, with the consequence that the majority of most companies' shares can be traded freely on the stockmarket; that allows one company to launch a hostile bid for another by buying its shares in the market;
- the existence of specialist institutions, known as investment banks or merchant banks, which encourage and profit from takeovers.

These characteristics distinguish the British and American financial systems from those of Continental Europe and Japan. The differences should not be overdone: the Japanese stockmarket overtook America's to become the world's biggest (in terms of market capitalisation) during 1987, while financial practice in France, Germany and Japan creeps closer every year to the Anglo-Saxon model. But for the time being, the two systems remain distinct.

Is the juxtaposition in Britain of a poor investment record and a market-orientated financial system coincidental or causal? The link seems self-evident to many industrialists, who have been prompted by the takeover boom of the mid-1980s—in 1987 there were £15 billion of public mergers and acquisitions—to rail against the City's supposed short-termism.

Fund management short-termism

The first short-termist critique of the

City claims that the diminishing time horizons of money managers has a harmful impact on industry. Pension fund trustees increasingly farm out the money they control—British pension funds total about £220 billion—to money management firms such as merchant banks. The trustees of a pension fund may review the performance of their money manager every three months. A firm stained with several poor three-monthly periods is likely to get the sack. Thus staff at money-management firms—whose pay is often linked to their own performance—are under pressure to beat the market, which encourages them to buy and sell shares frequently—'churning'. They eagerly seize on analysts' tips and their own whims to buy undervalued shares, and—assuming the shares rise—may sell them for a quick profit a month or two later.

According to research published by the Bank of England, the average pension fund turned over 25 per cent of its portfolio in 1981, and 41 per cent in 1986. Turnover of unit trusts—an industry now worth £40 billion—in the same period grew from 85 per cent to 116 per cent. This growth came before the much cheaper dealing costs that Big Bang offered, and was largely inspired by the increasing competitiveness of the money management industry.

But it does not necessarily follow that industrial companies will have to pursue the short-term perspective of the fund managers. For whether he or she is looking for a profit over three months or three years, the fund manager will want to buy a share that appears to be undervalued. Suppose that Beecham announces an investment in a new drug on which no returns are expected for seven years. The share price should rise immediately, so long as investors hear about and believe in the investment. The Beecham share price rises because it 'discounts' (ie, takes into account) the earnings expected in future years. It does not matter if a fund manager sells out a couple of months later. For if too many institutions sold, the share price would again become undervalued (relative to similar companies), and sharp-nosed money managers would step in to buy the shares. Thus the short-term perspective of the money manager, and an increased volume of share trading, make the market more efficient.

In a takeover situation, however, the fund manager's time perspective *can* prove harmful. If the bidding company offers existing shareholders a price much higher than the existing share price, it may be hard for a fund manager worried about his three-monthly performance to forego a quick capital gain. Even if the fund manager believes that the company's existing management is competent, and engaged in a strategy that will produce a strong share price for the next five years, it is difficult to refuse a predator who is offering a considerably higher price for a company than the market had previously thought justified.

Many pension fund trustees, facing a statutory obligation to obtain as high a return as possible, impose a similar obligation on their firm of money managers. That makes it hard to refuse a bid made by a company determined to pay 'too much', ie, one driven by the egotistical ambitions of its managers (should it not be made compulsory for a firm bidding for a much larger one to ask its shareholders' permission?).

But many institutional investors, especially the insurance companies, do behave responsibly during hostile takeovers. They listen to presentations by both sides, and generally have a bias in favour of the existing management. Research published by the Bank of England in 1987 suggests that most large institutions are not tempted by the chance of a short-term gain in a takeover situation. But the Bank noted that some smaller pension funds and unit trust companies were not so responsible.

Stockmarket short-termism

The second and related short-termist critique of the City is that the stock-

market's myopia discourages companies from investing.

The idea goes as follows. The stockmarket often fails to appreciate the long-term benefits that an investment may bring a company. So if an investment reduces a company's profits in the short-term, the share price falls, and the company becomes vulnerable to takeover—in which case managers would lose their jobs. Managers therefore adopt the cautious policy of eschewing any investment likely to reduce earnings per share.

There is a large corpus of academic studies of share prices which contradicts this thesis, and suggests that stockmarkets are efficient in the informational sense. That is, they accurately reflect the information that is publicly available about economic conditions and about companies' prospects. So if GEC announces a new product, its share price will immediately move up or down depending on the market's view (determined largely by analysts) of the product.

The academic work goes further, and claims that current share prices accurately discount future earnings prospects. That is, the market attaches about the right weight to prospective future dividends, compared to current dividends. The implication of this research is that the market does not misunderstand companies when they make long-term investments that do not produce immediate dividends.

Imperfect efficiency

But despite this dominant academic view—which has been questioned by economists who are less enamoured of free markets—a significant minority of industrialists believes that financial markets *are* short-termist. That matters, since beliefs influence behaviour. The 1987 report by the Confederation of British Industry on City-industry relations was largely a whitewash—hardly surprising since its taskforce was drawn from the banking and business establishment—but included much revealing detail.

The CBI accepted that there was a problem of underinvestment in capital equipment, research and development and training. But it pointed out, quite correctly, that there may be many causes of underinvestment other than the short-termism of financial markets. It concluded: "The most important constraints inhibiting companies from taking strategic investment decisions in the long-term interest of the company and its shareholders appeared to be the high cost of capital and/or fears of an inadequate return. Short-term pressures from financial markets and investors are much less important, with a majority of companies not regarding them as a significant constraint on their ability to take strategic investment decisions".

But the detailed returns from a questionnaire the CBI sent out to 200 mainly manufacturing companies produced a different slant. The chief executives—most of whom worked for firms with turnovers of over £100 million—were asked what factors constrained their companies from taking investment decisions in their long-term interest. Of the 109 who replied, 12 per cent cited fear of a takeover as significant or of major significance; 23 per cent mentioned pressure from financial institutions or analysts; 41 per cent answered a weakness in their share price. So a substantial minority of chief executives believes that financial markets, in one form or another, *do* constrain their ability to invest.

These chief executives reckon short-termism is worsening. When asked in what ways they had changed their criteria for evaluating an investment since the late 1970s, 50 replied "higher rate of return/shorter payback", 42 said "no change" and 11 went for "lower rate of return/longer payback". Why had those with shortening investment horizons changed their ways of evaluating an investment? They mentioned an adverse economic environment, high real interest rates and financial market pressures in roughly equal

proportions.

Information flows freely

The CBI, like the business schools, believes that the system itself is faultless: stockmarkets are essentially efficient, they do not over-emphasise the short-term earnings of companies, and if there is a problem—they have to concede that occasionally, some of the time, the market does not do justice to some companies—it can be overcome by making the market even more efficient. Industrialists should spend more time explaining their plans to analysts and institutional investors. If only information flowed more freely, all would be fine.

It is common sense that if a firm explains itself well, the market is more likely to get its share price right. The CBI report rightly proposed that companies should reveal how much they spend on R&D in their annual report and accounts. Why not also make them report the ratio of their capital spending to their depreciation of capital, so that analysts know whether capital stock is being replaced? And why not spending on training?

There is some evidence that if companies communicate well with analysts and investors, the market can take a long-term view. One recent study of 324 American companies by the Securities and Exchange Commission concluded that when firms spend more on R&D, their share price normally rises. And when British drugs companies announce plans to invest in new products, the market generally responds positively. However, pharmaceutical companies have been an unusually popular sector in Britain in the late 1980s; electronics companies have not always met the same response.

Analysts play a key role in the Anglo-Saxon financial system. Investors lack the expertise to judge the worth of say, a new telephone exchange planned by Plessey. They depend on stockbrokers' analysts to have the technical knowledge to take an informed view of the impact of an investment on a company's prospects.

The problem is that the quality of many analysts is less than their pivotal role in the system requires. Many are inexperienced and know little about the industries they cover. Analysts are supposed to be taught complex formulae for predicting the value of company shares several years ahead. But in practice most of them use rules of thumb for forecasting share values and earnings per share for this year and next year, and ignore the longer-term outlook.

Analysts can argue that if they often fail to carry out fundamental and detailed research on companies, it is because their clients do not want that service. Money managers worried about their quarterly performance expect analysts to provide stock tips, and will feed more business to a firm of stockbrokers that provides a steady stream of successful 'buy' recommendations. The more respected analysts shift prices up or down with their tips, and encourage institutions to churn their portfolios.

The more complex the 'industry', the more difficult it is for analysts to mediate successfully between companies and investors. That may be one reason why much of the anecdotal evidence for short-termism comes from high-technology industries such as electronics.

- The share price of Oxford Instruments, for example, dropped 10 per cent in June 1987 after it announced that annual profits were up 6.7 per cent to £19.7 million. The market reacted to sluggish sales of super-conducting magnets, which provide half the firm's earnings. Investors appeared to ignore that Oxford Instruments was laying the base for diversification into new product lines and took no notice of the contemporaneous announcement of a £10 million contract to supply IBM with a new sort of super-conducting atom-smasher, which was positive news for the firm's long-term prospects.

- Not only electronics firms claim they suffer from short-termism. In America, Levi-Strauss went private in 1985, abandoning having its shares quoted publicly because it did not like having to make decisions in response to Wall Street pressures. For example in 1984 it had to sack 15 per cent of its workforce to satisfy the markets. Since going private, Levi-Strauss has flourished; the company has restructured itself and put a new emphasis on marketing. The firm claims that the stockmarket would not have given its new strategy enough time to work.

Fundamental flaws

Faced with such tales, defendants of the system claim all that is needed is managers better-skilled at 'investor relations', and analysts and investors better-trained to understand the insides of companies.

But more efficient flows of information may not be enough to make markets work efficiently. The Anglo-Saxon system contains inherent problems. Take a company in a high-technology industry. If it reveals enough detail about a new project for the analysts to understand its significance, a competitor could get to hear and then copy it. This dilemma is worsened in Britain by the dispersal of ownership and effective control among dozens of institutional investors. In Japan, a company could easily inform the one or two banks which control it about a new and secret project, confident that news would not leak out. If ICL devoted the time and the effort to explaining a new computer to all its major shareholders in private, rivals would soon hear. Yet if ICL denies its shareholders sufficient detail, they may not understand the investment well enough to treat any consequent short-term fall in profits sympathetically.

This may explain why the British stockmarket sometimes fails to appreciate firms which invest in new products. Investors are particularly reluctant to back a product that has not been proven in the market. Thus in 1984, when Racal announced that it was moving into the cellular telephone business through a subsidiary named Vodaphone, the stockmarket took a gloomy view of its prospects. But when carphones boomed, Racal's decision turned out to have been correct and profitable. Subsequently the stockmarket still failed to appreciate the worth of Vodaphone, and so Racal's share price remained relatively weak. Therefore in April 1988, Racal announced that it would float off a portion of Vodaphone, since the valuation the market would have to put on that—about £2 billion—would force it to upgrade Racal's own valuation. So it did: Racal's share price shot up 50 per cent.

A recent report for the Cabinet Office secretariat by John Fairclough, seconded from IBM UK, concluded that (for the period 1985-6) the British electronics industry spent too little on R&D to remain competitive internationally. But the problem with the British electronics industry is not simply that the stockmarket dislikes spending on R&D. Indeed analysts have on occasion marked down Amstrad for spending so little, since that endangers its long-term prospects.

It is rare for specific investment decisions to be abandoned for fear of the market reaction. But the stockmarket's short-termism has blighted Britain's electronics industry in a more subtle way. The market does not like a company which seems to be adventurous. Take Plessey and STC, both of which spend similar amounts on R&D. Analysts now love STC, just as they used to love GEC, because it has become a cautious company run with tight financial discipline. They do not like Plessey, partly because of doubts about its top management, but partly because it has grand ambitions. The City marked it down when it bought Ferranti's semiconductor business. Such a business is anathema to stockmarket opinion: it is capital-intensive, cyclical and extremely competitive. There is an assumption

that if the big Japanese and American firms are competing in a market, British companies are bound to lose. The market prefers electrical companies that milk a few profitable niches and guarantee stable earnings for the next few years. Japanese bankers lending money are often less over-cautious in their view of a company's prospects than the British stockmarket.

The stockmarket's short-termism towards some sorts of company—which increases their exposure to takeover—has fostered a climate of caution among many British managers. These industrialists often appear to lack the ambition to build up worldwide market share—in contrast to their counterparts in Germany and Japan who are free from worry about a falling share price and the risk of takeover. There is often a conflict between short-term profitability and growth of market share, which in British companies is usually resolved in favour of the former.

The British electronics industry is more profitable, but slower-growing than that in most other western countries. In 1986, British output of information technology goods was just 6.5 per cent of GDP, compared to 12.5 per cent in Japan and 20 per cent in America. Thorn-EMI had global ambitions when it bought Inmos, but now it has sold or is selling its high-technology units, and is returning to the easier life of retailing electrical goods. British electronics firms have largely abandoned the production and development of microchips. In most of the principal segments of the electronics industry—telecommunications, computers, components and consumer goods—Britain lacks a world class firm. Only in defence electronics is Britain a match for the rest of the world.

Both the 'fund management short-termism' and the 'stockmarket short-termism' arguments often lack substance, at least in their simplest and most mechanistic forms. But because of its impact on takeovers, the short-term perspective of much City opinion can discourage managers from taking the long view. And the fact that many industrialists *believe* there is a problem of short-termism influences their investment performance. In high-technology industries, the stockmarket's fear of bold strategies can discourage companies from pursuing the sorts of long-term plans that Japanese firms take for granted. In such industries—and in any industry, should a company hit hard times—companies would benefit from firm and committed shareholders. The Anglo-Saxon financial system militates against such commitment.

5. The example of Japan

The theory of efficient markets supposes that so long as information flows freely from companies to investors, there can be no short-termism. But Professor Colin Mayer, of the City Business School, has sought to demonstrate that the structure of the British and American systems—with the stockmarket separating the institutional owners of industry from its managers—provides an insurmountable barrier to the necessary flows of information.

Mayer claims that the providers of funds in the Anglo-Saxon system are not committed to the users of funds, because they do not know enough about the companies they own. He also believes that both the competitive nature of the Anglo-Saxon financial system and the prevalence of hostile takeovers worsens the two-way lack of commitment between institutional investors and banks on the one side, and corporate managements on the other.

Mayer's key word is commitment. He points to Japan, where each company has a close relationship with one bank, known as its main bank. The bank will make long-term loans to the company and will probably own an equity stake. The law limits that stake to 5 per cent, but in practice the long-term loans act like an equity shareholding: they are seldom called in, and it is understood that the providers of the long-term loans should have some say in the company's management. In Britain it is the big institutions which ultimately control most large companies, but in Japan it is the banks.

The important difference between the two countries is that Japanese banks are much closer to their companies than are British insurance companies and pension funds. Because the banks are in a good position to understand companies' strategies, and assess their managements, they are often prepared to make a commitment to support companies. Thus they may be sympathetic to a firm that wants to invest in a new product that will depress earnings in the short term. And if a company hits a rough period, Japanese banks may provide the sort of help that their British counterparts would seldom dream of providing —such as market intelligence, advice on restructuring, the secondment of management, the rescheduling of debts and subsidised loans.

The gain for Japan is that its companies are frequently bold enough to take a long-term view on the development of new markets and new products. And it is extremely rare for the banks to allow large firms to go bust. Yet the result has *not* been a nation of lame-duck industries. When Japanese banks restructure companies, they use their influence to make them slimmer and more productive. The banks reckon it is worth the effort, for in the long-run a revived company should feed its bank much profitable business.

There lies the rub. In Japan there is a commitment of bank to company and company to bank. In Britain these relationships are much weaker and the banks compete much harder to win business from companies. Large British companies take advantage of this and generally auction a bond issue, a trade credit or a cash management system to the cheapest bidder—even if they use a regular house bank to clear their cheques. Many British firms will regularly switch business among half-a-dozen banks.

British banks therefore cannot be blamed for failing to support their companies through thick and thin. Suppose a British bank pumped hundreds of millions of pounds and hundreds of hours of management time into a failing electronics company. Suppose, then, that the commitment proved farsighted, and the firm returned to profitability. In Britain, the company would probably say thanks very much and give its next syndicated loan to a rival bank which offered a cheaper price. Bank-industry relations in Japan are less fickle, because the financial system is less competitive.

Mayer points out that institutional investors in Britain, just as much as banks, are guilty of a lack of commitment.

They discourage managers from thinking long term. Suppose that a manager devotes much time and effort to an expansionary strategy that should pay off five years hence. Whether or not the share price suffers in the short term—that is not the issue for Mayer—the manager's plans may be scuppered by a takeover. If a predator offers a price significantly above the market price, it is in the institutional investor's interest to sell. At arm's length from the company it owns, the institution feels little loyalty to the manager whose plans it may not have understood. The manager will probably lose his job after the takeover—receiving little or no reward for his efforts. So why bother?

Different culture

It would, however, be impractical to transplant the Japanese model wholesale into Britain. Japanese financial practice has evolved gradually amidst a very different culture—one in which, for example, ideas of consensus make the concept of a hostile takeover almost unimaginable.

Two caveats about the Japanese and German systems are worth noting. First, the concentration of power in these countries is in the hands of bankers. Second, the Japanese model is changing. Over the last ten years, the slowing of growth in Japan has led to less investment, and bank lending to industry has therefore declined. Many industrial companies are now much freer than they were from banks' influence.

Nevertheless, Mayer's analysis has relevance for Britain. It reminds us that more competition in financial markets is not always necessarily good. Before further liberalisation governments should consider the likely costs as well as the benefits.

Beyond this there are three lessons to be drawn from Mayer's work. First, banks should get stuck into the companies they lend to. They should train industrial experts who can provide practical advice to client companies. Japanese management has probably been little better than British management; but its industry has performed better thanks to the high quality advice of its bankers, particularly those from the long-term banks. As David Walker said shortly before he left the Bank of England, bankers should not see their relationship with a company as limited to a loan contract. They should be well informed about a client, and be ready to apply gradually increasing pressure in the event of under-performance. They should not just wait until the breach of the loan agreement allows the bank to demand repayment or threaten the receiver.

Second, companies too should change their behaviour and be encouraged to use one or two house banks, even though the result may be fractionally more expensive than if they auctioned all their financial business.

Third, the Government should champion any scheme that encourages the big institutions to stick with their holdings and get closer to the companies they own. We look at some ideas designed to achieve this in chapter 7.

6. Takeovers

Takeovers are not wholly malign. So long as the providers of finance fail to discipline weak managements, takeovers will continue to play a necessary role. But an overwhelming dependence on takeovers is not the most efficient means of rooting out bad managers. To adapt an old cliché that has often been flung at the left, a takeover culture leads to an exaggerated concern with the redistribution of existing assets rather than the creation of new ones.

However much takeovers may benefit the shareholders of some individual companies, their impact on the national economy has, overall, been negative. They have produced an over-concentration of capital, while the performance of merged firms is often worse than that of their original constituents. Takeovers may harm the interests of employees, while they have encouraged managers to think of next year's dividend rather than long-term growth.

Over-concentration

It is impossible to prove that high spending on takeovers is a cause of low new investment, since it is not known how companies would behave in an acquisition-free economy. Similarly, it is difficult to prove that the high concentration of manufacturing output in the largest 100 firms (around 40 per cent) is a result of a permissive takeover system—but it seems a reasonable supposition.

That is the conclusion of the standard work on *Concentration in Modern Industry* by L Hannah and J A Kay. They write: "It is not an accident that Britain, which combines a highly developed securities market with negligible legal restrictions on mergers, has achieved increases in and levels of concentation which are the highest among developed countries" (Macmillan, 1977). Such over-concentration has almost certainly contributed to British industry's lack of dynamism. The important role of small- and medium-sized firms is better appreciated now than it was in the 1960s—when the Labour Government worked hard to promote mergers in the belief that big was best.

Performance

Academics have found several ways of measuring the performance of merged companies, such as profits, efficiency, growth, investment and share price. But none of these techniques has yet been able to prove that mergers benefit the economy as a whole. Some of the benefits for shareholders, such as economies of scale, elimination of duplicate functions, and increased market share, are more easily quantifiable than the costs, so one would expect them to be reflected in share price studies.

Franks and Harris examined the share-price performances of 2,000 acquisitions from 1955 to 1985. They concluded that share prices of the acquiring companies performed comparably to the market as a whole, during the two years following the merger. But acquirors' share prices performed worse than they had done before the merger. In contrast the shareholders of companies that were bought experienced clear share price gains *(Shareholder wealth effect of corporate*

takeovers: the UK experience, 1955-1985, LBS working paper, Nov. 1986).

What is good for some groups of shareholders is not always good for the rest of the economy. An appendix to Lord Young's Department for Enterprise document *Merger Policy* (March 1988) recalls a 1978 Green Paper which compared profitability before and after merger. It concluded that in half the cases examined, the mergers had an unfavourable or neutral effect on the profitability of the companies concerned. Drawing on nine pieces of subsequent research, the document said: "Evidence on post-merger performance that has emerged since the Green Paper supports the earlier findings of disappointing or inconclusive performance". Astonishingly, the main argument of *Merger Policy* is that takeovers are of great benefit to the economy and that the free market should not be tampered with except on grounds of competition.

Companies like Grand Metropolitan and Reed International, which grew by acquisition in the early 1970s, had to be partially deconstructed and reconstructed in the mid-1980s when it became clear that the first stage of combination had failed.

Anti-growth management

The takeover culture has fostered a particular style of industrial management. The investment institutions have tended to reward those companies which function in their own image. In their prime, companies like Slater Walker, Hanson Trust or GEC could do no wrong in the eyes of fund managers, partly because they seemed to view their acquisitions as an investor might regard a bundle of under-valued securities.

Because investors view acquisitive growth as cheaper and less risky than organic growth, companies which excel at it have often enjoyed a higher share rating than organic plodders. Many of these conglomerates made huge profits from rationalising Britain's creaking industrial base in the 1970s and 1980s. The fund managers naturally rewarded them with rocketing share prices, which in turn recharged their takeover ambitions.

Thus, bull markets and takeover waves feed off each other. When the market is near a peak, the shares of acquisitive companies with investor followings are at their most over-valued. That is when it seems cheapest and easiest for the managements of these companies to pay for fresh acquisitions by issuing new, over-rated shares—rather than using cash. Not surprisingly, research shows a higher return to shareholders from cash bids than paper bids; those bidding with paper are easily tempted into paying too much.

Much of the rationalisation accomplished by a Hanson or a GEC was necessary and welcome. But too many of Britain's most successful companies have been rationalisation- rather than growth-driven. They are what the Centre for Business Strategy at the London Business School has categorised financial controllers. These stockmarket darlings such as BTR, Hanson, GEC and most of the 'mini-conglomerates' typically have a small central headquarters, which allows subsidiaries a high degree of strategic autonomy but exerts tight control on investment and financial targets.

The LBS found that financial-control companies tend to be low investors, to be risk averse, and to retreat into high-margin niches. Managers are encouraged to seek high profits with strategies designed to minimise the use of capital; this does little to promote long-term, capital-intensive projects and encourages short-term milking. Hence financial controllers tend to pass-up new opportunities because of the risks involved. Both GEC and Ferranti had an early lead in the MOS-technology segment of the gate-arrays market (custom-built microchips), but both turned down the chance in invest in it, and the market is now dominated by LSI Logic.

The system also takes its toll on non-acquisitive managements through

diverting time and money into anti-takeover defences, or even defensive acquisitions or excessive indebtedness.

Employees

Even acquisitions which are of unequivocal benefit to shareholders may damage employees. Take the case of a 56 year-old production manager who had worked at Ever Ready for more than 25 years. In 1981 Hanson Trust bought Ever Ready, reducing the management layers from nine to three and cutting staff by 60 per cent. The production manager lost his job, but eventually found another with British Telecom, though on a smaller salary and with reduced pension rights. After spending most of the next four years in a state of depression he died at the age of 60.

This sad history illustrates a point made by Andrei Schleifer and Lawrence Summers in their paper, *Hostile takeovers as breaches of trust* (LSE Financial Markets Group, Dec. 1986). They argue that employees enter into a large range of implicit understandings and contracts with their companies, on the basis of a long-term relationship. The employee accepts relatively low wages in return for the expectation of job security. He invests heavily in acquiring specific skills which he knows he cannot transfer elsewhere. He also believes that if he loses energy and ability as he approaches retirement, he will be moved into an easier job rather than be sacked.

Schleifer and Summers argue that by a hostile takeover, a predator can dash these expectations at a stroke, and the employee may have few means of redress because he failed to contract explicitly for such rights. Thus the advantages of a stable relationship between employee and manager may be destroyed by the lack of a long-term commitment on the part of shareholders. While efficiency is normally desirable—and surplus layers of management are not—takeovers which effectively shift wealth (in its broadest sense) from staff to shareholders do not necessarily promote productivity. Demotivated staff work less hard.

Evidently, if companies were better managed in the first place, they would not need to suffer the sudden shock of demanning. But this ideal is more likely to be realised through shareholders providing tougher and consistent monitoring of managements (see below), than by the current combination of non-interventionism and corporate trauma.

The bias to acquisition

The nature of our financial system often encourages large firms to grow by acquisition rather than organically. Why build a new sausage factory if you cannot be certain the extra demand will still be there on completion, when you can buy one with an existing market share *and* enjoy the benefits of rationalisation?

But apart from this favourable cultural climate, there are other, more specific biases towards acquisitive growth in Britain. Hoards of City institutions prosper by encouraging the takeover business—merchant banks, stockbrokers, accountants, lawyers and public relations firms. The City's cut from takeovers in 1986 was estimated at over £800 million—boosted no doubt by over-pricing. To take the example of one leading merchant bank, two thirds of Morgan Grenfell's profit of £51 million in the first half of 1986 came from advice on mergers and acquisitions.

Commercial banks also find this activity nourishing. In an age of securitisation—the replacement of traditional lending by the issuance of tradable securities—banks are desperate for profitable lending opportunities. They have thrown money at companies in support of leveraged acquisitions, where the predator finances his bid largely with borrowed money. Although they are still much rarer in Britain than in America, debt-backed bids are growing increasingly popular, especially as a means of allowing small companies to buy much larger ones. Often the intention of such

bids is to break up the target company into several bits, and then sell them off to get the cash to repay the debt.

The arrival of arbitrageurs from New York since the mid-1980s is another factor which has helped swing the balance in favour of hostile bids. Ivan Boesky was an "arb"—someone who buys a stake in a company in the hope another party will subsequently launch a bid and buy them out at a premium. Arbs encourage takeovers, because once a few move in, psychological pressure puts the target company 'into play'. The knowledge that large blocks of stock are held by footlose shareholders is likely to prod a would-be bidder into action.

Thus Pearson (which owns the *Financial Times* and Penguin) suffered when Carlo De Benedetti took 5 per cent; the Italian entrepreneur did not hold for long and flogged his stake to Rupert Murdoch, enabling the Australian to build up a 20 per cent-plus holding by early 1988. Arbs are beloved of free-market theorists: by buying undervalued assets they make stockmarket prices more efficient, they pressure managements to pull their socks up, and they provoke value-adding takeovers.

Britain's archaic accounting system gives takeovers another fillip. Some bidders openly admit that benign accounting rules are a motive for an acquisition—for example FKI when it took over the much larger engineering group Babcock in 1987. The rules of acquisition accounting allow firms to make provisions against putative "reorganisation" costs, which, if subsequently found to be unnecessary, can be fed back into the profit and loss account in future years, giving the illusion of impressive growth.

There is nothing to stop predators undervaluing acquired assets, which maximises the goodwill (the difference between the market value of a company and the value of its physical assets). Goodwill can be written off against capital in one go and so does not hurt profits. In subsequent years profits rise impressively, since companies can make a lower depreciation charge against the falling value of their assets than they should. And they may take huge one-off profits on the sale of an asset which had been undervalued.

While these pressures for takeovers continue, the Government has largely reduced its role in the market. The DTI's 1988 policy document on takeovers reaffirmed the so-called Tebbit guidelines of 1984. The then Secretary of State, Norman Tebbit, shifted merger policy in a more liberal direction. He said that the DTI would refer takeovers to the Monopolies and Mergers Commission primarily, though not exclusively, on competition grounds.

Previously, it was quite common for non-competitive issues to count as the public interest and therefore as grounds for referral. For example, the MMC blocked the Hongkong and Shanghai Bank's 1982 bid for Royal Bank of Scotland on grounds of regional interest. The 1988 document says that issues such as employment, regional development, spending on R&D and foreign ownership do not merit (except in exceptional cases) government intervention. The Tebbit rules are particularly kind to conglomerate bidders, such as Hanson, which by definition tend not to have a prohibitively large market share in any one industry and so can never be stopped on grounds of competition.

The current rules are more laissez-faire than they seem, because even evidently anti-competitive bids are waved through when a special interest can lean on government. Thus the MMC approved British Airways' bid for British Caledonian in late 1987. Fortunately, after the MMC had approved the merger, the European Commission intervened and forced British Airways to unload some of its European routes. By the 1990s, the Commission will take an increasingly interventionist role in European Community mergers and competition policy. That is probably no bad thing, since the Commission—reflecting the views of other member states—is unafflicted by the free-market bias of the British authorities.

7. Some alternatives

A recognition of the visible and invisible costs of our capricious system of takeovers is surprisingly widespread. But if the practice is to be restrained, other means of disciplining and motivating managements are needed. *Attitudes need to be nudged along two distinct but related paths: owners—the institutions—must behave more like managers, while managers (and employees) must behave more like owners.*

The simplest way to reduce over-dependence on takeovers would be to reverse the burden of proof. A bidding company should justify to the authorities not, as at present, that the bid does not harm the public interest; but that it positively promoted it. Other desirable reforms would include the abolition of rigged accounting rules, the provision for employees of a right to be consulted, and a rule that predators should pay their target's costs during a hostile bid.

Despite the complexities involved, it should be possible to decide whether a takeover is in the public interest. A reformed authority—for simplicity's sake the Monopolies and Mergers Commission merged into the Office of Fair Trading—would consider approving a bid if it offered the prospect of high investment and growth; the development of new products, markets and exports; and of job preservation or creation. Given that some companies over-invest or invest in the wrong things, and suffer from over-manning, it is likely that the OFT would sometimes accept cuts in the workforce and in investment. But it would veto bids that appeared to be angled only at short-term rationalisation. Bidders would have to make commitments to the OFT, which, if broken, would warrant severe punishments.

Owners as managers

The growing institutional ownership of industry has not produced the stable support for companies that might have been expected. The increasingly competitive investment strategies of the big institutions has made the individual shareholder, by comparison, seem a paragon of long-termism. Yet, as David Tucker, a former director of the M&G unit trust group, has said: "The institutional investor is much better-equipped to play a proprietorial role than the private shareholder, and the risk that companies will become exposed to a tyranny of government by a few institutions is surely outweighed by the advantages of experience and resource beyond the scope of the largely disorganised private shareholder".

And despite the performance pressure of recent years, there remains an honourable tradition of institutions as stakeholders, rather than mere rentiers. There are some shareholders who accept the obligations as well as the privileges of the corporate relationship—supplying funds for growth, defending companies against opportunistic takeovers and ensuring the appointment of boards of suitable quality.

There have been a handful of cases when a few major shareholders have become interventionist, and acted to change a company's management without changing its ownership. In 1982 Prudential helped install Francis Tombs in the troubled engineering group, Turner & Newell; he subsequently refocussed it and turned it round, rewarding Prudential's effort.

Many institutions evade the issue and

say that they are not equipped to act as management consultants. But that is not good enough. An experienced fund manager has an overview of corporate behaviour and a nose for what makes a company strong or weak that is at least as good as the average management consultant.

The problem is that there are currently few incentives, and plenty of disincentives, for the big investors to become interventionist. Why waste time and money trying to tackle weak managements, when a bid will do it for you?

But in the future, a combination of fewer takeovers and widespread indexation of funds ought to give fund managers the time to get more involved. Some could win the approval of their clients through proving themselves effective interveners, rather than ineffective spotters of undervalued securities. The fund managers themselves would not have to sit on boards: they should seek out and appoint non-executive directors to act as their agents. The objection to such interventionism is the so-called 'free-rider' problem. Big institutions which do devote time to troubled companies complain that they bear the cost when all shareholders—some of them competitors—enjoy a cost-free benefit.

The state could mitigate this problem. A small pro-rata tax could be levied on institutions, to finance an Industrial Management Institute. This would act as a forum for institutional strategies, and provide a pool of experienced non-executive directors and company doctors. If the institutions objected to the tax, the state could fund the venture. The IMI could be run jointly by representatives of the Bank of England, the DTI and the institutions, with the support of a full-time research staff.

The IMI could draw up and monitor a code of corporate conduct. This could cover, for example, the minimum number of non-executive directors that companies should appoint. And the code could insist on fuller disclosure of spending on R&D, training and new product development.

One objection to the idea of an IMI is that if it was to be effective in working out a plan to reform a weak company, it would need access to inside information. But it is already common for institutions to accept restrictions on dealing when they are taken into company confidences; the same would apply to those institutions that became involved through the IMI. The principle is clear: for all their different priorities and timescales, and their greater competitiveness, financial institutions (or at least their customers) have a mutual interest in effective company monitoring. This mutual interest ought to find a collective institutional expression.

Consider the case of sleepily-managed Distillers. The large institutions claim that for years they were individually seeking to force the Distillers board to change its ways. If they had had a means of pressing their complaints *collectively* the ghastly affair of Guinness's takeover would have been unnecessary.

Pension funds

Pension fund trustees also need nudging. Companies appoint them to oversee the management of their pension fund assets, which now account for about 35 per cent of the British stockmarket. Some trustees have been guilty of hypocrisy. On the one hand they demand higher performance from fund managers—implicitly encouraging them to accept opportunistic bids; while on the other hand, wearing their corporate hats, they complain that fund managers are taking too short-term a view of their own companies.

Trustees should play closer attention to the fund managers they employ. If they insisted on a greater disclosure of the fund managers' activities it would help discourage churning and other abuses. Trustees should demand to be consulted on takeover bids, and they should insist that their fund managers play a committed role in monitoring the companies they control stakes in.

In light of the poor performance of most pension fund managers, trustees

should also look closely at the virtues of indexation (see page 5). Or they should lay down clearer guidelines on asset allocation (such as the proportion of a fund allocated between bonds and equities). That could help prevent a repeat of the fund managers' lemming-like rush into equities through the first nine months of 1987, which contributed to the October crash. And trustees could save money by paying fund managers on a fixed-fee basis. At present most fund management companies charge a percentage of funds under management, which allows them to enjoy the rewards of a rising market however poor their relative performance.

Two things hold trustees back from intervening in a bolder fashion. First, they do not have enough time for these issues and are thus easily intimidated by the jargon of fund management specialists. Considering how important pension funds have become as profit centres—some have built up such huge surpluses that corporate managements have declared 'pension fund holidays' during which they cease to make contributions—this amounts to a short-sighted misallocation of management resources.

Secondly, legal restrictions on trustees have encouraged this short-sightedness. Even David Walker, then of the Bank of England, regarded as 'plausible' the view that: "Trust law is no longer able to cope with strains placed upon it by the weight and importance of the modern pension fund, and new pensions legislation may be required . . . to set out more clearly where the responsibilities of trustees lie".

The law's narrow interpretation of the financial interests of current and future pensioners makes an artificial distinction between the individual as employee and as pensioner. For example, it could be in the interests of the individual beneficiary to forgo a slightly higher return on invested funds—especially if these are substantially in surplus—in return for well-paid, secure, current employment.

Trade union trustees have been particularly cowed by the notorious Megarry judgement, which ruled that the National Union of Mineworkers trustees of the Coal Board pension fund could not block investments in foreign countries or non-coal energy firms. Judge Megarry appeared to say that any fettering of investment managers' discretion was wrong, and that the only investment criteria that trustees could lay down was the narrow one of financial returns.

A new Pensions Act could provide a clearer and wider definition of the financial interest of beneficiaries, without exposing funds to excessive risk. Such an act could also lay down the rights and responsibilities of trustees, and a minimum number of employee representatives among the trustees. And it should prevent an acquiror from manipulating a fat pension-fund surplus at a company it buys—for example by adding it to its own pension fund, or by taking a holiday from making further contributions.

Managers and employees as owners

In Britain there is an excessive bias towards public company status. Stockmarkets do provide a reasonable means of evaluating companies and of allocating capital, and a public quote is sensible for most large firms. But by succumbing to the cult of the stockmarket, many firms incur needless flotation expenses and then afterwards have to divert an inordinate amount of management time to investor relations.

A return to Victorian family ownership is not the answer. But a progressive Government should use tax incentives to promote a variety of alternatives to the joint-stock company. Such incentives could encourage managers to keep off the stockmarket, or, for those in public companies, to take their businesses private in a management buy-out. Better still, the Government should promote Employee Share Ownership Plans.

There are plenty of historical cases of

firms that have chosen to insulate themselves from the vicissitudes of the stockmarket. The International Leisure Group, for example, decided in 1987 to go private in a £150 million management buy-out. ILG claimed that its diversification into the airline business involved risks that were not appropriate to a quoted company. Similarly, Air Call, the radio paging group went private in 1986 because it expected that investment in a new product range would depress profits for several years ahead. And Tullis Russell, a Scottish family firm which exports paper and has annual sales of £80 million has chosen to stay private. The firm spent £13 million on a new machine which makes high-quality gloss paper. It took Tullis Russell three years to learn how to use the machine efficiently, but the investment has subsequently proved lucrative. David Erdal, the chairman, reckons that if his firm had been public, the stockmarket would not have been prepared to wait for the machine to work well, and a takeover would have ensued.

Tullis Russell is now (in 1988) planning to launch an Employee Share Ownership Plan. ESOPs have proved popular in America, where about seven million employees work under them. They typically involve the setting up of a trust, which, with borrowed money, buys shares from existing shareholders (or new shares from the company) and distributes them free to workers over a period of years. Thus some shares are held directly by workers, and others are held on the workers' behalf by the trust. The company makes regular payments to the trust, which uses this money to repay the loan. When workers retire they can sell their shares back to the trust. American companies are encouraged to set up ESOPs by a number of tax incentives; for example payments to the trust are tax-deductable, which makes an ESOP a cheaper way of raising fresh capital than a straightforward equity issue.

There have so far been less than a dozen ESOP schemes in Britain, because British law does not recognise the concept and confers no tax benefits. This means that complicated and expensive legal structures, involving two separate trusts, have to be set up to produce the effect of a quasi-ESOP. And families are discouraged from selling their shares to an ESOP because they face stiff capital gains tax, which rose in the 1988 Budget from 30 to 40 per cent. Yet they are encouraged to sell out to a larger firm, since if they are paid with new shares the capital gains tax can be rolled over. Legislation is needed, first, to allow companies' payments to an ESOP trust to be tax-deductable, and second, to excuse family owners from capital gains tax if they sell their shares to an ESOP.

Unlike co-operatives, companies with ESOPs are joint-stock companies and can therefore raise capital in a normal way. Financial institutions are therefore readier to deal with them than with co-ops. Because of the inflexibility of their ownership structure, co-ops can be unsuitable for many larger and middle-sized companies in competitive markets. ESOPs can work well in most sorts of company. They can combine a conventional management structure—allowing some normal shareholders—with many of the advantages of a co-op.

Companies can tailor ESOPs to allow any degree of worker ownership (ie, 10 per cent or 100 per cent), and any degree of worker control (workers may elect some of the trustees, while the trust may elect some of the company's directors). They give workers a stake in their company's growing worth. Studies of America's 7,000 ESOPs show that so long as managers learn to be more communicative to the worker-shareholders, ESOPs stimulate both the motivation of employees and the efficiency of the company.

ESOPs also protect managers from institutional owners who may be tempted to sell to a bidder in return for a quick gain. ESOPs shorten and strengthen the bonds between owners and managers—which is what Britain's current financial system, with its obsessive pursuit of short-term dealing gains, has failed to achieve.

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Making the City work

There is now greater interest than ever in the City of London following the Big Bang, the explosion in salaries, a seemingly never-ending wave of giant takeovers, scandals such as Guinness and Barlow Clowes and the October 1987 stockmarket crash.

In this pamphlet, David Goodhart and Charles Grant look at the role played in the British economy by financial markets. They set out the arguments in favour of using markets to make investment decisions and also review the performance of Britain's financial institutions.

The authors highlight the growing importance of financial services both for employment and earnings. And they rebut the accusation that the City's international bias damages the real economy in Britain. Ruling out a return to exchange controls, Goodhart and Grant suggest that the outflow of capital since 1979 may actually have helped British industry.

Critics of the City are on firmer ground, according to Goodhart and Grant, when they accuse investment managers of 'short-termism'. Despite the strength of academic arguments in favour of the existing stockmarket-based system of industrial finance, the authors find evidence that British industry has not been well-served by the City—especially in takeover battles. A closer relationship between industry and the providers of finance is needed as is found in Japan.

Among their proposals to overcome the divide between industry and the City are the following:

- an Industrial Management Institute to encourage investment institutions to pool their information about companies and co-ordinate policies to improve management;
- new pensions legislation, to protect pension fund surpluses from corporate raiders, and to enable trustees to insist that their fund managers behave responsibly during takeovers;
- a reduction of the systematic bias which favours takeovers: the rules of acquisition accounting, and official policy on mergers need rewriting;
- legislation to make it easier to establish Employee Share Ownership Plans.

Fabian Society

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