Lecture 19

FINANCE & GROWTH: The Control of Capital
I. Financing Industry

II. Financing States

III. The Power of Finance
I. Financing Industry

A. • Industrial Finance

B. Modes of Finance

C. Consumer Finance
Capitalizing Industry

- Industry needs capital
  - Long-term production investment
  - Short-term commercial credit

- Self-finance
  - Big corporations mostly self-financed*
  - Small business mostly bank financed

- Financial institutions
  - Provide commercial credit
  - Bank loans & new stock & bond issues

JK Galbraith, *The New Industrial State*,
Doug Henwood, *Wall Street*
Ties That Bind

- **Finance-industry ties**
  - **Specialists**
    - Banks & investors linked to certain industries
      - E.g., Mellon Bank & steel, VCs & electronics, Bank of America & agriculture
  - **Regionalists**
    - Financing the region & recycling surplus (savings)
      - E.g., San Francisco, Chicago, L.A.
    - Loss of regionalists
      - E.g., Baltimore, New Orleans
Venture Capitalists

- High-risk investors
  - Finance start-ups
  - Put together businesses
  - Channel risk-seeking capital

- Silicon Valley fever
  - Geographic concentrations
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Financial Oversight

- Financial discipline
  - Internal budgeting
  - External evaluation
    - Banks & stock markets
    - Investment advisors

- Reports & audits
  - Accounting firms
  - Making finances public
Allocating Capital

- **Temporal allocation**
  - How much for how long?
  - Patient vs. impatient investors
    - Bank ties, trust funds
    - Fast finance

- **Sectoral allocation**
  - Moving K from industry to industry
    - Profit rate equilization
    - Rising & falling industries
    - Capital markets & oversight
Spatial Allocation

- Geographic shifts in investment
  - Region to region, country to country

**CHINESE BANKS ABSORBED US$32.78B IN FOREIGN CAPITAL**

EH LTN recently learned that, as of the end of Y 2008, 12 countries and regions have set up 28 foreign owned banks, two joint venture banks and two foreign-owned finance companies in China. 75 foreign banks from 25 countries and regions have set up 116 branches in China.
National Models of Finance

- Anglo-American
  - Capital markets > banks
  - ‘Arms-length’

- European
  - Close bank ties
  - E.g., Germany
    - Strong cooperative & regional savings banks
Asian Models of Banking

- Japan
  - Banks & industrial groups

- Korea
  - Chaebol cannot own banks
  - Private + State Banks
    - Industrial Bank of Korea, Korean Development Bank

- China
  - State banks & industry
Liberalization

- Germany
  - Universal banks
- France
  - Denationalization of banks
- Korea & Taiwan
  - After 1997 crisis (IMF)
- China
  - Gradual privatization of banks
I. Financing Industry

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Consumer Credit

- Promotes sales
  - Key durable goods
  - Homes, cars

- Corporations & customers
  - Corporate credit arms
    - GMAC, GE Capital
  - Tied credit cards
    - Airlines, dept. stores

- Banks & consumers
  - Mortgages
    - Mortgage banks
  - Cars & other small loans
Government & Consumers

- Government support for consumer credit
  - Underwriting mass consumption
  - Promoting housing industry

- Loan guarantees & markets
  - FHA, VA & Fannie Mae/Freddie Mac
  - Key role of housing

- Government & infrastructure
  - Public goods
    - Roads, water & sewer, parks
  - Local government debt
US Consumer Debt

- Fed (Greenspan) promoted consumer debt
  - Pump up economy after 1997 & 2000 crises
  - US role in world economy
- Maintaining standard of living
  - In the face of stagnant wages, rising house prices
  - Using homes as ATMs
    - Re-fi boom, 25% of M debt
- Debt bubble blows up
II. Financing States

A. • Financing the State

B. Financing Development

C. External Finance
State Debt & Rise of Capitalism

- Early modern states big borrowers
  - To finance wars & infrastructure

- Rise of the Medici
- Hapsburgs & Fuggers
- Spain & Dutch financiers
The British System

- Bank of England & the state
  - Keystone of 1688

- State bonds & the rich
  - Gather surplus for use
  - Payoff to the wealthy
U.S. Local Debt

- Progressive revolution
- The modern city
- Local debt & infrastructure
- Income tax deduction

State and local governments debt since 1975

State and local governments have accumulated $1.85 trillion in combined debt, up 852 percent from the $194.8 billion combined debt they had in 1975.

Source: The Federal Reserve Board
Graphic by Danny Dougherty - Stateline.org
U.S. National Debt

- Government borrowing
  - Deficit spending
  - For war & stimulus

- Domestic borrowing
  - Paying off the rich

- Foreign borrowing
  - Asian imbalance
  - Where’s the IMF?
  - What future?
Why Global Imbalances?

- East Asian export surplus
  - Build up dollar reserves

- US trade deficit
  - Leaving beyond means

- US as world’s banker
  - Asians buy T-bills & balance US payments

- US interest rates fall
  - Easy credit pushes spending spreee

- Need a new currency regime
  - Dollar-Euro-Yuan
II. Financing States

A. Financing the State

B. Financing Development

C. External Finance
Internal financing

- Most places finance own development
  - Regions (California)
  - Nations (US, Japan, China)
  - Continents (EU, East Asia)
Savings & investment

- Steps to high capital formation
  - Surplus
  - Savings
  - No leakage
  - Reinvestment
  - Capital formation
National savings rates

- Past its peak?
  - Japanese savings rate peaked at 23% of HH income in 1973 and fell to under 3% by 2006.
II. Financing States

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C. • External Finance
External capital

Types of external capital
- Corporate investment
- Government loans
- Bank loans
- Securities (portfolio)

Neo-liberal model
- Open up to all external finance
  - It’s all good

East Asian model
- Selective FDI
  - Learning by doing & studying
  - Capital controls
    - Influx & outflow
  - Walking on two legs
Foreign Direct Investment

- FDI = Investment by foreign firms

- Is it helpful?
  - Industry & jobs
  - Major projects
  - Profit repatriation?
  - Reinvestment
  - Technology transfer
  - Worker training
International Loans

- Most to governments
  - State to state
    - World Bank, Int’l Aid banks, IMF
  - Bank to state
    - Explodes in 1970s

Chart 4
Shortening of debt maturities and crises in developing countries
Ratio of short-term debt to total bank debt

Note: Oil crisis 1 and oil crisis 2 refer to the crises that followed the raising of oil prices by the Organization of Petroleum Exporting Countries in 1973 and 1979.
Portfolio Investment

- Securities investors
  - Government bonds
  - Corp. stocks & bonds

- Growth in 1990s
  - Eclipses bank lending

Figure A.1 Argentina
External Government Debt by Creditor Type
(US$ million)

Source: Authors’ calculations based on Cowan et al. (2006).
What is Done with the Money?

- States
  - Infra. projects
  - State loans & banks
  - Corruption
  - Debt payments
    - Short term debt trap

- Corporations

- How much & how fast can they absorb it?
Hazards of External Finance

- Bank loans
  - Growing debt burden
  - National defaults
    - Mexico 1982, etc.

- Portfolio investment
  - Bubble effects
  - Flight from trouble
III. The Power of Finance

A. • Finance vs. Industry

B. Finance vs. States

C. Finance vs. the People
Non-Productive Finance

- Finance versus industry
  - Finance for its own sake
    - Pursuit of quick profits
  - Parasitic side of finance
    - They want interest & asset value

- Includes business finance, land rents & effect on wages
  - Recall Ricardo & H. George
Finance over the Corporations

- The corporate raiders of 1980s
  - Junk bond financing (Milken)
  - Asset stripping

- Profit seekers of 1990s
  - New managers & profit sharing
  - Short term & stock price

- Smartest guys in the room
  - Hollow corporations
Finance Über Alles?

- Finance earns 40% of US corporate profits
  - (without hedge funds)

- C. Romer to bankers, “Go make something”
III. The Power of Finance

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Finance & Poor States

- **Banks & the IMF**
  - Extract their pound of flesh
  - Demand restructuring

- **Virtues of bankruptcy**
  - Works for corporations
  - Works for nations (but not legal)

- **Paying down debt**
  - Path to independence (Brazil)

- **Revenge of the state**
  - Putin & the Russian oligarchy
Revenge of the Bankers

- Finance under wraps in postwar era

- 1970s turning point
  - Era of low returns
    - Inflation & wages – the bankers’ tradeoff
  - Finance unleashed
    - Eurodollar & the banks
    - Freeing the securities markets
    - Derivatives & financialization
Political Power of Finance

- Who rules?
  - The Parties of Wall Street
  - Merry-go-round
    - Rubin, Simon, Geitner, Volcker, Summers, Paulson et al
III. The Power of Finance

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C. • Finance vs. the People
Finance Vs. the People

- Implications for democracy
  - Is financial power a threat?

- American Populist tradition
  - Jefferson, Jackson, & the early Republic
  - Farmer Populists & Progressives
  - New Deal restraints
Popular Anger

- General sense of abuse
  - Bankers bonuses
  - Mortgage foreclosures

- Often confused
  - Blame government/party in power
  - Blame Jews - Anti-Semitism
  - But rarely capitalism