



DOUG HENWOOD

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WALL STREET

*How It Works
and for Whom*



DOUG HENWOOD



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Contents

	Acknowledgments	ix
	Introduction	1
1	Instruments	10
2	Players	56
3	Ensemble	118
4	Market models	137
5	Renegades	187
6	Governance	246
7	What is (not) to be done?	301
	Appendix	323
	Bibliography	333
	Index	357

Introduction

It's rare that someone should develop an obsession with Wall Street without sharing its driving passion, the accumulation of money. It would probably take years of psychoanalysis to untangle that contradiction, not to mention others too sensitive to name here.

No doubt that contradictory obsession has early roots, but its most potent adult influence was probably my first job out of college, at a small brokerage firm in downtown Manhattan. The firm had been started by a former Bell Labs physicist, who wanted to use his quantitative skills to analyze and trade a then-new instrument known as listed options. The refugee physicist was considerably ahead of his time; few people understood options in 1975, and fewer still were interested in using the kinds of high-tech trading strategies that would later sweep Wall Street.

My title was secretary to the chairman, which meant not only that I typed his letters, but also that I got his lunch and even went out to buy him new socks on those occasions when he'd left his old ones in a massage parlor. On a more elevated plane, I did a little computer programming to test out his trading strategies. And I studied the place like an anthropologist, absorbing the mentality and culture of money. It was fascinating in its own way, but it also struck me as utterly cynical and empty, a profound waste of human effort.

One morning, riding the elevator up to work, I noticed a cop standing next to me, a gun on his hip. I realized in an instant that all the sophisticated machinations that went on upstairs and around the whole Wall Street neighborhood rested ultimately on force. Financial power, too, grows out of the barrel of a gun. Of course a serious analysis of the political economy of finance has to delve into all those sophisticated machinations, but the image of that gun should be kept firmly in mind.

On what is loosely called the left, such as it is these days, two unhappy attitudes towards modern finance prevail — one, the everything's-changed-and-capital-no-longer-matters school, and two, a stance of uninformed condemnation. An example of the first is this silly but representative eruption from Jean Baudrillard (1993, pp. 10–11, 33):

Marx simply did not foresee that it would be possible for capital, in the face of the imminent threat to its existence, to transpoliticize itself, as it were: to launch itself into an orbit beyond the relations of production and political contradictions, to make itself autonomous in a free-floating, ecstatic and haphazard form, and thus to totalize the world in its own image. Capital (if it may still be so called) has barred the way of political economy and the law of value; it is in this sense that it has successfully escaped its own end. Henceforward it can function independently of its own former aims, and absolutely without reference to any aims whatsoever.... Money is now the only genuine artificial satellite. A pure artifact, it enjoys a truly astral mobility; and it is instantly convertible. Money has now found its proper place, a place far more wondrous than the stock exchange: the orbit in which it rises and sets like some artificial sun.

This isn't that surprising from a writer who can ignore a couple of hundred thousand Iraqi deaths and declare the Gulf War a media event. But it displays an understanding of finance apparently derived from capital's own publicists, like George Gilder, who celebrate the obsolescence of matter and the transcendence of all the old hostile relations of production. Cybertopians and other immaterialists are lost in a second- or even third-order fetishism, unable to decode the real relations of power behind the apparently disembodied ecstasies of computerized trading.

And, on the other hand, lefties of all sorts — liberal, populist, and socialist — who haven't succumbed to vulgar postmodernism have continued the long tradition of beating up on finance, denouncing it as a stinkpot of parasitism, irrelevance, malignancy, and corruption, without providing much detail beyond that. Many critics denounce "speculation" as a waste of social resources, without making any connections between it and the supposedly more fundamental world of "production." Sociologists who study power structures write portentously of "the banks," but their evidence is often vague and obsolete (see, for example, Glasberg 1989b, a piece written at the end of one of the great financial manias of all time that nonetheless relies heavily on evidence from the 1970s). It's as if such people stopped thinking and collecting evidence 20 or even 60 years ago.

INTRODUCTION

This book is an attempt to get down and dirty with how modern American finance works and how it's connected to the real world. It's a system that seems overwhelming at times — almost sublime in its complexity and power, reminiscent of Fredric Jameson's (1991, pp. 39–44) reading of John Portman's Bonaventure Hotel, at once packed and empty, a spatial analogue of our disorientation as subjects in the dizzy world of modern multinational capitalism. (It seems especially dizzying as I write this in early 1997, with the U.S. stock market at or near its highest levels of valuation in 125 years, and the broad public the most deeply involved it's been in decades, and maybe ever.) As an antidote to that sense of disorientation, Jameson suggested the need for “cognitive mapping,” critical expositions of that vertiginous world that remind us that despite its vast scope, it is the product of human intelligence and society, comprehensible with a little effort, and maybe even transformable with a little more.

In a soundbite, the U.S. financial system performs dismally at its advertised task, that of efficiently directing society's savings towards their optimal investment pursuits. The system is stupefyingly expensive, gives terrible signals for the allocation of capital, and has surprisingly little to do with real investment. Most money managers can barely match market averages — and there's evidence that active trading reduces performance rather than improving it — yet they still haul in big fees, and their brokers, big commissions (Lakonishok, Shleifer, and Vishny 1992). Over the long haul, almost all corporate capital expenditures are internally financed, through profits and depreciation allowances. And instead of promoting investment, the U.S. financial system seems to do quite the opposite; U.S. investment levels rank towards the bottom of the First World (OECD) countries, and are below what even quite orthodox economists — like Darrel Cohen, Kevin Hassett, and Jim Kennedy (1995) of the Federal Reserve — term “optimal” levels. *Real* investment, that is, not buying shares in a mutual fund.

Take, for example, the stock market, which is probably the centerpiece of the whole enterprise.¹ What does it do? Both civilians and professional apologists would probably answer by saying that it raises capital for investment. In fact it doesn't. Between 1981 and early 1996, U.S. nonfinancial corporations retired over \$700 billion more in stock than they issued, thanks to takeovers and buybacks. Of course, some individual firms did issue stock to raise money, but surprisingly little of that went to investment either. A *Wall Street Journal* article on 1996's record-breaking pace of stock issuance (McGeehan 1996) named overseas privatizations (some

of which, like Deutsche Telekom, spilled into U.S. markets) “and the continuing restructuring of U.S. corporations” as the driving forces behind the torrent of new paper. In other words, even the new-issues market has a lot more to do with the arrangement and rearrangement of ownership patterns than it does with raising fresh capital — a point I’ll return to throughout this book.

But most of the daily trading in the stock market is of existing shares, not newly issued ones. The record-breaking number for 1996 looks likely to be around \$110 billion — but that yearly total would be dispensed with in about a week’s trading on the New York Stock Exchange.²

One thing the financial markets do very well, however, is concentrate wealth. Government debt, for example, can be thought of as a means for upward redistribution of income, from ordinary taxpayers to rich bondholders. Instead of taxing rich people, governments borrow from them, and pay them interest for the privilege. Consumer credit also enriches the rich; people suffering stagnant wages who use the VISA card to make ends meet only fatten the wallets of their creditors with each monthly payment. Nonfinancial corporations pay their stockholders billions in annual dividends rather than reinvesting them in the business. It’s no wonder, then, that wealth has congealed so spectacularly at the top. Chapter 2 offers detailed numbers; for the purposes of this introduction, however, a couple of gee-whiz factoids will do. Leaving aside the principal residence, the richest 1/2% of the U.S. population claims a larger share of national wealth than the bottom 90%, and the richest 10% account for over three-quarters of the total. And with that wealth comes extraordinary social power — the power to buy politicians, pundits, and professors, and to dictate both public and corporate policy.

That power, the subject of Chapter 6, is something economists often ignore. With the vast increase of government debt since the Reagan experiment began has come an increasing political power of “the markets,” which typically means cuts in social programs in the name of fiscal probity. Less visibly, the increased prominence of institutional investors, particularly pension funds, in the stock market has increased rentier power over corporate policy. Though globalization and technology have gotten most of the blame for the recent wave of downsizings, the prime culprits are really portfolio managers demanding higher stock prices — a demand that translates into layoffs and investment cutbacks. This growth in stockholder influence has come despite the fact that outside shareholders serve no useful social purpose; they trade on emotion and perceptions of emo-

INTRODUCTION

tion, and know nothing of the businesses whose management they're increasingly directing. They're walking arguments for worker ownership.

This book concentrates almost entirely on American markets. That's not only for reasons of the author's nationality, but also because the U.S. (and British) financial system, with the central role it accords to loosely regulated stock and bond markets, has been spreading around the globe. Henry Kaufman (1994) called this "the 'Americanization' of global finance." The World Bank and its comrades in the development establishment have urged a stock-market-driven model of finance and corporate control on its client countries in the Third World and the former socialist world, and the English-language business press is full of stories on how the Germans and Japanese are coming to their senses, or have to if they know what's good for them, and junk their stodgy old regulated, bank-centered systems for a Wall Street/City of London model. And all evidence is that they are, though never quickly enough for the editorialists.

Also, the international financial markets, which Japanese and German investors participate in, resemble the Anglo-Saxon system in all their looseness and speed. Finally, the stock market has become a kind of economic ideal in the minds of neoliberal reformers everywhere: every market, whether for airline tickets or human labor, has been or is being restructured to resemble the constantly fluid world of Wall Street, in which prices float freely and arrangements are as impermanent as possible. For these reasons, a study of the U.S. financial markets, particularly the stock market, could be of interest to an audience beyond those specifically curious about the American way of financial life.

This book inhabits a strange world between journalism and scholarship: the first three chapters in particular look at the empirical realities of the financial markets — the instruments traded and the agents doing the trading — and then the fourth and fifth chapters look at some of the things economists have said about finance over the past two centuries. I hope that I've managed to bring the two normally separate worlds together in an illuminating way, but of course the risk is that I'll only succeed at alienating both the popular and the academic audience. It's worth the risk. Most financial journalism is innocent of any theoretical and historical perspective, and academic work — mainstream and radical — is often indifferent to daily practice.

I must confess that I am not a "trained" economist. For someone not initiated into the priesthood, several years spent exploring the professional

literature can be a traumatic experience. One of the finest glosses on that experience came long ago from, of all people, H.L. Mencken, in his essay "The Dismal Science": "The amateur of such things must be content to wrestle with the professors, seeking the violet of human interest beneath the avalanche of their graceless parts of speech. A hard business, I daresay, to one not practiced, and to its hardness there is added the disquiet of a doubt." That doubt, Mencken wrote — after conceding that in things economic he was about as orthodox as they come — was inspired by the fact that the discipline

hits the employers of the professors where they live. It deals, not with ideas that affect those employers only occasionally or only indirectly or only as ideas, but with ideas that have an imminent and continuous influence upon their personal welfare and security, and that affect profoundly the very foundations of that social and economic structure upon which their whole existence is based. It is, in brief, the science of the ways and means whereby they have come to such estate, and maintain themselves in such estate, that they are able to hire and boss professors.

Apostates, Mencken argued, were far more unwelcome in the field than in others of less material consequence (like, say, literary studies).

There are few subspecialties of economics where this is truer than in finance. The bulk of the finance literature consists of painfully fine-grained studies designed for the owners and managers of money capital. Important matters, like whether the financial markets serve their advertised purpose of allocating social capital effectively, are studied with an infrequency surprising only to someone unfamiliar with Mencken's Law.

But the violet of interests is no longer hidden behind graceless parts of speech alone; mathematics is now the preferred disguise. The dismal science now flatters itself with delusions of rigor — an elaborate statistical apparatus built on the weakest of foundations, isolated from the other social sciences, not to mention the broader culture, and totally dead to the asking of any fundamental questions about the goals of either the discipline or the organization of economic life itself.

I do ask, and I hope answer, lots of those difficult questions, but I also want to take on the dismal scientists on their own terms. For many non-specialist readers, this may seem like heavy going. I've tried, wherever possible, to isolate the heavily technical bits and plaster appropriately cautionary headlines on the dangerous sections. But too much writing these days, and not only on the left, consists of anecdote, narrative, moralizing,

INTRODUCTION

and exhortation. Even though both the financial markets and the discipline of economics have penetrated so deeply and broadly into much of social life, these institutions remain largely immune to critical examination. The next 300 pages undertake that examination, and perhaps in more detail than some readers might like, but I don't ever want to lose sight of this simple fact: behind the abstraction known as "the markets" lurks a set of institutions designed to maximize the wealth and power of the most privileged group of people in the world, the creditor-rentier class of the First World and their junior partners in the Third.

I've committed at least two commercial sins in writing this book — one, the omission of practical investment advice, and two, going lightly on scandal-mongering and naming of rotten apples. As penance for the first, I'll offer this bit of advice: forget about beating the market; it can be done, but those who can do it are rare. And for the second: pointing to rotten apples implies that the rest of the barrel is pure and refreshing. My point is that the entire batch of apples is pretty poor nourishment. By this I don't mean to imply that everyone who works in finance is devious, corrupt, or merely rapacious. There are many fine people who underwrite, analyze, trade, and sell securities; some of them are my friends and neighbors. Their personal characteristics have nothing to do with what follows. That's the point of a systemic analysis — to take apart the institutions that are larger than the personalities who inhabit them.

As I wrote this introduction, many figures in this book are a couple of releases out of date. The U.S. stock market has continued to rise, to truly extraordinary levels of valuation, the highest since modern records begin in 1871. In the past, high valuations have been associated with nasty subsequent declines, but it's always possible this is a new era, a Nirvana of capital, in which the old rules don't apply. If Social Security is privatized, it could constitute an official stock price support mechanism. But this manic bull market has come along with the weakest growth of any business cycle expansion since World War II; though the stock market's rise has helped fuel talk of a new Golden Age, it's hard to read in the standard statistics.

Households — presumably mostly in the upper half of the income distribution — plunged into stocks (through the medium of mutual funds) in a way not seen in 30, or maybe 70, years. At the same time, households — presumably poorer ones than the mutual fund buyers — have also continued to get deeper in debt, and with record debt levels matched by record bankruptcy filings. The more a society polarizes, the more people on the bottom borrow from those on the top.

When I started this book, the prestige of Anglo-American stock-market-centered capitalism was a lot lower than it was when I finished it. I say a few kind things about Japanese and Germanic systems of corporate finance, ownership, and governance that would have been taken as semi-respectable in 1992. In 1997, it is deeply against the grain (though not as against the grain as saying kind things about Marx). But I'll stick to my position. The stagnation of Europe has a lot less to do with rigid structures and pampered citizens than it does with fiscal and monetary austerity dictated by the Maastricht project of unification. To blame Japan's problems on overregulation is to ignore that the 1980s bubble was the product of partial deregulation and a speculative mania. And to treat a space of five years as the last word on the subject is to ignore 40 previous years of strong, and in Japan's case staggering, economic growth. Growth rates in Asia over the last several decades have no precedent in the history of capitalism; they're two or three times what the U.S. and Britain experienced at their peaks. In most Asian cases, growth was promoted by strict regulation of finance and trade by an interventionist state.

It's not clear why the weakest U.S. expansion in decades should be taken as vindication of the American Way. It may be as capitalisms mature, financial surpluses break the bounds of regulated systems, and force an American-style loosening of the bonds. Moving beyond this technocratic terrain, to say a U.S.-style system "works better" doesn't say what it's better at. U.S. financial and ownership relations, which are fragmented, abstract, and manic, seem deeply connected to other social mechanisms — partly as causes, partly as effects — that make this such a voracious, atomized, polarized, turbulent, often violent culture, one that insists each of us be in competition with every other. If this is success, then the U.S. model is a great success. It may even be partly duplicable in countries interested in a fresh lifestyle strategy.

After several hundred pages of diagnosis, readers have a right to expect a prescription for cure at the end. I've tried to fulfill that, but the final chapter is short and mainly suggestive. I could get high-minded and say that the reason for that is that a transformative agenda is worth a book in itself, which is true enough. But another reason is that financial reforms are no easy or isolated matter. Money is at the heart of what capitalism is all about, and reforms in the monetary sphere alone won't cut much ice. If you find the hypertrophy of finance to be appallingly wasteful and destructive then you're making a judgment on capitalism itself. That's not very chic these days, when Gen-X financial tipsheets treat mutual funds as

INTRODUCTION

the pinnacle of hipness, and small investors believe that by plunging into the markets they're doing something bravely self-reliant, but if I thought that this cultural pathology would persist forever, then I wouldn't have written this book.

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New York, March 1997

notes

1. In many ways, credit markets are more important, but they don't enjoy the same attention from the broad public, nor do they inspire the same lusts that stocks do.
2. Despite the prominence of the stock market, daily trading volume in U.S. Treasury securities is about ten times that of the NYSE — about \$180 billion in federal paper in early 1996, compared with \$18 billion in stocks.

1 Instruments

In May 1996, \$1.25 trillion a day crossed the wire connecting the world's major banks. That figure — which captures most of the world's financial action with the U.S. dollar on at least one side of the trade — was a mere \$600 billion around the time of the 1987 stock market crash. After that inconsequential cataclysm, daily volume resumed its mighty rise, passing \$800 billion in 1989, and \$1 trillion in 1993 (Grant 1995, 1996). It is a prodigious number: an amount equal to a year's U.S. gross domestic product (GDP) turns over in a week, and total world product in about a month.

Where does it all come from, and where does it go? Open the *Wall Street Journal* or the business section of a major metropolitan daily, and you get a clue. Every day, they publish an overwhelming array of price quotes — thousands upon thousands — for stocks, bonds, currencies, commodities, options, futures, options on futures, indexes, options on indexes, mutual funds.... If you own a hundred shares of Iomega, or you're short wheat for April delivery, then you have no problem deciding what they all mean — your money is at stake. But do all these prices, with acres of type and graphics devoted to analyzing and charting their often fevered movements in loving detail, have any meaning beyond the narrowly mercenary? Is the movement of the Dow, reported in about 30 seconds on every evening network newscast, of interest to anyone besides the minority of the population that owns stocks, or the 1% of the population that owns them in meaningful quantity? And do these price gyrations have any relation to the other news reported in the paper or on TV — to the fate of corporations, to the real standard of living, to our public lives?

Figuring that out has to start with a picture of the elements of this financial universe — the instruments and institutions that construct the claims that people make on each other over time and space. These claims are denominated in money, the stuff that economists study, but economists

forget that money is a form of social power. One of the persistent delusions of conventional theory is that money is “neutral,” a lubricant with no influence of its own, one that merely simplifies transactions in an economy based on the exchange of goods.¹ In a barter economy, the seller of wheat would have to find a personal buyer; in a money economy, the wheat-holder can sell for money, and let the system take care of the rest.

Money is a richer phenomenon than that explanation allows; it is one of our fundamental principles of social organization. Ownership is represented through monetary claims, and the exchange of those claims in the financial markets amounts to the social construction of ownership.

Over the last decade or so, these “markets” — usually conveniently referred to as an anonymous external force, as pervasive and inevitable as gravity — have grown enormously. It’s a cliché of the daily press that the markets are now more powerful than governments, that the daily votes cast by the bond and currency markets are more important than elections, legislatures, and public budgets. The cliché contains a partial truth: these markets are tremendously powerful. But they are social institutions, instruments of power, that derive their power in part from the sense of powerless awe they inspire among non-initiates. Say “the markets won’t like” a minimum wage increase or a public jobs program, and critical scrutiny often evaporates, like wishes crushed by the unfriendly voice of God.

While modern financial markets seem sublimely complex, they’re essentially composed of several basic instruments and institutional participants. Most of the instruments, despite their apparent novelty, are quite old, their age measured better in centuries than decades.

What are these markets, and who populates them?

stocks

To many people, the stock market is Wall Street, and the New York Stock Exchange (NYSE) is the stock market. A recent edition of Paul Samuelson’s warhorse economics text even described the exchange as the “hub” of capitalism, with no further explanation. Geography reinforces this perception; the NYSE stands at the intersection of Broad and Wall, at the spiritual epicenter of Manhattan’s financial district. But in fact, stock market trading volume is dwarfed by trading in bonds and foreign exchange, and the NYSE itself accounts for a declining share of stock market volume.

These mere facts aside, there is some justification in giving the stock market the prominence it enjoys in the popular mind. But one notion that

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must be quickly dismissed is the idea that the market raises lots of capital for real investment.² Corporations typically sell large blocks of stock when they go from private (a small circle of family or otherwise tight owners) or state hands (in a privatization) to “public” hands. It goes without saying that a very narrow segment of the public is involved. Afterwards, public firms rarely issue significant amounts of stock, and new flotations are but a blip in the chart of corporate cash flows. Since the early 1980s, thanks to buyouts and buybacks, more stock was retired than newly floated, transactions that were mostly funded through heavy borrowing.

But just because the stock market plays a very minor role in raising investment finance doesn't mean it's a sideshow. Shares of stock represent ownership claims on an economy's real productive assets, and claims as well to a portion of the present and future profits generated by those assets. Though managers of public corporations enjoy partial autonomy — just how much is a matter of dispute — they are the hired agents of the stockholders, and ultimately answerable to them. In moments of crisis, stockholders can intervene directly in the running of their corporation; in more normal times, pleasing investors, which means pushing up the stock price, is a prime managerial concern. Failures to please are punished by a chronically low stock price, a condition that can be an invitation to a take-over. In mainstream theory, this is how the market disciplines managers; that it doesn't work very well is one of the themes of this book.

Stock comes in many flavors. Most prevalent — 98% of the market value of the NYSE, almost all the Nasdaq — is common stock. Common stockholders have the last claim on a corporation's income and assets; though firms will occasionally stretch to meet a dividend, dividends are normally paid after interest owed to creditors — making common stockholders “residual claimants” in legal jargon. After debtholders but ahead of common stockholders are holders of preferred stock, who must be paid all dividends due them before owners of the common stock can get a penny. In a bankruptcy, common stockholders are often wiped out; creditors and holders of the preferred get paid off first. Common's allure is that if a corporation does well, creditors and preferred stockholders can be easily satisfied, and the excess juice all goes to the stockholders.

evolution from a founding principle

Today's stock markets have their roots, as do many institutions of modern finance, in medieval Italy, though unlike the more sophisticated early Italian financial institutions, their early stock markets were pretty rudimentary.