

On Anwar Shaikh's treatment of Stock Exchange *

by Nasser Saber

(January 2000, New York)

Statement of the Problem

Let us follow three entrepreneurs who plan to produce two different products A, B and C. They prepare a detailed plan and concludes that to build the plant, buy the equipment and raw materials, hire workers and start production they need \$10 million, \$30 million and \$40 million, respectively.

The first two entrepreneurs, like so many men of ideas, have no money of their own, so they decides to raise the funds from people who might be interested in the venture. So, they incorporates two companies A and B and offer 1,000,000 shares of each company at \$10 and \$30, respectively to the public. The offering is a success and the shares are all sold. Entrepreneur A has \$10 million. Entrepreneur B has \$30 million.

With \$10 million in hand, entrepreneurs A and precede to build the plants, purchases the equipment, hires the workers and begins producing products A and B, respectively.

Entrepreneur C, unlike the two, is a wealthy man himself. He does not need to raise fund from others. He simply writes a check for the amount of \$40 million from his own account and pay for building plant, equipment, etc., with his own money. After a while, his production apparatus is also ready. He can now start producing product C.

What is Shaikh Saying?

Shaikh is saying two things. First, he is saying this: if the rate of return in one industry is below (above) the average, capital will leave (flow to) that industry.

That is obvious. Everyone agrees on that. I do too! In our example, if products A and C return 12% and B, 8%, no one will invest in the production of product B. Of course in real life, the rate of return is rarely exactly equal across various industries in a given year. But over long run, this rate indeed tends to be more or less equal. If not, the industry that is consistently less profitable will die from lack of investment. Such was the case, more recently, with the steel in the US. The entire Ohio and Pennsylvania steel mills were shut down and let to rust. In theory, the equality of the rate of return—more accurately, the tendency of the rate of return to be equal across various industries – is accepted by all theorist, as it should be.

Shaikh's Problem

So far so good. Nothing new there. But then like many academics who do not know the difference between various form of capital, Shaikh brings in the “financial sector” and the

* The text by Anwar Shaikh referred to by the present Nasser Saber's paper is *The Stock Market and the Corporate Sector. A Profit-Based Approach*. New School for Social Research, New York, 1995.

“stock exchanges” as a different, independent line of industry. In doing so, he unravels everything he has said. To see how, let us go back to our three industries and product lines.

Industrial and Finance Capital

Products A, B and C could be any three industries such as computers, cars and fertilizers. Or chemicals, gambling and housing. Or railroad, airlines and cosmetics. But financial industry is not one of these “manifold sectors.” We should not confuse industrial and finance capital. There is an important difference between the social form which gave rise to industries A and B, versus industry C.

Let us look at A and B first.

Entrepreneurs A and B raised \$10 million and \$30 million, respectively, from investors. An investor who bought 1000 shares of company A, parted with \$10,000 of his money and, in return, received a receipt in the form of a stock certificate evidencing the ownership of 1000 shares. Likewise, an investor who bought 1000 shares of company B, parted with \$30,000 of his money and, in return, received stock certificates evidencing his ownership of 1000 shares of B.

Now, what happens if these two investors, in A and B, want to get their money back? They certainly cannot go to entrepreneurs A and B and demand their money. Their money, together with the money of other investors, is “invested” in factory. It is SPENT. Furthermore, that money does not exist twice, once in the form and raw material, assembly line, workers’ wages, etc., and second time, in the hands of investors. With money being already spend on production apparatus, what investors in A and B have is evidence of a capital which does not really exists. It is a virtual, a “notional” capital. That is the mystery of the definition of a “security” which had bedeviled the scholars of securities law for more than half a century and which solved in beginning of Chapter 2 of Vol. 1 and then, in more detail, in Chap. 4 of Vol. 2

What happens if investors in A and B really want their money back? Is there no other way for them to do so? Of course there is. It is called securities or stock market. They can go to a stock market and sell their shares to a new investor. The new investor will pay \$10,000 to A and \$30,000 to B and buy their 1000 shares of companies A and B from them. After this exchange, the original owners of the stock have money but no capital. Their original money which was converted to capital because it was invested in production apparatus is back to money form again. Capital earns profit, as they did from 12% return of companies A and B. Money does nor earn profit. Money, taken out of the circuit of capital, is money alone. It can be hidden inside a mattress but does not increase in quantity.

Of course, for simplicity we assumed that the shares in companies A and B trade for their original price of \$10 and \$30, respectively. In real life, the price of securities in the securities market have their own dynamics which can be seemingly independent of the rate of return of capital earned by producing products A and B. Indeed the biggest mystery of the rise in the stock market in the US have been the total disregard of P/E ratios. Historically, one would expect if product A produces a 12% rate of return, i.e., \$1.2 a year, its price would be between 10 to twenty times its earning, say \$12 to \$24. In the current climate in the US, the P/E ratio of technical stock is well over 100. In many cases, it is infinity [!] because the stock has no earning at all. Chief among them is Amazon. The joke in Wall Street is that if one day Amazon shows 1 cent profit, the stock market will crash! Now why the stock of a company with no earning hits \$400 is something that is impossible to understand unless one knows what Speculative Capital is. But I am getting too far off the subject. Let us return to our subject.

More on Industrial and Finance Capital

What about entrepreneur C? What is his situation? What happens if HE wants to cash in his investment?

Recall that entrepreneur C did not raise money from outside investors. The entire \$40 million he spent on production apparatus is his own. As such, he has no partners, no investors, and he has issued no securities. The entire profit from the production of C is his. He is an industrialist. And his capital is industrial capital.

If entrepreneur C wants to get his money back, he has to sell the entire business. For that, he has to find someone with \$40 million. That is a considerably more complicated job than finding, say, 1000 investors with \$40,000 each. Of course, finding 1000 investors with \$40,000 also seems difficult, but over time, institutions grew which attracted the capital of many investors, pooled them and then directed it towards one large investment. These institutions—banks and investment houses – attracted the capital of many investors with the idea of investing them in opportunities they saw promising. In our example, we assumed entrepreneurs A and B went to 1000 different investors and sold 1000 share to each. In reality, this is impracticable. Entrepreneurs do not have time and cannot reach 1000 investors. Rather, investors put their money in a bank or investment house and the entrepreneurs then approach a single investment house which invests the money on behalf of investors and get some commission for itself. That is called “going public” which is now very popular with internet stocks in the US.

The pool of money so gathered in one place is finance capital. The rise of finance capital gradually overpowers industrial capital, which, because it is limited to fortunes of few, cannot compete with its new cousin. That is why in the early 20th century, we see J. P. Morgan the financier is able to buy the steel mills of Andrew Carnegie the industrialist and incorporate them into a large trust called US Steel. J. P. Morgan also controlled virtually all private railroad lines in the eastern US. Railroad construction by nature demanded huge outlays of capital. It was also risky. No single person could command sufficient capital to build his own railroad and undertake all the risks. That was possible only through pooling capital from various sources. Finance capital was going to be the king.

A Closer Look at Shaikh

According to Shaikh, and here I am quoting you (Paolo Giussani, *ndr*), “capitals move into and away from the stock market exactly for the same reasons that they move into and away from any other sector of the economy - namely the search of a higher rate of profit.”

What does this statement mean? If the rate of return of A is greater than that of B, no one will invest in B. That we agreed on. Let us now assume that the rate of return of B falls after a few years. In that case, investors will sell stock B and buy stock A. Remember: we have a total of \$10M + \$30M + \$40M=\$80M in investment. So the money is shifted from one area of the stock market into another. When Shaikh says that capital “moves away from the stock market,” he assumed that the rate of profit of A AND B is very low. But compared with what? If it is compared with credit capital—the bonds—finance capital will then find its way into the bond market. No mystery there. As a investor in Eurobonds, you know that very well. But of course the bond market is not a corporate sector. So where else can capital go to give a meaning to Shaikh’s assertion? May be product C then becomes very attractive. But there are no shares to be purchased in C. So two things have to happen: Either entrepreneur C will be given so much money for his interest that he will sell his company – remember, that is called going public – or, because he refuses to sell, finance capital will find entrepreneur C1, will make available to him \$40 million, which just left the stock market, and ask him to make a plan to produce profitable

product C. In either case, because it is FINANCE CAPITAL that is underwriting the operations, the money will be shifted within the stock market itself. That is, either company C will issue new shares and new company C1 will issue shares. There is NO WAY that capital can leave the stock market. That means that finance capital must disappear. And saying that is laughable, to say the least. (If the 2000 investors who have put a total of \$40 million into A and B withdraw their capital, what would they do with it? If they put it into a “corporate sector,” a new factory for producing profitable C, by definition, C must have shares –because many shareholders have invested in it—and that would mean that the value of stocks of A and B will drop to zero and the value of capital invested in C and/or C1 will increase to \$80 million.)

More Critical Comments on Shaikh!

1. Shaikh’s assertion that the only difference between the “corporate sector” and “stock exchange investments” is that buying and selling stock is short term[!] is nonsense. You can buy a stock and keep it for 50 years. That is what the pension funds in the US do. But I know why he is saying that: he knows it is much easier to buy or sell 1000 shares of company A or B than to sell a \$40 million factory C. But that is the difference between the industrial and finance capital which we already know and Shaikh doesn’t.
2. I don’t know how Shaikh’s “empirical” analysis is constructed. Presumably, he was comparing the return of stock of A and B against the return of privately held C. Privately held companies do not even have to disclose their earnings (in the US). Anyway, maybe he was able to find a few such private enterprises in the 1960’s which were worth analysing. As you pointed out, after the breakdown of the Bretton Woods system and the rise of Speculative Capital and total dominance of finance capital, private companies are in no position to “compare” their return with corporations (which have shares and are thus, backed by finance capital!) Nowadays, in the US, I am not aware of a single privately held company –what Shaikh calls “corporate sector”—which can plausibly be compared with giant corporations. The latest private company of any significance were Goldman Sachs and UPS, both of which went public last year. Of course, there are many privately held grocery stores and shoe stores in New York and their rate of return in numerical terms might also be better than anything available in the stock market but I doubt they can absorb the trillions of dollars that is invested in the stock market. So I am afraid the turbulent arbitrage between them and the stock market is not possible!
3. Finally, there is the question of industrial companies “buying and selling shares to make more profit.” Here, we have to use a precise language.

Company A is incorporated to produce product A. It can only do that and nothing else. The business of IBM, for example, is building computers, etc. Now if IBM sells its headquarter and makes a profit of \$200 million, accountants will obviously recognize it as such, but will categorize it under “special items.” That is the LAW. I am sure that is also the case in Italy. All corporations have a “purpose,” which states what line of business they are in. Any profit made outside that line is to be recognized separately (the function of IBM, after all is not buying and selling buildings).

Now, if company A decides to use its profits and buy the shares of company B because the rate of return in B is thought to be higher, that act is strictly illegal. In the US, the financial officer of company A who make such decision will be fired. He/she might even go to jail. Note the difference between making a profit in selling a building and making a profit in buying and

selling stocks. In the first case, the transaction is incidental to company's business. Many companies buy buildings for their own use and later might find it too small for the purpose. Consequently, they might want to sell it. But there is no such justification for buying and selling stocks. It is strictly prohibited, unless that is your business. That is, unless you are a bank or an investment bank, which is of course a different story. (A company can also buy back ITS OWN stock. That is allowed because it does not constitute purchasing securities.)

But what about company B incorporating a new entity with the specific purpose of buying and selling stocks?

Until the collapse of the Bretton Woods system, even that was prohibited. Now under the pressure of finance capital, it is allowed. Indeed, as I state in Chapter 3 of Vol. 1, the trend for industrial companies to create a "finance" subsidiary is difficult to miss. General Motors has a huge and profitable GM finance Corporation. General Electric's 60% of profits come not from electrical or even defence produce but from its subsidiary, GE Capital. Sears, a major retailer, is making money mostly thanks to its credit card division.

What do these examples show? They show that finance capital is becoming ever more dominant, meaning it generates higher rate of return and is thus more attractive. When General Electric directs its profits to its GE Capital subsidiary, it is saying that investing money in lending and buying and selling stocks is more profitable than making electrical appliances. When that happens, money does indeed move from "corporate sector" to the stock market, to use a Shaikh terminology. But the important point that he misses is that there is no arbitrage because the movement is always one way: from corporate sector the stock markets. No person so far has bought all the assets of a financial company and privately invested them in a steel factory. (That would be a movement to "corporate sector.") So, no, Japanese and American industrial companies establishing finance subsidiaries is not a confirmation of what Shaikh is saying. Rather, it is proof that the rate of return in the stock market is higher than what is available or industrial companies. But what is the stock market but the evidence of ownership of these companies? How could the return on the evidence of owner of these companies be higher than what these companies actually generate? That is the controversy surrounding the unprecedented rise in the US stock market which many consider ridiculously overvalued. But of course it is impossible to understand its dynamics unless you carefully read the two volumes of *Speculative Capital* and certainly Vol. 1!