OECD FORUM 2006
BALANCING GLOBALISATION
22-23 May 2006, Paris

Financial markets and growth

Kenneth V. Georgetti, President, Canadian Labour Congress

Thank you for the invitation to speak on this important panel on the links between financial markets, growth and - I would add - shared prosperity. I was somewhat hesitant to speak on such a technical issue.

However, I will begin by reminding you that the founders of Long Term Capital Management - including several winners of the Nobel Prize in Economics - were once described as "the best finance faculty in the world".

These supposed experts came very close to wrecking the entire global economy, and may have done so if the Federal Reserve had not intervened to bail them out of very badly-judged speculative positions.

This episode - not to mention the Asian financial crisis and the many corporate financial scandals of recent years - should remind us of the importance of regulation of the financial system in the interests of overall economic stability.

All economic actors - including investors - are, of course, hurt by instability. But much of the burden is borne by ordinary workers, who can lose their jobs and, often, their pensions when firms restructure in response to a financial crisis.

Financial markets have always played an important role within our economic system, by directing savings and resources to the real building blocks of economic growth. These are investment in infrastructure, in plant and equipment, in research and development and product and process innovation, and in the skills of people.

The financial sector's performance must be judged by how well it serves the performance of our economy as a whole.

There are huge differences both between countries, and between different points in time within countries, with respect to the relationship between financial markets and the real economy of firms producing goods and non financial services.

The role of the financial sector has generally increased over the past decade and more, and more of the OECD countries have been moving towards the Anglo-Saxon or neo-liberal model of capitalism in which financial markets play a dominant role.

Let me give you just one indicator. The stock market valuation of financial compared to non financial firms in the US has increased from about 8% to almost 30% over the past 25 years. This tells us that a growing portion of total corporate profits is going to the financial

sector, and that it is playing an increasingly important role in the overall investment process.

On the plus side, deep and liquid financial markets have proved capable of directing vast resources to promising new investment opportunities in the real economy. Productivity growth in the US in the late 1990s was certainly pushed up by major new investments in the new information technologies which have transformed entire economic sectors.

At the same time, the dot com mania of the last half of the 1990s also squandered resources in massive over-investment in some parts of the new economy, such as fibre optic cable. Clearly, investment in many sectors got well ahead of demand.

Millions of ordinary investors - and pension funds - lost huge amounts when the speculative mania surrounding the new economy collapsed precipitously in 2000. We saw a major meltdown of equity values, particularly in the US.

That episode should have put a final nail in the coffin of the economic theory that financial markets rationally allocate resources to the most productive investment opportunities.

One of the more disturbing financial developments of recent years has been rampant short-termism in the real economy as the result of strong pressures from the financial system.

One of the factors at play has been the rise of large institutional investors, whose managers are judged almost exclusively by their ability to pick investments which yield above average quarterly returns.

This remains a common practice, despite overwhelming evidence that virtually no one investor or investment manager consistently beats the odds in terms of picking winners. In fact, the practice of rewarding short-term performance means that investment professionals tend to follow the herd, and constantly churn their portfolios, greatly exaggerating speculative booms and busts.

Most large financial investors also promote and support compensation systems for senior corporate executives which reward those who maximize short-term stock performance. In theory, this is supposed to maximize returns to shareholders by closely aligning senior corporate executive and shareholder interests.

A recent US study found that average annual CEO pay at S&P 500 companies trebled in the 1990s, reaching a high of $17.4 Million in 2000 when the stock market peaked. This largely reflected the increased importance of stock options. The ratio of CEO compensation to average production worker compensation has jumped from 30 to 1 in 1970, to 500 to 1 today.

The share of corporate profits taken as personal compensation by the top 5 executives in the 1500 largest US public companies has doubled, from 5% to more than 10% of total corporate profits, over the past decade, to a total of more than $40 Billion per year. That leaves a lot less for reinvestment, for wage increases for ordinary workers, for shareholders, or to fund pension plan liabilities.

Studies find that little, if any, of this obscene increase in CEO pay is related to individual CEO performance. Much of it reflects a ratcheting up by executives and directors who sit on each others compensation committees.

The relentless rise of CEO pay unrelated to long-term corporate performance is not only excessive and wasteful, it also undermines attempts to forge productive partnerships with workers and unions.

Stock option fuelled senior executive pay packages have given corporate insiders a huge incentive to maximize short-term financial results, regardless of the long term costs. In a number of notable cases like World Com, Parmalat and Enron, losses have been hidden or magically transformed into profits by insider manipulation, misrepresentation and outright fraud, leaving ordinary investors with close to worthless stock at the end of the day.

Recent scandals flowed not just from the actions of corporate insiders, but also from the fact that virtually all of the major players in the financial system had incentives to collude to boost short-term stock values. That included the financial analysts, the accountants, and the investment managers. Meanwhile, the regulators sat mainly on the sidelines.

Central banks warned - mainly quietly - about unsustainable bubbles, but did nothing to limit lending to speculators, or to encourage longer term time horizons on the part of investors.

The dominant focus on high short-term profits imposed by the financial sector has been achieved by slashing jobs, wages, and pension and benefit coverage of ordinary workers. It is a key factor behind rising income inequality. Much of the income gains from economic growth have gone to the top 10% or even 1%, while average real wages have stagnated.

The fact that income inequality has increased the most in the US and the UK is often attributed - quite correctly - to the lack of labour market regulation in the interests of workers. But it can also be blamed in part on the fact that US and UK companies are under the most intense pressure from financial markets to maximize short-term profits.

In a wider sense, corporate short-termism has undermined a major underlying source of savings for long-term investment - the savings of workers in the form of defined benefit pension funds.

The relentless drive for short-term profits has been one factor behind the sharp erosion of defined benefit pension plan coverage among US and UK workers.

Companies which are not prepared to make a long-term commitment to their workforce do not believe in such plans.

As the Governor of the Bank of Canada has warned, this erosion of coverage not only threatens the well-being of the future elderly, it also threatens to deplete an important source of long-term savings and investment.

Short-termism also favours mergers and acquisitions over long-term strategies for company growth. While restructuring for financial purposes boosts the incomes of senior

executives, board members, investment bankers, corporate lawyers and some shareholders, they are usually disruptive for workers and seldom improve the long term value of the firm or its underlying performance.

In the current climate, companies place a huge premium on high returns to pay dividends to shareholders in order to secure the firm against predatory take-overs and to keep institutional investors happy. Technical innovation and building long-term market share become secondary objectives.

It used to be the case that companies were relatively insulated from pressures to maximize returns to shareholders over the very short-term. This facilitated long-term planning within the corporate sector, placed some premium on stable labour-management relationships, and likely fostered corporate attention to the interests of the broader community.

Companies must have an eye to the long term if they are to invest enough in research and development, innovation and the skills of workers. These are the real building blocks of productivity and long-term growth in a knowledge-based economy.

Adding relentlessly to the immediate financial pressures on corporate managers to maximize returns to shareholders likely comes at a cost in terms of lower productivity.

It is far from clear that the neo-liberal/Anglo-Saxon financial market centred model of corporate governance is the most successful. Many European and Asian transnationals with rather different relations to the financial sector do well in global competition, and some of the major success stories in today's global economy are smaller European countries with more stable financial and corporate structures than those in the US, the UK and Canada.

The obstacle to long-term, stable growth and shared prosperity today is not a lack of corporate profits. As the International Monetary Fund detailed in its last World Economic Outlook, corporate profitability is at an all time high in most of the OECD countries.

In many countries, including Canada, corporations flush with cash, are buying up their own shares, converting themselves into income trusts, and adopting other ways to pump out that cash to shareholders.

What they are not doing is investing in a major way in what it will take to boost productivity and growth. Levels of real investment lag far behind the increase in profitability which has been driven in part by financial pressures.

National regulatory frameworks as they exist today were not designed to deal with this financial short-termism and its impact on productivity.

It is in the interests of all of us to reduce the incentives towards destructive short-termism. A mix of regulatory and tax policies should encourage longer-term shareholding and corporate re-investment of profits.

We must address the issue of executive remuneration to make an explicit link to long-term shareholder value. And there should be closer regulation of mergers and acquisitions, with

attention to the impact on workers and to public interest issues not covered by competition law.

Part of the solution, I think, needs to come from the labour movement and our particular role as trustees of workers' capital.

Pension fund assets representing the accumulated savings of workers have, unfortunately, played a major role in driving the unfortunate developments I have described above. The long-term interests of workers and the economy as a whole must become more important factors in pension fund investment decisions.

As many of you know, I chair a global committee on workers capital, and we fully intend to use this body to educate and mobilize for progressive corporate governance.

There will always be a tension between maximizing returns on capital and corporate social responsibility in terms of promoting decent wages and working conditions, respect for human rights, and protection of the environment. However, I believe that this tension is lessened when there is a focus on longer term returns. Pension trustees can lead the way in terms of broadening the focus of investment decisions.

Some important pension funds and institutional investors have already begun to move in this direction. The OECD has an important role to play in stimulating these kind of discussions. The Trade Union Advisory Committee has put forward a major paper on corporate governance which I commend to all of you, in the hope that the dialogue will continue and, most important, bring about some badly needed changes.